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**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

**SURREBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

**FILED<sup>3</sup>**

**JAN 22 2002**

**Missouri Public  
Service Commission**

**UTILICORP UNITED INC.  
d/b/a MISSOURI PUBLIC SERVICE**

**CASE NOS. ER-2001-672 and EC-2002-265**

*Jefferson City, Missouri  
January 2002*

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**Response to Mr. Burdette's Rebuttal Testimony**

Q. Do you agree with Mr. Burdette's rationale for including short-term debt in the capital structure of UtiliCorp, which is used to determine the rate of return for MPS?

A. No. Mr. Burdette is correct that UtiliCorp has had a wide range of short-term debt balances over the past year: from as low as \$75,000,000 in November 2000 to as much as \$408,175,000 in July 2000 (UtiliCorp response to OPC data request 2004). However, what he fails to identify in his rebuttal testimony is that the level of short-term debt remained virtually constant for several months leading up to June 30, 2001 at around \$100,000,000. Mr. Burdette labels my use of the June 30, 2001 short-term debt balance, which was \$151,445,000 on UtiliCorp's June 30, 2001 balance sheet, not the \$100,000,000 indicated in UtiliCorp's response to OPC's DR 2004, as a "snapshot." He claims that a "snapshot" of "short-term debt is not necessarily reflective of the Company's actual usage over the course of the year." (Burdette Rebuttal, p. 3, ll. 25-27). He also claims that short-term debt is "much more date dependent" than other forms of "relatively stable, capital structure components." (*Id.* ll. 28-29). If Mr. Burdette were concerned about stability when he chose to include short-term debt, then I would think that he would observe the fact that the short-term balance has been constant in the most recent four months of the update period. Consequently, my "snapshot" capital structure is more reflective of UtiliCorp's current financial situation and should be used for ratemaking purposes.

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1 Q. Are there any events that occurred before June 30, 2001 that may make the  
2 short-term debt balance as of June 30, 2001 more reflective of UtiliCorp's short-term  
3 debt balance on a going forward basis than the average that Mr. Burdette used?

4 A. Yes. Page 17 of UtiliCorp's June 30, 2001 United States Securities and  
5 Exchange Commission 10-Q filing indicates that "short-term and long-term debt,  
6 including current maturities of long-term debt, together decreased by \$268.8 million due  
7 to debt repayments made with cash proceeds from the sale of Aquila shares by UtiliCorp  
8 and the issuance of additional UtiliCorp shares." These are events that occurred during  
9 the Spring of 2001, which may explain why short-term debt has been reduced to a lower  
10 level and become more stable. Mr. Burdette's use of short-term debt balances before this  
11 period could be considered irrelevant.

12 Q. Are there any events that may cause you to revisit the issue of short-term  
13 debt in true-up?

14 A. Yes. UtiliCorp has been involved in significant activities related to the  
15 reacquisition of Aquila's publicly traded shares and the possible acquisition of Midlands  
16 Electricity PLC, which may affect their financial statements during the true-up period. I  
17 will evaluate whether short-term debt should be included after I evaluate UtiliCorp's  
18 financial statements through January 31, 2002 in the true-up phase of this proceeding.

19 **Response to Mr. Dunn's Rebuttal Testimony**

20 Q. Mr. Dunn claims that you failed to make a risk adjustment for MPS in  
21 your analysis. (Dunn Rebuttal, p. 3, ll. 3-10). Is this claim correct?

22 A. No. On page 29, line 19 through page 30, line 12 of my direct testimony, I  
23 explain the methodology I used to make a 20 basis point adjustment to my proxy group

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1 cost of common equity range. This adjustment is based on the fact that UtiliCorp is a  
2 BBB rated company where the average credit rating of the proxy group is A-. The exact  
3 methodology used to arrive at this 20 basis point adjustment is explained fully in my  
4 direct testimony. Therefore, Mr. Dunn is not correct in stating that I did not calculate a  
5 risk adjustment to apply to MPS. However, this is the only adjustment that should be  
6 made because as a whole my proxy group of companies is comparable to MPS. If you  
7 were to select a group of companies such as Mr. Dunn's, which are not comparable, then  
8 an analyst may have to make adjustments to the proxy recommendation. In the case of  
9 Mr. Dunn's proxy group, I would argue that he should have made an adjustment  
10 downward because he is clearly relying on a group of companies that are not typical  
11 regulated electric utilities.

12 Q. Mr. Dunn's rebuttal testimony focuses to some extent on recent changes in  
13 dividend policy of utility companies. Why do you believe the dividend policy of some  
14 utilities may have changed recently?

15 A. As I explained on page 19, line 12 through page 20, line 15 of my rebuttal  
16 testimony, one of the major reasons some utility companies may be slowing or stopping  
17 their regular dividend increases is to fund their investments in the deregulated segments  
18 of the energy business. Once again, the idea of choosing a comparable group of  
19 companies is to "weed out" the companies that are heavily involved in deregulated areas  
20 of the energy industry. However, it is becoming more difficult to find companies that  
21 operate solely in a conservative, regulated environment. This is the reason that I have  
22 chosen to use the percent of revenues from electricity operations as a factor when I

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1 selected my comparable companies, even though some of these revenues may come from  
2 deregulated operations.

3 Q. What effect will an electric company's decision to retain more earnings to  
4 pursue deregulated business ventures have on a company's expected growth rate?

5 A. Obviously, if a company determines that capital is better spent on  
6 investment opportunities in the deregulated market, then it expects that these investments  
7 will increase shareholder value more than if it had paid these earnings out as dividends.  
8 If analysts that project growth in earnings per share believe that the company is deploying  
9 its capital towards these opportunities effectively, then they will project higher growth  
10 rates in earnings per share for these companies.

11 Q. Could this higher growth rate expectation be a result of the deregulated  
12 business investments?

13 A. Absolutely.

14 Q. Did Mr. Dunn make any downward adjustments to his growth rate  
15 estimation for MPS to consider this?

16 A. No. Instead, he actually made upward adjustments to his recommended  
17 cost of common equity to reflect that "MPS is more risky than the average of the proxy  
18 group as the result of several factors including the smaller size of MPS, and the greater  
19 volatility of its earnings." (Dunn Direct, p.47, ll. 10-12).

20 Q. Should MPS ratepayers fund deregulated investments that stand to benefit  
21 the investor?

22 A. No. If a company chooses to pursue investments in the deregulated  
23 market, then the investors should bear this risk. The ratepayers of the regulated entity,

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1 MPS, should not be required to fund these higher-growth, deregulated and more volatile  
2 investments through the awarding of a higher cost of common equity that is a result of  
3 electric companies' decisions to enter the deregulated segments of the electric industry.

4 Q. Do you agree with Mr. Dunn's contention that "a calculation such as the  
5 retention rate calculation for dividend growth based on historic facts is no longer  
6 appropriate in any event and that is not even arguable?" (Dunn Rebuttal, p. 6, ll. 5-7).

7 A. This statement by Mr. Dunn would lead one to believe that dividends or  
8 their growth no longer matter to investors. This conclusion by Mr. Dunn makes it  
9 evident that he is not in touch with the current capital market conditions. Mr. Dunn must  
10 believe that every investor in the stock market is a growth investor. Even during the  
11 stock market boom from the middle 1990's to early 2000, it would not be prudent to  
12 conclude that every investor was a growth investor, and therefore, they ignored  
13 dividends. For example, you may have risk averse investors, such as those close to  
14 retirement, that see high yielding, low growth, regulated utility companies as attractive  
15 investments specifically because they are a low risk investment. An investor that invests  
16 in a dividend yielding stock is also able to realize the possible appreciation in the stock  
17 while receiving the dividend yield. I would argue that after the technology meltdown of  
18 March 2000, investors have become even more mindful of the benefits of receiving a  
19 dividend.

20 Q. Do you have any evidence from the popular financial media that illustrates  
21 investors' interest in dividends and possible dividend growth?

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1           A.     Yes. There are many, but I will only provide a few to refute Mr. Dunn's  
2     assertion that investors no longer rely on dividend growth rates to make investment  
3     decisions.

4           The first is an article entitled, "CRASH PROTECTION What holds up  
5     well when the market swoons? Stocks that pay good old dividends," by Vincent  
6     Apicella, page 196 of the June 11, 2001 edition of *Forbes*. While this article recognizes  
7     Mr. Dunn's assertion that dividends for the broader market, such as the Standard &  
8     Poor's 500, are near their 20th-century low, it also recognizes that stocks that pay a  
9     dividend of at least 3 percent are only down 15 percent from their 52-week highs, where  
10    stocks that don't pay a dividend are down 55 percent. This article maintains that the new  
11    economy did not make the payment of dividends "passé." The article also mentions a  
12    couple of analysts, Gary L. Cooper, Banc of America Securities and Martin Feldman,  
13    Salomon Smith Barney, who like companies such as Polaris and Philip Morris that have a  
14    history of being able to grow dividends and the possibility of growing dividends in the  
15    future.

16           A second article, "Some Races Are Not To The Swift: *Many dividend-*  
17    *payers offer rising income streams,*" by Margaret Popper, appeared in the  
18    December 31, 2001 issue of *Business Week* on page 88 to 89. This article discusses some  
19    of the advantages of dividend paying stocks in today's current low interest rate  
20    environment. I discussed these advantages on page 19 of my rebuttal testimony. This  
21    author points out that "with short-term interest rates at 40-year lows, even a 2 percent  
22    dividend looks pretty generous." When you consider the fact that my comparable group



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1 averages a dividend yield of 5.73 percent, these yields should look even more generous to  
2 an investor.

3           This article indicated that according to a study by T. Rowe Price  
4 Associates, "in the year 2000 the prices of dividend-paying equities in the Standard &  
5 Poor's 500-stock index rose an average of 3.1%; those that paid no dividends dropped  
6 39.2%." The article further states that: "If nothing else, a company with a good track  
7 record on paying and increasing dividends probably is one with a good earnings history  
8 as well."

9           There are a couple of other issues in this article that are worthy of  
10 mentioning. The analysis done in this article makes several assumptions about dividend  
11 growth, earnings growth, and stock appreciation. For dividends, they used the company's  
12 historic dividend growth rate. For earnings, they used the five-year growth projected by  
13 Wall Street analysts, which was then "sliced by a third, since they're always too high."  
14 They then assumed that the stock price would appreciate in line with earnings. Such  
15 analyses refute Mr. Dunn's claim that investors are no longer interested in dividends and  
16 that they can no longer be considered a driver in the price of a stock. This is obviously  
17 not true, especially in today's market. Although dividends are still considered important  
18 to investors, the earnings growth rate remains a major factor in the calculation of the  
19 growth rate in the discounted cash flow model. However, as stated in this article, one  
20 must be careful in relying fully on the projected growth rates of analysts because there is  
21 the perception that projected growth rates tend to be too high. For this reason, historical  
22 growth rates of the company should also be considered because they are observable.

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1           The *Business Week* article also recognizes the fact that utility stocks are  
2 still considered "traditional high yielders" when it recommends TXU Corp. as an  
3 investment possibility. The author indicates that this company "boasts a 5.3% dividend  
4 yield and a history of growing it by 3.3% each year." This is yet another example that  
5 investors, especially conservative ones, do not disregard dividends in their investment  
6 decisions, especially when it involves traditional high yielding utility companies, such as  
7 those in my comparable group.

8           The final and most recent article, "After Enron, Quarterly Dividend Takes  
9 Center Stage for Utilities," was on pages C1-C2 in the January 15, 2002 *Wall Street*  
10 *Journal*. Actually, this article not only speaks about the importance of dividends, but  
11 also provides support for the comparable companies I have chosen and the resulting cost  
12 of common equity I recommended.

13           The article legitimizes some of the things I have already touched upon,  
14 such as the fact that dividend yields of many energy companies are now above 5 percent,  
15 which looks attractive considering today's low interest rate environment. Not only are  
16 companies reevaluating their dividend policies, but they are also reevaluating some of  
17 their investments. For example, Exelon Corp., owner of big electric utilities in Chicago  
18 and Philadelphia, "courted growth in recent years partly through its Exelon Enterprises  
19 unit that put money into unregulated ventures like wireless communications and  
20 engineering services." Co-Chief Executive John Rowe said that the results in some of  
21 these ventures have been disappointing and now "top managers are considering shying  
22 away from additional investment in unpredictable businesses and instead boosting the  
23 firm's dividend rate."

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1           Another interesting remark in this article is by Hyman Schoenblum, vice  
2 president of development for New York's Consolidated Edison. He indicates that:  
3 "A lot of companies were enamored with the 'generation play,' that is, expanding their  
4 portfolios of generating plants in markets where prices had been deregulated." He  
5 indicates, "one way to raise capital [to buy or build more plants] was to cut the dividend."  
6 He says "ConEd never went off in that direction because it was billing itself as a  
7 conservative company for investors who would rather buy a ticket on the carousel than  
8 the roller coaster." It is interesting to note Mr. Schoenblum's comments about the reason  
9 many companies cut their dividends. If utility companies cut their dividends to invest in  
10 the deregulated aspects of the utility industry, then their investments are not related to the  
11 regulated entities, such as MPS. In essence, utilities' lower dividend growth rates and  
12 higher projected earnings growth rates can be attributed to companies' desires to pursue  
13 deregulated investments. It is inappropriate for Mr. Dunn to maintain at this time that a  
14 rate of return witness should only focus on earnings growth, in light of the fact that much  
15 of the earnings growth that utilities are realizing is from their deregulated business  
16 activities. The ratepayers of a regulated utility should not serve as the providers of funds  
17 for these investments. Rather, the investors that may realize the gains on these  
18 investments should bear this cost.

19           This article also provides support for the use of my comparable  
20 companies. Mr. Dunn maintains that my comparable companies are not comparable to  
21 MPS for many questionable reasons, but this article specifically mentions three of my  
22 comparable companies, Puget Energy, Hawaii Electric, and Potomac Electric, as being in  
23 the top ten dividend paying utilities for the period 1992 to 2001, with Puget Energy being

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1 rated number one. The article also rates two other utilities in my comparable group, DPL  
2 and NSTAR, in the top ten utility companies for total return, stock appreciation plus  
3 dividend yield, for the period 1992 to 2001. Mr. Dunn only has one representative of his  
4 comparable group, OGE Energy, in these rankings.

5 Q. In light of the above discussion, refuting Mr. Dunn's claim that dividends  
6 should not be considered when calculating the growth rate for a company, do you believe  
7 that only dividend growth rates should be used to estimate the growth rate for a  
8 company?

9 A. No. Although investors may evaluate the growth in dividends for a  
10 company, they may also evaluate the growth in earnings per share and the book value per  
11 share in order to determine their estimated growth rate for a company. The historical  
12 growth in dividends per share, earnings per share and book value per share are all  
13 financial growth indicators that investors may use to estimate future growth. This is  
14 precisely why the historical growth rates of these items are published in the Value Line  
15 tear sheets that investors use to evaluate companies for possible investment. These are all  
16 items that an investor (and consequently, a rate of return witness) should consider when  
17 estimating growth rates to be used for determining the recommended cost of common  
18 equity.

19 Q. Mr. Dunn claims that you should have excluded negative growth rates  
20 when you calculated the average earnings per share for your proxy group. (*Id.* pp. 8-9,  
21 ll. 14-8). Do you agree with Mr. Dunn's assertion?

22 A. No. It is not appropriate to "cherry pick" growth rates when doing an  
23 analysis of growth rates. If Mr. Dunn proposes to remove negative growth rates because

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1 they are not what investors will expect in the future, then he should also exclude those  
2 growth rates that may be considered too high to be sustainable in the future. If I were to  
3 remove the three high growth rates to offset the three negative growth rates that  
4 Mr. Dunn proposes that I remove, then only one earnings per share growth rate remains  
5 to average. Of course, this would no longer be considered an average. Investors do  
6 consider negative growth rates when determining whether to invest in a company. If an  
7 analyst is trying to achieve a proxy group estimated growth rate, then it is necessary to  
8 review all of the growth rates, whether negative or positive, to determine a proxy group  
9 growth rate.

10 Mr. Dunn's comment that investors will not invest in a company that has  
11 expected negative growth in the future is especially interesting when one considers the  
12 fact that he chose to include an abnormally high earnings per share growth rate of  
13 17.55 percent in his average earnings per share growth rate on Schedule JCD-6 of his  
14 direct testimony. I have already explained my concerns with this methodology on page  
15 22, line 17 through page 24, line 12 of my rebuttal testimony. It is clear that Mr. Dunn's  
16 exclusion of negative growth rates and inclusion of abnormally high growth rates is a  
17 matter of "cherry picking" that results in an upwardly biased growth rate.

18 Q. Is it possible that investors will expect negative growth for a company in  
19 the future?

20 A. Yes. As I recently discovered in the December 7, 2001 Value Line  
21 Investment Survey: Ratings and Reports, Value Line is expecting DQE, Inc., a company  
22 contained in my comparable company analysis, to have a negative two percent growth in  
23 earnings for the next five years. Therefore, it is obvious that investors recognize that

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1 negative earnings growth is a very real possibility and they will consider this when  
2 estimating the growth rate for a company.

3 Q. If a company has had or is expected to have negative growth rates and  
4 investors "ignore the stock" as Mr. Dunn states on page 9, line 4 of his rebuttal  
5 testimony, what would happen to the stock price and resulting dividend yield of that  
6 company?

7 A. The stock price would fall because investors do not think the current price  
8 of the stock reflects the growth rate potential of the company. This would cause the  
9 dividend yield component of the DCF model to increase because the dividend divided by  
10 the lower stock price would result in a larger dividend yield as a percentage of the stock  
11 price. This is exactly what has occurred to DQE, Inc.'s stock price and dividend yield in  
12 recent months.

13 Q. What effect would Mr. Dunn's exclusion of negative growth rates, which  
14 may act to decrease the stock price of a company, have on his overall DCF calculation?

15 A. It would act to increase his overall DCF cost of common equity  
16 calculation. Because Mr. Dunn is using the stock prices of companies that may reflect  
17 negative growth rates, he is realizing a higher dividend yield. However, by excluding the  
18 negative growth rates that may have caused lower stock prices, he is assuming a higher  
19 than probable or realistic growth rate. By choosing to ignore negative growth rates,  
20 Mr. Dunn is achieving the benefit of having a high dividend yield and an unrealistic high  
21 growth rate in order to arrive at his recommended cost of common equity. The DCF  
22 calculation includes two parts, the dividend yield and the growth rate. If the dividend  
23 yield rises because the growth projections do not turn out as expected, then a prudent rate

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1 of return analyst will lower his estimated growth rate to take this into consideration. It is  
2 not proper to recognize the benefit of the higher dividend yield, but not recognize the  
3 lower growth that caused the higher dividend yield.

4 Q. Mr. Dunn made some comments on page 10, line 1 through page 11,  
5 line 11 of his rebuttal testimony about your DCF calculation for UtiliCorp. Did you use  
6 the UtiliCorp cost of common equity calculation to determine your recommended cost of  
7 common equity for MPS?

8 A. No. As explained in my direct testimony on page 27 line 3 through  
9 line 12, UtiliCorp has many high-growth, unregulated, riskier operations that would  
10 likely make the overall cost of common equity higher for UtiliCorp as a whole than it  
11 would be for an electric utility provider such as MPS that is not heavily involved in  
12 riskier operations, such as energy marketing and trading. Because of UtiliCorp's  
13 completed reacquisition of the 20 percent of Aquila shares that they did not own and  
14 UtiliCorp's announced intention to embrace the higher risk energy merchant operations  
15 of Aquila as its core strategy, it is not appropriate to use UtiliCorp's cost of common  
16 equity for the recommended cost of common equity for MPS.

17 Q. Mr. Dunn claims that the higher dividend yield that UtiliCorp now has  
18 because of its decrease in stock price should be reflected in your DCF recommendation.  
19 Do you agree with Mr. Dunn's claim?

20 A. No. I did not use UtiliCorp to determine my recommended cost of  
21 common equity. I included the calculated cost of common equity of UtiliCorp for  
22 illustrative purposes only. However, it is important to note that Mr. Dunn is proposing

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1 that my recommended cost of common equity should be increased to reflect UtiliCorp's  
2 lower stock price and resulting higher dividend yield.

3 Q. Is it appropriate to increase the recommended cost of common equity for  
4 MPS based on UtiliCorp's decreased stock price?

5 A. No. It is entirely inappropriate to ask MPS ratepayers to incur the  
6 increased cost of common equity based on the decreased stock price of UtiliCorp.  
7 UtiliCorp had owned 80 percent of Aquila shares and now owns 100 percent. As stated  
8 in the October 5, 2001, Value Line Rating and Reports, UtiliCorp's largest source of  
9 earnings is from Aquila. As explained before, Aquila is involved in the energy merchant  
10 business, which includes wholesale power generation and energy marketing and trading.  
11 In wake of the Enron collapse, companies that are involved in the energy marketing and  
12 trading business have seen their share prices take a beating in the stock market.  
13 UtiliCorp's stock price has also decreased in wake of the Enron collapse because of its  
14 interest in Aquila. Therefore, in effect, Mr. Dunn is proposing that MPS ratepayers pay  
15 for the increased cost of common equity that UtiliCorp's stock price reflects because of  
16 its involvement in the deregulated aspects of the energy business. This is entirely  
17 inappropriate and should not be considered.

18 Q. Do you agree with Mr. Dunn's comments in his rebuttal testimony on  
19 page 13, line 4 through line 16 that you have too many averages of the averages?

20 A. No, I do not. First, Mr. Dunn claims that my inclusion of an average  
21 historical growth rate of 1.72 percent "reduced the results by over four percentage  
22 points." I chose a growth rate range of 3.50 to 4.50 percent. This range is roughly 1.8 to  
23 2.8 percent higher than the historical growth rate of 1.72 percent, not the four percent that



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1 Mr. Dunn would lead you to believe. Mr. Dunn is correct that the average historical  
2 growth rate is over four percent less than the average projected growth rate of  
3 6.25 percent. However, I am not basing my recommendation on projected growth rates  
4 alone because as stated in the aforementioned *Business Week* article, projected growth  
5 rates are not always accurate. If you follow the logic of the article in *Business Week*, one  
6 should cut the projected growth rates of 6.25 percent by a third to determine a reasonable  
7 growth rate. This technique would result in a 4.17 percent growth rate, which is within  
8 my growth rate range.

9 As far as the "averaging of the averages" comment is concerned, it is the  
10 rate of return witnesses' duty to arrive at a reasonable recommended cost of common  
11 equity, which includes a reasonable recommended growth rate. I simply chose to  
12 calculate a consensus projected growth rate and compared that to the historical growth  
13 rate to determine my recommended range of growth. I would consider my methodology  
14 as more of a consensus-gathering methodology, not an "averaging of the averages."  
15 After evaluating actual historical growth rates with what analysts expect to happen, I  
16 have chosen what investors, as a group, may believe is a reasonable growth rate.

17 Q. Mr. Dunn claims that you did not focus on risk when you chose your  
18 comparable companies. Do you agree?

19 A. No. My criteria are objective and risk related. I think the best way to  
20 address the appropriateness of my selection criteria is to focus on Mr. Dunn's subjective  
21 selection criteria. Mr. Dunn explains his subjective selection criteria on page 29, line 4  
22 through 14 of his direct testimony. It appears from Mr. Dunn's comments that he read  
23 through all of the business descriptions contained in the January 5, 2001 Value Line

1 Investment Survey in order to identify a group of companies that **"have most of their**  
2 **activities confined to the electric utility business"** (emphasis added). After Mr. Dunn  
3 selected his "comparable" companies based on his subjective approach, he eliminated  
4 companies that were **"many times larger** than the typical electric utility company,  
5 companies that had less than ten years of history and all companies controlled by  
6 mergers" (emphasis added). All of his criteria were included in my selection process, but  
7 my criteria were much more objective and precise than Mr. Dunn's vague criteria.  
8 Mr. Dunn's vague criteria allow him a lot of room to pick companies that achieve the  
9 results he wishes to achieve.

10           One of the goals of my criterion of at least 70 percent of revenues from  
11 electric operations was to choose companies that have "activities that are confined to the  
12 electric utility business." This criterion is the most important of all of my criteria because  
13 it ensures that I am using utility companies whose core business involves electric  
14 operations. Companies that are in the same industry tend to face similar risks. Therefore,  
15 this is definitely a risk-related criterion.

16           The goal of my criterion of total capitalization of less than \$5 billion, once  
17 again more specific than Mr. Dunn's elimination of companies that "were many times  
18 larger," is to choose companies that are more comparable in size to the operations of  
19 MPS. Although there is considerable debate on the effect company size has on risk, it  
20 still may be considered a risk factor.

21           The goal of the criterion of not having nuclear operations, which  
22 Mr. Dunn did not use, was to eliminate companies that investors may perceive as being

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1 riskier because of their nuclear power generation. MPS does not have nuclear operations  
2 so this is an important criterion to include.

3           Nevertheless, Mr. Dunn attacks my criteria as not being risk related,  
4 although his criteria are quite similar to mine. If Mr. Dunn does not consider my criteria  
5 as risk related, then his criteria cannot be considered risk related, either.

6           Q.     On page 18, line 4 through page 20, line 8 of his rebuttal testimony,  
7 Mr. Dunn discusses his concerns with your comparable group of companies. Mr. Dunn  
8 chooses to pick out specific characteristics of each company to prove that they are  
9 incomparable to MPS. Do you agree that this picking apart of each company makes the  
10 group as a whole incomparable to MPS?

11           A.     No. As Mr. Dunn so graciously pointed out on page 18, line 7 through 11,  
12 of his rebuttal testimony, my comparable group of companies contains a company that  
13 has "recently embarked on a major non-utility diversification effort. It is also operating  
14 in a deregulated environment and has sold its gas distribution business." Actually,  
15 Mr. Dunn criticized my use of this company in my comparable group even though he  
16 included it in his own group of comparable companies. I guess Mr. Dunn feels that this  
17 company is appropriate for his analysis, but not for mine. In spite of Mr. Dunn's  
18 comments about my inclusion of DPL, the company still receives 99 percent of its  
19 revenues from electric operations (C.A. Turner Utility Reports, September 2001). He is  
20 correct that much of this revenue may be received from the deregulated, generation  
21 aspect of the business, but it is still considered an electric company. If anything, DPL  
22 may have too high of a projected growth rate because of its involvement in deregulated

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1 activities. I chose not to make any adjustments because the company met the criteria that  
2 I established to select comparable companies.

3 Mr. Dunn also criticizes my use of companies that are more involved with  
4 the distribution of electricity rather than both generation and distribution of electricity.  
5 Apparently, Mr. Dunn has done a risk analysis of the riskiness between purchasing power  
6 and generating power because Mr. Dunn claims that purchasing power is less risky than  
7 generating power "if the purchase contracts are carefully developed." Mr. Dunn must  
8 have added this language because of debacles like the one in California, where the  
9 purchase of power at very high prices was not allowed to be passed through to the users  
10 of the electricity. Regardless of whether his perception on the riskiness of purchased  
11 power versus generated power is correct, it is interesting to note that MPS purchases  
12 approximately 22 percent of its power based on Staff's fuel model.

13 In a proxy group analysis, it is the "sum of the parts" that is important.  
14 Obviously, there will always be nuances that make each company a little different than  
15 the subject company. The idea that these nuances will cancel each other out makes a  
16 proxy group analysis reliable as long as the companies you have chosen are in the same  
17 general line of business.

18 Q. Do you agree with Mr. Dunn's methodology of using standard deviation to  
19 determine a risk adjustment to be made to your proxy group cost of common equity  
20 recommendation?

21 A. No. As I have stated before, the risk adjustment should be based on the  
22 credit rating differences of the proxy group versus UtiliCorp. Further, Mr. Dunn did not  
23 provide any supporting calculations for his standard deviation calculation.

Surrebuttal Testimony of  
David Murray

1           Q.     How could a rate of return analyst avoid having to make too many  
2 adjustments to his recommended cost of common equity?

3           A.     He could set up criteria that would allow him to achieve what he truly felt  
4 was a comparable group of companies. If an analyst truly feels that he has chosen a  
5 proxy group of companies that are comparable to the subject company, then he would not  
6 need to make questionable adjustments to his proxy group recommended cost of common  
7 equity. In fact, the Commission recognized this in its Report And Order On Remand in  
8 Case No. ER-93-37. In its Report And Order On Remand, the Commission stated, "if  
9 MoPub truly believed that the companies it chose for its pure play group were less risky  
10 than MoPub, it should have used different comparables." Therefore, if Mr. Dunn truly  
11 felt that he had chosen a comparable group of companies to MPS, the he would not have  
12 needed to make any further adjustments to the proxy group cost of common equity  
13 recommendation.

14          Q.     Mr. Dunn proposes that the cost of debt for MPS should be 7.906 percent  
15 rather than your recommended 7.35 percent. (Dunn Rebuttal, p. 22, ll. 5-8). Do you  
16 agree?

17          A.     No. Once again, Mr. Dunn did not provide any support in his rebuttal  
18 testimony for his updated recommended cost long-term debt of 7.906 percent. Mr. Dunn  
19 did not provide any support in his direct testimony for his original recommended cost of  
20 long-term debt of 8.215 percent. My embedded cost of long-term debt is fully supported  
21 in my direct testimony on Schedules 10-1 and 10-2. Mr. Dunn claims that UtiliCorp has  
22 a "process for allocating long term debt to the individual divisions based on a permanent  
23 assignment of long-term debt to the individual divisions based upon the need of the

1 division.” (*Id.* p. 22, ll. 13-15). As I stated before, Mr. Dunn does not provide support as  
2 to which debt issuances are assigned to MPS. Regardless, I presume that the assigning of  
3 these debt issuances entails the same accounting and management decisions that are made  
4 when determining an allocated capital structure. Therefore, as I have explained before,  
5 these assignments cannot be accepted as verifiable because these debt issuances are not  
6 issued by MPS.

7 Q. Mr. Dunn claims that international debt should not be included in the  
8 embedded cost of long-term debt because it is short term or floating and also because  
9 clauses in the indenture “requires that the debt be solely used within the borders of the  
10 country and for a specific purpose.” (*Id.*, p. 23, ll. 10-11). Is this consistent with your  
11 consolidated capital structure and embedded cost of long-term debt methodology?

12 A. No. First, Mr. Dunn states that his Schedule JCD-11 “clearly  
13 demonstrates the fact that international debt cannot be used outside of the country of  
14 origin.” (*Id.* p. 23, ll. 14-15) I have reviewed these documents and do not find that they  
15 clearly demonstrate what he claims they demonstrate.

16 Regardless, because MPS is a division of UtiliCorp, it derives all of its  
17 capital from the parent company. MPS does not have any direct debt issuances, and  
18 therefore, its cost of debt cannot be directly estimated. Once the dollars from all of  
19 UtiliCorp’s debt issuances enter the corporate coffers, it is not possible to determine what  
20 dollar came from which debt issuance. Therefore, because it is not possible to verify  
21 which debt dollars are being used to finance MPS activities, I used the UtiliCorp  
22 consolidated embedded cost of long-term debt.

Surrebuttal Testimony of  
David Murray

1           Q.     Did UtiliCorp provide you all of the information needed to calculate the  
2 embedded cost of long-term debt in their original response to your data  
3 request (DR) 3802?

4           A.     No. In UtiliCorp's first response to my DR 3802, they only provided the  
5 domestic debt issuances. After further request, I was able to obtain the international debt  
6 issuances in order to calculate the consolidated cost of long-term debt.

7           Q.     Mr. Dunn makes several comments on page 23, line 16 through page 30 of  
8 his rebuttal testimony on why he feels that an allocated capital structure is appropriate for  
9 ratemaking purposes. How do you respond?

10          A.     I have explained many of my arguments against the use of UtiliCorp's  
11 allocated capital structure on page 3, line 3 through page 13, line 5 of my rebuttal  
12 testimony. However, I would like to make it clear that the main reason that I feel that  
13 UtiliCorp's consolidated capital structure should be used is because it is reasonable,  
14 verifiable and it is the capital structure of the source of MPS's capital.

15                 Further, as I stated in my rebuttal testimony, if one were to use an  
16 allocated capital structure system similar to the one UtiliCorp uses, the equity ratio would  
17 have to be much lower than the 48 percent that UtiliCorp allocates to MPS. In my  
18 rebuttal testimony, I cited numerous sources and reasons why the equity ratio would need  
19 to be in the range of 36 to 43 percent if one utilizes an allocated capital structure system  
20 for an electric utility. Since I wrote my rebuttal testimony, I have come across another  
21 study done by Lehman Brothers that cites an average 36 percent equity ratio for utilities.  
22 Although I am not taking the position that the Commission should use an allocated

Surrebuttal Testimony of  
David Murray

1 capital structure for MPS, it is quite apparent that UtiliCorp's current allocated capital  
2 structure for MPS does not reflect reality.

3 Q. In light of the above, do you have any comments about Mr. Dunn's claim  
4 that "financial analysts require companies to maintain capital mixes and capital tracking  
5 procedures which are appropriate to the **times and the state of financial knowledge**"  
6 (emphasis added) (*Id.*, p.29, ll. 12-13).

7 A. Although Mr. Dunn did not provide any real world evidence of what  
8 financial analysts require, I would presume that if a financial analyst were to review  
9 UtiliCorp's allocated capital structure for MPS and compare it to my proxy group and all  
10 of the indices that I have mentioned, he would have to conclude that UtiliCorp is not  
11 allocating capital to MPS appropriately. Although a financial analyst may disagree with  
12 the amount of equity UtiliCorp allocates to MPS, he would not make a recommendation  
13 on whether to buy or sell the company because of this disagreement. The analyst would  
14 review the consolidated operations of UtiliCorp and make his recommendation based on  
15 the potential performance, or lack thereof, of the consolidated company because this is  
16 what the investor would be purchasing.

17 Q. Do you have any general comments and/or observations that further  
18 support your recommended cost of common equity in this proceeding?

19 A. Yes. Although the Financial Analysis Department has not historically  
20 relied on the capital asset pricing model (CAPM) and the risk premium model as the  
21 primary tool to determine its recommendation for the cost of common equity, in this case,  
22 it is interesting to note that both models support my recommended cost of common equity  
23 range. The CAPM indicates a long-term period, 1926 to 1999, cost of common equity of



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David Murray

1 9.49 percent. The CAPM indicates a short-term, recent period, 1990 to 1999, cost of  
2 common equity of 10.32 percent. Both CAPM results fall within the range of my DCF  
3 analysis. The risk premium model indicates a 10.43 percent cost of common equity,  
4 which is exactly at the upper end of my range.

5 The results of these models further corroborate my DCF recommended  
6 cost of common equity. It is important to note this because neither the CAPM nor the  
7 risk premium model requires decisions about the proper growth rate of a company, which  
8 is an area of contention in this case. These models support my selected growth rate and  
9 resulting cost of common equity recommendation from my DCF analysis.

10 Q. Do you have any comments about Mr. Dunn's speculation that inflation  
11 will cause a higher cost of common equity (*Id.* p.31, ll. 12-13)?

12 A. Obviously, Mr. Dunn is taking the position that the level of interest rates is  
13 a factor in the cost of common equity for at least a utility company. However, I do not  
14 feel it is appropriate to speculate about the future direction of interest rates. Mr. Dunn  
15 made this same speculation in Case No. ER-93-37, which was filed on July 31, 1992. A  
16 review of Schedule 5-3 in my direct testimony will show that after Mr. Dunn's  
17 prognostication, interest rates actually decreased for the next year and then increased to a  
18 high at the end of 1994. Since 1994, interest rates have generally trended downward  
19 except for an increase in 1999. Regardless of whether or not Mr. Dunn's speculations  
20 have been right or wrong, it is not appropriate for rate of return witnesses to adjust the  
21 cost of common equity because of speculation about interest rates. Investors'  
22 expectations on the future direction of interest rates will already be factored in to the

1 price they pay for the stock of a company. Consequently, the DCF model will capture  
2 investors' expectations.

3           Nevertheless, it is important to observe the effect the current interest rate  
4 environment has on the cost of capital. The most obvious effect of a lower interest rate  
5 environment is that the cost of debt will decrease as interest rates for debt decrease.  
6 Under the theories of the CAPM and the risk premium model, this would also result in a  
7 lower cost of common equity. Under the CAPM theory, which is explained in detail on  
8 page 30, line 15 through page 32, line 12 of my direct testimony, a lower cost of common  
9 equity occurs because a market risk premium ( $R_m - R_f$ ) multiplied by the beta is added to  
10 the current risk-free rate. The market risk premium can be calculated from a variety of  
11 periods. In my analysis, I chose to calculate a risk premium for a long-term period of  
12 1926 to 1999 and short-term period of 1990 to 1999. These risk premiums are calculated  
13 by subtracting the average annual total return of long-term government bonds from the  
14 average annual total return of large company stocks. The risk premium is based on an  
15 average difference of period returns so it will not fluctuate as much as the first variable,  
16 the current risk-free rate, in the CAPM equation. As a result, the CAPM results are quite  
17 dependent on the current level of interest rates. Consequently, the resulting cost of  
18 common equity will tend to decrease with decreasing interest rates.

19           The historical risk premium model cost of common equity result will also  
20 tend to decrease with decreasing interest rates. The risk premium model, which is  
21 explained in detail on page 32, line 13 through page 33, line 6 of my direct testimony,  
22 produces a cost of common equity based on the addition of an average risk premium for a  
23 certain historical period, in my analysis ten years, over the current risk-free rate. If the

Surrebuttal Testimony of  
David Murray

1 current interest rates are at a low level, then the addition of this average risk premium  
2 will result in a lower cost of common equity. Therefore, both of these models are quite  
3 interest rate sensitive.

4           There are also some real world observations by analysts about the  
5 attractiveness of utility stocks and their dividends in today's low interest rate  
6 environment. The article, "Current Rich Dividends Demand Caution: Lofty Levels are  
7 Alluring, but Analysts Warn They May Not Last," on pages C1-C2 of the *Wall Street*  
8 *Journal* on October 25, 2001, contained some comments about the attractiveness of  
9 dividends. This article discussed some of the cautions one should observe when buying a  
10 stock that has a high dividend yield, when it looks like the dividend cannot be sustained  
11 because of cash flow problems. However, Richard Bernstein, chief quantitative strategist  
12 at Merrill Lynch & Co., has researched companies "whose dividends are more secure yet  
13 offer yields of 5 percent or more." He indicates "at the top of his list are utilities such as  
14 Puget Energy, with a dividend yield of 9.6% and Semco Energy, at 6.1%." Actually,  
15 Puget Energy is a company contained in my comparable group of companies.  
16 Mr. Bernstein further states that: "We view these stocks as pseudo-bonds that offer equity  
17 participation." If analysts are comparing utility stocks that pay dividends to bond yields,  
18 then in today's current low interest rate environment a utility stock yielding between 5 to  
19 7 percent or even lower may look very attractive to an investor.

20           Q.     Do you have any general comments about the capital markets that support  
21 your recommended cost of common equity as being reasonable?

22           A.     Yes. Although I have touched on the capital market conditions in my  
23 direct testimony, it is appropriate to review some of the year-end results that were

Surrebuttal Testimony of  
David Murray

1 reported in the *Wall Street Journal* on January 2, 2002. According to the *Wall Street*  
2 *Journal* the Dow industrials fell 7 percent, the S&P was down 13 percent and the  
3 NASDAQ was down 21 percent for the year. The U.S. stock market has had its worst  
4 two-year period in more than 23 years. Not only has the stock market been down the past  
5 two years, Warren Buffett, renowned investor, expects it will only average a 7 to  
6 8 percent return over the next ten years. Considering the past negative market  
7 performance and potential low market performance in the future, a return on common  
8 equity in the range of 9.43 percent to 10.43 percent appears quite attractive. If one  
9 considers the return of 7 to 8 percent predicted by Mr. Buffett for the entire stock market  
10 as the opportunity cost of investing in a utility that is allowed a return on equity of  
11 9.43 percent to 10.43 percent, then it would be hard to imagine why an investor would  
12 invest in the broad market rather than the utility.

13 Q. Have you come across any information that you think is worthy of  
14 mentioning before you close your surrebuttal testimony?

15 A. Yes. Because the Financial Analysis Department did not have the current  
16 2001 edition of Ibbotson's Stocks, Bonds, Bills and Inflation yearbook, my CAPM  
17 analysis relied on the 2000 yearbook. Because the large company stocks' compound  
18 annual total returns for both the long-term and short-term period have decreased as a  
19 result of the downturn in the stock market the last couple of years, and because the long-  
20 term government bond compound annual total returns have increased for both the long-  
21 term and short-term periods, the CAPM cost of common equity (9.23% and 9.18%)  
22 actually supports the lower end of my recommended cost of common equity range.  
23 However, it should be noted that the December 2001 risk-free rate of 5.48 percent is the

Surrebuttal Testimony of  
David Murray

1 same risk-free rate that was used as of September 2001. Therefore, the difference in the  
2 resulting CAPM costs of common equity are specifically due to the change in the market  
3 risk premiums in columns (3) and (4) (see attached Schedule 18-amended).

4 **Summary and Conclusions**

5 Q. Please summarize the conclusions of your rebuttal testimony.

6 A. I conclude the following:

- 7 1) The calculation of the cost of capital for MPS should be based on  
8 the actual capital structure of UtiliCorp as of June 30, 2001, as  
9 shown in Schedule 9 of my direct testimony;  
10  
11 2) My cost of common equity stated in Schedule 24, which is 9.43  
12 percent to 10.43 percent, would produce a fair and reasonable rate  
13 of return of 8.49 percent to 8.98 percent for the Missouri  
14 jurisdictional electric utility rate base for MPS, a division of  
15 UtiliCorp United, Inc.

16 Q. Does this conclude your surrebuttal testimony?

17 A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

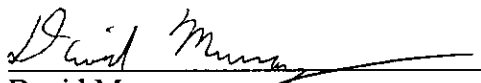
**OF THE STATE OF MISSOURI**

In the Matter of the Application of the Tariff                     )  
Filing of Missouri Public Service (MPS)                         )  
A Division of UtiliCorp United Inc., to                         )       Case No. ER-2001-672  
Implement a General Rate Increase for Retail                     )  
Electric Service Provided to Customers in the                     )  
Missouri Service Area of MPS   )

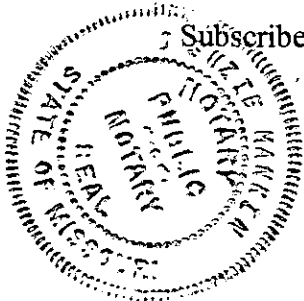
**AFFIDAVIT OF DAVID MURRAY**

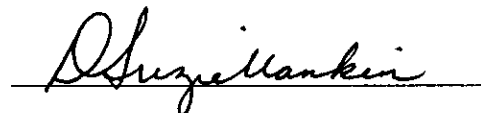
STATE OF MISSOURI         )  
                                      )       ss.  
COUNTY OF COLE         )

David Murray, being of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 28 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

  
David Murray

Subscribed and sworn to before me this 21<sup>st</sup> day of January 2002.





D SUZIE MANKIN  
NOTARY PUBLIC STATE OF MISSOURI  
COLE COUNTY  
MY COMMISSION EXP. JUNE 21, 2004

MISSOURI PUBLIC SERVICE  
CASE NO. ER-2001-672

**Capital Asset Pricing Model (CAPM) Costs of Common Equity Estimates  
for the Comparable Electric Utility Companies**

|                        | (1)            | (2)                       | (3)                             | (4)                             | (5)                                    | (6)                                    |
|------------------------|----------------|---------------------------|---------------------------------|---------------------------------|--|--|
| Company Name           | Risk Free Rate | Company's Value Line Beta | Market Risk Premium (1926-2000) | Market Risk Premium (1991-2000) | CAPM Cost of Common Equity (1926-2000) | CAPM Cost of Common Equity (1991-2000) |
| DPL, Inc.              | 5.48%          | 0.60                      | 7.30%                           | 7.20%                           | 9.86%                                  | 9.80%                                  |
| DQE, Inc.              | 5.48%          | 0.45                      | 7.30%                           | 7.20%                           | 8.77%                                  | 8.72%                                  |
| Hawaiian Electric      | 5.48%          | 0.50                      | 7.30%                           | 7.20%                           | 9.13%                                  | 9.08%                                  |
| IDACORP                | 5.48%          | 0.50                      | 7.30%                           | 7.20%                           | 9.13%                                  | 9.08%                                  |
| NSTAR                  | 5.48%          | 0.50                      | 7.30%                           | 7.20%                           | 9.13%                                  | 9.08%                                  |
| Potomac Electric Power | 5.48%          | 0.50                      | 7.30%                           | 7.20%                           | 9.13%                                  | 9.08%                                  |
| Puget Energy, Inc.     | 5.48%          | 0.55                      | 7.30%                           | 7.20%                           | 9.50%                                  | 9.44%                                  |
| <b>Average</b>         |                | <u><u>0.51</u></u>        |                                 |                                 | <u><u>9.23%</u></u>                    | <u><u>9.18%</u></u>                    |

Sources:

Column 1 = The appropriate yield is equal to the average 30-year U.S. Treasury Bond yield for December 2001 which was obtained from the St. Louis Federal Reserve Website: <http://www.stls.frb.org/fred/data/irates/gs30>.

Column 2 = Beta is a measure of the movement and relative risk of an individual stock to the market as a whole as reported by the Value Line Investment Survey: Ratings & Reports, July 6, August 17, and September 7, 2001.

Column 3 = The Market Risk Premium represents the expected return from holding the entire market portfolio less the expected return from holding a risk free investment.  
The appropriate Market Risk Premium for the period 1926 - 2000 was determined to be 7.30% as calculated in Ibbotson Associates, Inc.'s Stocks, Bonds, Bills, and Inflation: 2001 Yearbook.

Column 4 = The Market Risk Premium represents the expected return from holding the entire market portfolio less the expected return from holding a risk free investment.  
The appropriate Market Risk Premium for the period 1991 - 2000 was determined to be 7.20% as calculated in Ibbotson Associates, Inc.'s Stocks, Bonds, Bills, and Inflation: 2001 Yearbook.

Column 5 = (Column 1 + (Column 2 \* Column 3)).

Column 6 = (Column 1 + (Column 2 \* Column 4)).