adopted by the Commission, will, in fact, meet that standard annunciated by the United States Supreme Court?

A. I believe it's detailed throughout all my testimony. I mean, one of the first calculations I performed was a pre-tax interest coverage calculation. And I recognized -- to be quite honest with you, at the time I debated whether or not to even use this pre-tax interest coverage calculation or put it in my testimony --

Q. Well, let me --

A. -- because of the concern that the debt cost for -- that are included in this pre-tax interest coverage calculation may be higher than what a utility could have received if they had a capital structure similar to Aquila's on a consolidated basis and they didn't have the exposure to the nonregulated operations.

Q. Let me back you up just a second. When you sat down to write your testimony in this proceeding -- and you said that this was your testimony, you wrote it and you put it in this language from the United States Supreme Court decision, and you've acknowledged that, you've indicated that you think this Commission needs to follow that -- was it your intention that your recommendation that you're presenting to the Commission will result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. I -- once again, I never have come out and said that they would be an investment grade credit rating. I --

Q. That wasn't my question. My question was, was it your intent that your recommendation would result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. No, that was never my intent to try to evaluate that.

Q. Thank you.

Now, you agree with me, do you not, that the Commission has jurisdiction over Aquila's regulated operations in Missouri; is that right?

A. Yes.

Q. And we talked about those being hard assets in the ground?

A. Yes.

Q. And you said you had some knowledge with those; is that true?

A. Yes.

Q. Would you agree that to the extent possible, the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for these two operating divisions?

A. Exclude from what? I'm sorry. You'll have to give me some clarification, please.

Q. Do you believe that the Commission, to the extent possible, should exclude the effects of Aquila's other undertakings, other investments, nonregulated operations and what have you, in determining a return in this case for the MPS and L&P operating divisions?

A. I believe the Commission should adopt a capital structure that reflects how UtiliCorp has historically been financed, which --

Q. That wasn't my question.

A. -- was not including the nonregulated operations.

Q. Now, that wasn't my question. My question was, do you think that the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for the operating divisions?

A. Sure.

Q. If you turn to your Surrebuttal Testimony, please, page 21, and you have the question there on line 4, Aren't you trying to determine what the cost of capital would be for MPS and L&P if they weren't part of Aquila?

A. Yes.

Q. Answer, Yes.

And that's consistent with what you've just said?

A. Yes, it is.

Q. Okay. Now, if you'd turn to your Rebuttal Testimony, please, and turn to page 4.

A. Yes.

Q. There at lines 12 through 14 in response to a question you state, It is important to match the capital structure components with their embedded costs as of the same date because they are closely related; otherwise, there is a mismatch of the cost and the capital structure components.

Is that your testimony?

A. Yes, it is.

Q. And is that still your testimony today?

A. Yes, it is.

Q. And would you agree with me that Aquila, the corporation, has assets located in many states?

A. Yes. Seven to be exact, I believe.

Q. And would you agree that Aquila, the corporation, has nonregulated businesses?

A. There are some that they're winding down, that's correct, and I think one remaining international operation.

Q. Notwithstanding those facts, that it has businesses in other states and it has nonregulated operations, you are suggesting to the Commission that it utilize the corporation -- the corporate capital structure for rate-making purposes in this case; isn't that true?

A. That's correct.

Q. Let me ask you this, Mr. Murray, what have you done to identify the capital structure for MPS that provides utility service to the MPS customers?

A. MPS and L&P don't have a capital structure so there's nothing to do to identify that. It's a -- it's been called an allocated capital structure by the company, which was based on a hypothetical study done in 1988.

And since that time, there's been the representation given that there's some -- an actual tangible capital structure there when even Aquila's own witness, Mr. John Reed, indicates that divisional capital structures are not discernible. It's not a reflection of reality.

Q. So the answer to the question is you haven't done anything to identify the capital structure for MPS that provides service to the MPS ratepayers; isn't that true?

A. Because capital structure doesn't exist.

Q. So you haven't done anything to attempt to identify it?

A. Exactly.

Q. And if I ask you the same question about the L&P operations, would your answer be the same?

A. Yes.

Q. And I think you indicated you have some knowledge of Aquila's assigned capital process?

A. Yes, I do.

Q. And has that not been the subject of some prior Commission decisions?

A. Probably since 1988, I believe so, that's correct.

Q. Do you know whether or not the Staff, the Commission Staff, has ever audited or attempted to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide utility service to those customers, the MPS customers?

A. Can you please define audit or verify?

Q. Well, you can use your own definition of that. Have you done anything to substantiate that?

A. The numbers just don't add up as far as my -- you know, my review. And based on comments made by Aquila personnel in the most recent collateralization case, that more equity is allocated to the nonregulated and less equity is allocated to the regulated, it's only natural and logical to understand that if that's the case, that the equity ratios that are allocated to the regulated would be less than the consolidated capital structure.

So I have tried to verify -- you know, I've tried to understand the process and the process just doesn't add up. It's fuzzy to me.

Q. What have you done to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets to provide utility service to MPS customers?

A. The only thing I'm aware of as far as -- and you have investments that are incurring in these properties I'm sure for quite some time. But I'm aware that in 1980 there was an equity ratio ruled on in that case of 27.5 percent equity.

Q. Well, that wasn't my question. My question was -- you said you tried to verify this. And my question is, what did you do to try to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide service to the MPS customers?

A. Well, I've looked at the fact that it's been -- it's been presented that this -- is the allocated capital structure is the actual capital structure that -- that supports the assets of MoPub and St. Joe.

Q. I'm not asking you what's been presented. I'm asking you what you have done to verify that.

A. I've reviewed what's been presented and I don't agree with it.

Q. And you don't agree with it?

A. No.

Q. And what have you reviewed?
A. I've reviewed the business allocation procedure, I've reviewed the testimony that contradicts itself from the company itself. And, like I said, the numbers don't just add up from a financial theory standpoint. It doesn't make sense. Now, have I written a report on this other than testimony? No.
Q. Well, that was going to be my next question. So since you don't think it makes any sense, do you know whether or not the Staff has ever recommended changes to Aquila's allocation method so that the cost of capital of MPS would more accurately reflect the cost of providing service to Missouri ratepayers?
A. No. Because we recommend the consolidated capital structure. There wouldn't really be a purpose for us to do that.
Q. Isn't it a fact that in Case ER-93-337 this Commission adopted the assigned capital structure for rate-making purposes?
A. That's correct. And there's two cases where they adopted the consolidated that were fully litigated, a '97 case and the 1990 case.
Q. Are you saying that the ER-93-337 wasn't fully litigated?
A. That's been my understanding all along.

Q. Has somebody told you that?
A. That's -- I believe so.
Q. Who told you that?
A. It's been subject to testimony for quite some time.
Q. Who told you that that case wasn't fully litigated?
A. I believe it was when I was reviewing the previous Staff consultant's testimony, Stephen Hill in the 1997 case. And Bob Schallenberg indicated that -- whenever I was discussing something with him about it, that there was a hang-up on one specific issue that --
Q. Are either of those people lawyers, Bob Schallenberg or Stephen Hill? Who's Stephen Hill?
A. Last time -- he's a consultant the Staff has hired. Last time we hired him was back in '97, which was a MoPub case.
Q. You hired him in '97 and he told you the '93 case wasn't fully litigated?
A. Yeah. That was indicated in his testimony. I didn't see anything to dispute that.
Q. Have you read the decisions in the 93-337 case?
A. Not the full decisions.
Q. How many decisions are there, do you know?

A. I don't know.

Q. And so when you say you haven't read the full decisions, what have you read? What parts of the decisions have you read?

A. The rate of return report and order. I've seen that portion of it.

Q. Have you read the portion of the orders that pertain to capital structure?

A. That includes the rate of return capital structure.

MR. SWEARENGEN: Could I approach the witness?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. I'm going to hand you a portion of a Report and Order in ER-90-337 that concerns rate of return, capital structure. You say you're familiar with that. Could you read into the record the material that I've bracketed here on page 17?

A. Sure. In comparing Public Counsel's proposed capital structure and MoPub's proposal, the Commission finds that MoPub's divisional capital structure is the most appropriate. MoPub's divisional capital structure is testable, understandable, based on public facts and material, has been in continuous operation for more than five years and has been subjected to substantial regulatory review.

MoPub's capital structure is reproducible in that all the material assumptions and data involved in its formation are either published, distributed to regulatory authorities or otherwise publicly available.

Also, MoPub's booked capital structure is reasonable due to its continuity. Modifications are made only to reflect year-to-year historical development. It is not as subject to manipulation as Public Counsel's hypothetical capital structure.

Furthermore, Public Counsel's hypothetical capital structure cannot reflect the history of activity within a utility nor the particular risk of that utility as does MoPub's booked capital structure. Thus, the Commission finds that the use of Public Counsel's proposed capital structure is not appropriate in this case.

Q. Now, you said you read that decision previously; is that true?

A. Yes.

MR. SWEARENGEN: May I approach the witness again, please?

JUDGE JONES: Yes.

BY MR. SWEARENGEN:

Q. What's the date of that decision? Do you know offhand?

A. June 18th, 1993.
Q. Okay. Thank you.
Now, I'm going to hand you another decision in that same case dated April 4, 1997, almost four years later, same case, and ask you to read the bracketed material beginning on page 38 concerning return on equity, capital structure. Start there and read over to the end of that capital structure paragraph, please.
A. Okay. This is Report and Order on remand in Case No. ER-93-337 issued April 4th, 1997.
Here's the reading: Because MoPub must raise capital through UtiliCorp, the use of UtiliCorp's consolidated capital structure may be a valid approach. However, this is not the best approach for this case because UtiliCorp's comprised of both operating utility divisions and unregulated subsidiaries and its capital structure -- excuse me, its capital structure reflects that mix.
Use of MoPub's assigned capital structure will help insulate it to some extent from UtiliCorp's unregulated subsidiaries. And the assigned structure is actually analogous to the capital structures of comparable electric utilities.
Q. Is that the end of that discussion?
A. No. I have one more paragraph.
Q. Thank you.

A. Although the capital structures proposed by MoPub and Public Counsel -- excuse me, Public Counsel are substantially the same, the Commission determines that use of MoPub's assigned capital structure is warranted.

This structure was assigned to MoPub several years prior to this case based upon a comprehensive system of capital structure allocation by UtiliCorp in conformity with Securities Exchange Commission requirements and generally accepted accounting principles. Use of it will allow year-to-year continuity and permit easier period-to-period comparisons.

Finally, the Commission determines that in this case it will not impose a different capital structure on a utility where the management of the company has chosen an appropriate capital structure.

That's it.

Q. Now, once again, what's the date of that decision?

A. Date of that is it was issued on April 4th, '97; effective date April 15th, 1997.

Q. Thank you.

Now, how many years have you been with the Commission?

A. Going on four years in June.

Q. And you're aware, I assume, of cases that took place prior to that time, including this one that we just discussed?

A. I'm aware of those cases.

Q. Are you aware of any rate case before this Commission that lasted over four years?

A. I don't know the details behind that case so I -- as far as if that rate case lasted that long?

Q. Well, you just said the first order was issued --

A. It was remanded. I'm not an attorney --

Q. I understand that.

A. -- so you're asking me questions that --

Q. Would you agree with me the first order was issued in June of 1993? I think we've established that. And the last one you read from was in April '97?

A. It was remanded, yes.

Q. And you still think that case wasn't fully litigated. Is that your testimony?

A. That's in my testimony.

Q. That's based on something somebody named Stephen Hill told you?

A. I believe that's his name, and I believe that's correct.

Q. Okay. Back to your recommendation for a capital structure in this case, make sure I've got the numbers right. Is it 35.31 percent common? Is that what you're proposing?

A. That's correct.

Q. And you've got a little piece of short-term debt, .38 percent; is that correct?

A. That's correct.

Q. And 64.31 percent long-term debt?

A. That sounds correct.

Q. Okay. Are you familiar with the term "investment grade bond"?

A. Yes, I am.

Q. And would you agree with me that for purposes of this case, Aquila has agreed that the cost of debt should be set at a level not to exceed the Standard and Poor rate for a triple B rated bond?

A. I'm aware of that commitment.

Q. And is that the lowest investment grade bond, a triple -- a Standard and Poor triple B bond?

A. A triple B minus actually is the lowest.

Q. And does Aquila currently have that rating --

A. No.

Q. -- a triple B rating?

Would you agree that if the bond rating of a company declines, you would expect that company's cost to borrow to increase?

A. Yes.

Q. And would you agree that the Standard and Poor's guideline for a triple B utility of average risk is 45 percent debt and 55 percent common equity?

A. Are you referring to the guidelines --

Q. Yes.

A. -- from this?

I want to say it was 47 to 55 not 45 to 55, but I could verify that.

The financial target for a business position of five for a triple B rated company is 47 to 55.

Q. And what's a business position five? What's that mean?

A. Basically you have business profiles from 1 to 10, 1 being the least risky, 10 being the most risky. Whenever you have a business profile that indicates less risk, the financial ratios, metrics do not have to be as solid, if you will, if that -- as far as the financial health in order to have, say, the same credit rating as a company with a business profile of five.

They have some more business risk so they need to have, say, for instance, more equity in their capital structure to -- to compensate for that additional risk in order to have the same credit rating.

And a company with a business profile of 1, 2

3 -- I don't see many with a 1, but 2 and 3 usually are water companies. A 4 is probably a fully regulated electric utility. You get to 5 and 6 and you're looking at vertically integrated regulated utilities with some -- some nonregulated.

Aquila when -- the nonregulated Aquila merchant operation business profile I believe was a 7, so when you get into energy marketing and trading, wholesale power, tolling agreements, etc., you're looking in the 7, 8 range. And that's how that -- how that's measured.

Q. Okay. Thank you.

You did say though that the -- back to the S&P guidelines for a triple B utility of average risk, the common equity ratio, the guideline is 55 percent?

A. Yes. The benchmark is 47 to 55.

Q. 47 to 55 on common; is that right?

A. No. This is total debt to total capital.

Q. Okay. There's a range. Is that what you're saying?

A. Yes. For triple B. This is not an exact science by any means. And these targets, you know, a lot of times aren't even met to achieve a certain credit rating.

Q. Your comparable companies, what document would I look at in your testimony that would show me the common equity ratios of your comparable companies?

A. Actually, I think we were just referring to them. Something about 25 percent for DPL and DQE. That is Schedule 20 in column 1.

Q. Schedule 20 to your Direct Testimony?

A. Direct Testimony, column 1.

Q. Schedule 20, column 1. And how many of those companies fall into this Standard and Poor's guideline range that you were just talking about?

A. It's interesting, there's only one. And actually that company is an A-rated company. You actually have NSTAR, which is an A-rated company, that has 37.8 percent common equity total capital. So I'm sure that falls even further outside the range that are normally required for -- or I wouldn't say required, but that's the target for an A-rated utility with, say, a business position of five.

So that just illustrates more that this is more of an art than it is a science in assessing the creditworthiness because these benchmarks tend not to be met by some of these companies.

Q. You've got two in there that we talked about earlier that I think you agreed probably don't belong in your group. And that's DPL, Inc. and DQE; is that true?

A. I don't think we agreed that they don't belong in my group, but those -- you know, those -- they had triple

B credit rating at the time and, once again, those fell out of the guidelines that are indicated by Standard and Poor's in their financial targets.

Q. How much is DPL, Inc. out of the guideline?

A. Over 20 percent.

Q. And how about DQE? How much is it out of the guideline?

A. Over 20 percent.

Q. Would you agree that the lower the interest coverage, the greater the financial risk?

A. Holding all things equal, yes.

Q. And holding all things equal, would you agree that the greater the financial risk, the higher the cost of the common stock?

A. Yes.

Q. Is it true that a higher interest coverage indicates greater security to the investor and suggests to the investor that he will receive his anticipated interest payments?

A. Holding business risk equal once again, yes.

Q. Do you still have Schedule 20 there in front of you?

A. Yes, I do.

Q. And what does column 3 show?

A. Column 3 shows pre-tax interest coverage ratios for my comparable companies.

Q. And the average is 2.65 times; is that true?

A. That's correct.

Q. And then if you turn to the next schedule, I believe, Schedule 21 --

A. Yes.

Q. -- do you show there what your recommended proposed interest coverage will be for Aquila?

A. Yes. With many assumptions, I have calculated it a pre-tax interest coverage ratio there.

Q. Is that in the third column on that page under the 9.64 percentage?

A. Well, there's actually a range. If you go down to item 8, it shows the pre-tax -- with many assumptions, it shows the pre-tax interest coverage ratio of 2.11 for 8.64, 2.17 for 9.14, 2.23 for 9.64.

Q. And those interest coverage figures that you just read into the record correspond to the range of your proposed return on equity in this case, 8.64 to 9.64; is that right?

A. That's correct.

Q. So on the high end of your recommended ROE range, the 9.64, the proposed interest coverage is only 2.23 times; is that right?

A. That's correct. And I did -- as I explained in my testimony, I still have many reservations from drawing too much of an inference from -- from this test of reasonableness because of the fact that Aquila's credit ratings are a result of its consolidated operations; therefore, the credit quality of the debt that is assigned to MoPub and St. Joe is a function of the nonregulated operations of Aquila and also Aquila's leveraged capital structure, which is all I'm trying to reflect in my recommendation here.

Since the debt costs are what they are and what they're -- what they're assigned to MoPub and St. Joe, it's only natural to go ahead and use the capital structure that is a function of that credit rating and the costs associated with it.

Q. With your recommended capital structure, did you calculate what return on common stock equity would have produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No. That doesn't drive my recommendation.

Q. Did you make that calculation?

A. No.

Q. Is that a hard calculation to make?

A. I've never made it. I don't know, you know, if -- probably have to do some algebra.

Q. You can't do it on the witness stand this afternoon?

A. I could do it for you later. I really don't feel like doing it right here.

Q. Let me ask you this. Would 14.16 percent return on common stock equity sound like a number that might make that turn out to be 2.65 times?

A. You'd have to show me the calculations.

Q. Okay. Could you make that calculation while we're on recess?

A. If you have the calculations, I mean, I can review your calculation because I wouldn't want to confuse our methodologies here.

Q. You didn't do this calculation, did you?

A. No. I said it's not something -- pre-tax interest coverage -- a desired pre-tax interest coverage ratio calculation is not driving my recommendation. It's the other way around.

I come up with a recommendation, I use pre-tax interest coverage ratio to test the reasonableness. As far as I know, it's never been a matter of pre-tax interest -- a desired pre-tax interest coverage ratio driving what a recommendation should be.

Q. And you said you did it to test the reasonableness, and that's the essence of my question. Did you calculate what return on common stock equity would have produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No.

Q. And don't you think you should have done that to test the reasonableness of it?

A. No.

Q. Why not?

A. Because I looked at -- I evaluated the current interest rate environment, I looked at the growth rates in my DCF model, I looked at the dividend yields in my DCF model, I evaluated all six of my comparable companies. And I realized that some of those comparable companies had some problems and I took that into consideration when I made my recommendation. I calculat--

Q. How did you take that into consideration when you made your recommendation, the fact that some of your comparable companies had problems?

A. If you want to take a look with me, I'll explain it to you.

Q. Yeah. I'd love to. First of all, what companies are you talking about that have problems?

A. Well, there's obviously volatile growth rates because it's the nature of the industry right now, unfortunately.

Q. Which companies in your comparable companies had problems?

A. Well, let -- as soon as I turn to it, I can just start going through some of this with you.

Q. Okay.

A. Okay. If you turn to Schedule 14.

Q. And that's to your Direct Testimony?

A. Yes.

Q. Okay. Which of your comparable companies listed there -- and you have all six of them -- are having problems?

A. And when I say "problems," I'm referring to the fact that their growth rates are differing as far as historical and projected. You've already pointed out some things about DPL and DQE with their negative growth rates and historical growth rates.

And one of the things that happens when a company has a negative historical growth rate, a lot of times their near term projected growth rate will be higher than what is actually sustainable.

I actually discussed this in the last Empire rate case when they had an anomalous year -- because of the fact that Value Line has a projected earnings per share five years out -- three to five years out, that they expect them to return back to a normal level, but because they had an anomalous year, their base year to use to calculate that projected compound growth rate is going to be lower than it normally would be so an analyst has to take this into consideration.

Q. You're talking about the Empire District Electric Company?

A. I'm explaining what has to be taken into consideration.

Q. Well, are you talking about the Empire District Electric Company?

A. I'm using it as an example to explain what has to be taken into consideration when you look at growth rates.

Q. That's not one of your comparable companies though?

A. No. I'm using an example to explain here --

Q. That's fine.

A. -- as to why you have to take these things into consideration.

Q. I just wanted to make sure that that wasn't being substituted here. Go ahead.

A. No, it's just an example. I'm just trying to help explain.

So if -- when you look at the growth rates within -- you know, within my comparable groups there, you look at some of the average historical and projected. For

DPL and DQE, as you pointed out, you know, there are some issues there, but I'm not going to exclude them. I have confidence enough in myself to be able to sort through this information and come up with a reasonable recommendation.

And for the average historical and projected growth of DPL and DQE, you're right, the average historical growth and projected growth is 1.5 for DPL, for DQE it's negative 1.01.

Well, if you look at a company like Cleco and Hawaiian Electric, which is one of more captive electric utilities just because of the nature of the fact that it's on an island, they have very little growth.

And that's -- that's not -- that's not surprising to me because the growth for a electric utility is a lot of times based on what they call organic growth, which is growth and demand for electricity, which, you know, may not be growing as high as at one time because of energy efficiency issues, could be growth in customers within -- within their jurisdiction. So I gave some weight to that. I also gave some weight to NSTAR because NSTAR looks like it had historical and projected growth rates that were, you know, fairly -- you know, fairly similar.

So I looked at all that and took that in consideration. And -- and as you can see, my proposed range of growth was, you know, 10 basis points below my highest average historical and projected, which was NSTAR. 3.1 gives some weight do Hawaiian Electric. And then if you go to Schedule 16 there, you'll see that as far as my column 5, my -- the high end of my recommendation is actually higher than the overall results that I came up for any of my companies, which was 9.48 for Cleco. The high end of my range is 9.64.

So, once again, I'm looking at NSTAR, I -- I looked at some of these results and decided, you know, I need to analyze this, just like Dr. Murry calculated several DCF calculations with just the dividend growth. And he was coming up with absurd results, 6, 7 percent. I mean, you can make these calculations and you can look at them. It doesn't mean you're going to necessarily go with that recommendation.

Q. I want to take you back to your statement you made earlier that some of these companies have problems and you never really defined what you meant by problems, but you referenced specifically DPL, Inc. and DQE, Inc. Are any of the other companies in your proxy group -- any of the remaining four companies problem companies from your standpoint?

A. No. And when I say "problems," I'm saying that there was some things I looked at as far as their growth rates. I had to recognize that there was some things going on there with the negative historical and -- and the -- you know, the positive forward-looking growth and weighing my decision on what -- what is reasonable to recommend in this case.

Q. So when you said problems, other than DQE and DPL, Inc. you didn't really mean that the companies had problems?

A. I just meant that it presented problems with my analysis, that I had to --

Q. Okay.

A. -- if I can say, I had to use a little judgment here.

Q. Let me ask you this. Would you agree that if there is an increase in the rate of inflation, it is likely that the Federal Reserve will increase the level of interest rates?

A. Well, that depends to be -- if the economy starts to pick up and the Federal Reserve will, you know, eventually act. They've made some unprecedented announcements that they do not intend to raise their federal funds rate for any -- any time soon.

Q. What if there's an increase in the rate of inflation? What do you think the Federal Reserve will do?

A. Your guess is as good as mine on that. I mean, that's -- analysts are trying to figure that out all the time. I don't know.

Q. What normally happens if there's an increase in the rate of inflation with respect to what the Federal Reserve does in terms of the level of interest rates?

A. Well, if it's a sustainable amount of inflation, they may raise the fed funds rate, but they have to weigh a lot of factors -- more factors than I can even try to get into here. And I don't know.

Q. If you turn to your Direct Testimony, Schedule 6, there you list several economic forecasts; isn't that true?

A. Yes.

Q. And what does the Value Line Investment Survey indicate that the inflation rate was in 2003?

A. 1.9.

Q. And what does it say the inflation rate will be in 2004?

A. 2.

Q. 2 percent?

A. 2 percent. Sorry.

Q. And what does it say the inflation rate will be in 2005?

A. 2.1 percent.

Q. And would that indicate to you that analysts expect inflation to increase?

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

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

A. It is.

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

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

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

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

A. Yes.

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

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

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

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

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

A. Yes.

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

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

Q. Have you ever looked at that book yourself?

A. No.

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

Are you familiar with that concept?

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

Q. I may be able to do that.

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

JUDGE JONES: Yes.

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

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

MR. SWEARENGEN: I've got it.

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

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

May I approach the witness?

JUDGE JONES: Yes, you may.

MR. SWEARENGEN: I've got a copy.

BY MR. SWEARENGEN:

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

A. Yes.
Q. My question is, do you agree with that statement?
A. You're referring to the statement, Some analysts and commissions base their overall estimate on what they regard as a typical objective or ideal capital structure?
That's the statement that you're referring to specifically --
Q. Yes, sir.
A. -- that's highlighted?
I agree with that statement. I agree that there's many opinions on that as well as far as what's typical, what's objective, what's ideal.
Q. One thing -- and are you familiar with any analysts that have said that or adopted that principle?
A. Not to my knowledge. As far as anybody specifically, no.
Q. But you would agree with it, nonetheless?
A. I'd agree that there are many things that you can do to evaluate whether or not a capital structure is, you know, typical or objective.
Q. You agree with the concept regardless of who said it --
A. Yes.

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

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

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

Q. Okay. Thank you.

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

A. MPS and L&P.

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

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

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

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

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

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

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

A. Yes, I do.

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

Is that your testimony?

A. That's my testimony.

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

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

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

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

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

ER-93-37 that went into some detail about that, did you not?
A. Yes.
Q. Have you ever read any of the record or transcript of proceedings or the testimony that was filed in that case, ER-93-37?
A. I think I stated before I read just the part of the Report and Order that dealt with the rate of return and -- and capital structure.
Q. And did the Commission not in that case endorse the approach to the divisional capital structure that Aquila was supporting in that case?
A. In that case.
Q. They did. Right?
A. In that case.
Q. Let me ask you this. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?
A. Can you repeat the question, please?
Q. Sure. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?
A. I would say that the -- the capital is assigned or allocated to all the divisions of the

consolidated operation of Aquila would -- would obviously have to add up to the consolidated equity ratio.

Q. Say that again.

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

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

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

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

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

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

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

A. No.

Q. You disagree with that?

A. Disagree.

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

A. Repeat the question, please.

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

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

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

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

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

A. The Commission weighed its evidence in that case.

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

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

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

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

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

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

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

A. I wasn't here in 1993.

Q. So you don't know?

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

Q. Do you know who was?

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

Q. Who's Jay Moore?

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

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

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

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

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

Q. At any level.

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

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

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

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

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

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

A. Yes.

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

That's your testimony?

A. Yes, it is.

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

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

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

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

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

A. If you looked hard enough, you might. It's not --
Q. Have you ever seen it?
A. It's not a generally recognized financial term.
Q. Have you ever seen it?
A. In my college financial text? I don't recall.
Q. Okay. How does a fictitious capital structure, however you define that, differ from a hypothetical capital structure?
A. Like I said, a hypothetical I think is the same as a fictitious capital structure. A hypothetical capital structure is used primarily just to come up with a discount rate.
There's no attempt, when you're using a hypothetical capital structure, to give the representation that that capital is -- that mix of capital is actually there. It's just to determine what the discount rate to use is for -- you know, as a net present value calculation for a project, whether it's a go or not.
Q. Has this Commission ever used a hypothetical capital structure for purposes of setting rates?
A. St. Joseph Light & Power, I believe.
Q. Really?
A. I believe it was proposed. I recall that it

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

Q. Proposed by who?

A. Proposed by Staff.

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

A. I believe that was the case.

Q. What case was that?

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

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

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

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

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

Q. What wasn't reasonable?

A. The capital structure.

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

A. The actual consolidated capital structure.

Q. Consolidated capital structure. What do you mean by that with respect to St. Joe Light & Power consolidated capital structure?

A. Its actual capital structure that's on the books reported to the SEC.

Q. Have you read that case? Are you familiar with that case where the hypothetical capital structure was proposed by the Staff?

A. Not in detail.

Q. Okay. Well, what did the Commission decide in that case?

A. You know, I don't recall if they -- if they adopted that or not.

Q. If the purpose of all this is to determine an appropriate capital structure for rate-making purposes, what is the difference between a hypothetical capital structure and an allocated capital structure?

A. Well, I believe -- I believe there's some dispute on that. I think in the collateralization case there was, you know, some indication from the company that Staff was trying to make a distinction without a difference.

There is definitely a difference. A hypothetical capital structure is used when the capital structure is determined to be unreasonable, whether it's because it's not consistent with the company's historical capital structure or whether it's not consistent with comparable companies, what have you. There's a decision to use a hypothetical capital structure.

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

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

Q. So is it a fictitious capital structure?

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

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

A. Exactly.

Q. Okay.

A. I mean --

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

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

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

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

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

A. I think they kept it within that case.

Q. Yeah.

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

JUDGE JONES: No.

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

JUDGE JONES: At least until 3:00.

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

BY MR. SWEARENGEN:

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

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

Q. Okay.

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

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

A. Yes.

Q. And is it fair to say that those are both theoretical processes or attempts to measure the returns required by investors?

A. Yes.

Q. And would you agree that those processes are based generally on the price of those equities, their projected future cash flows and their volatility?

A. I'd say the discounted cash flow is -- specifically addresses the prices of the stocks, the dividends associated with those stocks, potential growth rates for capital appreciation going forward, the capital asset pricing model doesn't necessarily involve the price of the stock.

It involves the beta, which is the measure of the volatility of the stock as it relates to the market added to some -- some interest rate which is usually a risk-free treasury with the beta times the market return to come up with an estimate. So that's not directly related to the price of stock as far as the CAPM.

Q. Would you turn to Schedule 16 to your Direct Testimony?

A. Yes.

Q. Is it on that schedule, Mr. Murray, that you set out your DCF estimated cost of common equity for your six comparable companies?

A. Yes.

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

A. That's correct.

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

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

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

A. Yes, I have.

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

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

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

A. That's correct.

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

A. No. It's impossible.

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

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

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

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

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

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

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

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

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

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

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

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

A. Well --

Q. -- other enterprises with corresponding risks?

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

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

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

Q. Well, let's say hypothetically you did a company-specific DCF analysis and you came up with a recommended return on equity of let's just say 10 percent. And then you went out and you selected a group of truly comparable companies and you did a DCF analysis on each one of those companies and then averaged them together and the average was 12 percent. What would that tell you about your company-specific DCF analysis that resulted in 10 percent?

A. Well, because of the fact that I did a company-specific DCF analysis, I would realize I did a very detailed analysis such as I did in Empire to have a very strong comfort level that that is the cost of capital to that company. And if -- if the cost of capital was higher for some of those comparable companies, there must be a reason for it.

Q. Well, wouldn't you try to look into it? I mean, if there was some reason, some problem with those companies, then maybe they really weren't comparable?

A. I'm not sure. If I knew -- if I knew the subject company well enough, which I obviously do any time I do a company-specific DCF analysis, I have a very -- I'll tell you, I have a fairly good comfort level that my cost of capital recommendation is reasonable already, but I can look at some of those just to get an idea. And unless there's something that's just totally out of whack, I'm not going to --

Q. Well, what I'm trying to get at is -- and I'm trying to figure out how things work here with the Staff and their return on equity recommendations. And I understand what the DCF-specific analysis is and I think you've explained that.

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

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

Q. Sure. That's fine

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

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

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

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

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

Q. To who?

A. To the utility company.

Q. Which one?

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

Q. Well, that's fine.

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

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

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

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

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

JUDGE JONES: Try to wrap it up.

With that, the objection's overruled.

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

BY MR. SWEARENGEN:

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

A. Yes.

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

A. Yes.

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

A. That's correct.

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

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

demand for electricity obviously.

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

A. Yes, I do.

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

A. Can you refer me to specific lines again?

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

A. Line 18?

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

A. Okay.

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

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

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

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

Q. Was it at about the 7,500 level two years ago, three years ago, do you recall?

A. I don't recall the specifics. I know it was -- obviously went down after March 2000. The specific levels I don't recall.

Q. You don't recall when it was ever at 7,500?

A. I don't recall specific dates.

Q. Let me ask you this question. Turn to page 39 of your Surrebuttal Testimony. There, beginning on line 4 of page 39 you make this statement, The Staff of the Missouri Public Service Commission does not use allowed ROEs in other jurisdictions in order to recommend a fair and reasonable ROE for utility companies in Missouri; is that true?

A. Yes.

Q. And I think you testified this morning that at least you personally have never read any decisions from any other regulatory jurisdictions; isn't that true?

A. I don't make a habit of that.

Q. Is this a policy of the Commission Staff in a Commission rule someplace that you're aware of?

A. No.

Q. Do you know whether this policy of the Commission Staff has ever been adopted by the Commission through a Report and Order?

A. I'm not aware.

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

A. I'm not aware.

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

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

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

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

Q. And who's that?

A. Ron Bible.

Q. And did he tell you that?

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

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

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

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

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

A. Yes.

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

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

Q. So you can't square the two?

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

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

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

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

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

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

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

Q. Page 9, I think line 5.

A. Yes.

Q. Do you recall that?

A. Yes.

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

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

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

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

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

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

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

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

A. Yes, I was.

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

A. Yes, we've consistently done that.

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

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

Q. And what was the date of that?

A. The date of that capital structure?

Q. Yes.

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

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

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

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

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

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

A. Rating agencies' view of what companies?

Q. Utility securities.

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

Q. Give some examples.

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

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

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

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

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

A. For what type of companies?

Q. For utility companies.

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

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

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

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

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

JUDGE JONES: Do you have many more questions?

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

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

MR. SWEARENGEN: Thank you, Judge.

(A recess was taken.)

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

BY MR. SWEARENGEN:

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

A. Yes.

Q. And on that document you show selected financial ratios for your comparable electric utility companies. Correct?

A. Yes.

Q. And the column No. 5 is 2003 Projected Return on Common Equity?

A. Yes.

Q. And it shows or suggests the projected return for your six comparable companies is 12.83 percent; is that true?

A. Yes.

Q. And the lowest of those companies is IDACORP, is that how you pronounce it?

A. Yes.

Q. At 4.5 percent --

A. Yes.

Q. -- projected return?

If you would eliminate IDACORP from that list, which is the extreme outlier on the low end, would you agree with me that the projected return for your comparable companies would be 14.5 percent?

A. I'll accept that.

Q. And, once again, how did the projected returns for your comparables compare to what you're actually

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

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

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

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

A. Yes.

Q. What is column 4 intended to show?

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

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

A. Yes.

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

A. That's correct.

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

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

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

A. That's correct.

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

A. That's correct.

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

A. For historical, that's correct.

Q. And so the average is .11 percent?

A. For historical, that's correct.

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

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

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

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

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

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

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

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

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

A. I believe I recall that data request.

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

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

A. That sounds correct.

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

THE WITNESS: Thank you.

JUDGE JONES: Thank you.

Will there be any redirect from Staff?

MR. MEYER: Very briefly, your Honor.

JUDGE JONES: Go right ahead.

REDIRECT EXAMINATION BY MR. MEYER:

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

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