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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

DAVID MURRAY

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

CASE NO. ER-2001-672

Jefferson City, Missouri
January 2002

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Q. Please state your name.

A. My name is David Murray.

Q. Are you the same David Murray who filed direct testimony in this proceeding for the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am.

Q. In your direct testimony, did you recommend a fair and reasonable rate of return for the Missouri jurisdictional electric utility rate base for Missouri Public Service, a division of UtiliCorp United, Inc. (UtiliCorp)?

A. Yes, I did.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Mr. John C. Dunn. Mr. Dunn sponsored rate of return testimony on behalf of Missouri Public Service (MPS). I will address the issues of appropriate capital structure, embedded cost of long-term debt, embedded cost of preferred stock and the cost of common equity to be applied to MPS for rate making purposes in this proceeding.

Cost of Common Equity, Capital Structure, Embedded Cost of Long-Term Debt and Preferred Stock

Q. Is there agreement between Office of the Public Counsel (OPC) and Staff on embedded cost of preferred stock and embedded cost of long-term debt?

A. Yes. As stated on page 8, lines 6 through 11 of Mr. Mark Burdette's (OPC's witness) direct testimony, OPC has chosen to adopt the Missouri Public Service Commission Staff's methodology and recommendation for the calculation of the amount and embedded cost of long-term debt. I believe that Mr. Burdette intends to adopt Staff's embedded cost of preferred stock in his rebuttal testimony.

Q. Is there agreement between MPS and Staff on embedded cost of preferred stock and embedded cost of long-term debt?

A. No. Mr. Dunn does not include preferred stock in his capital structure for his recommended rate of return. Therefore, he has not made this calculation anywhere in his direct testimony. Mr. Dunn does provide an embedded cost of long-term debt on page 27, lines 12 through 15 of his direct testimony. However, he does not provide any supporting schedules for this recommended embedded cost of long-term debt. Consequently, my embedded cost of long-term debt, which has supporting schedules, should be adopted.

Q. Is there an agreement between Staff, MPS and OPC on capital structure and cost of common equity for MPS?

A. Mr. Burdette uses UtiliCorp's consolidated actual capital structure in his direct testimony, which is the capital structure that I have recommended. However, he did include short-term debt, which I did not because as of June 30, 2001, the construction work in progress (CWIP) balance exceeded the short-term debt balance. Mr. Burdette recommends a slightly different cost of common equity than Staff. Staff and MPS have not agreed on any specific capital structure or on a recommended cost of common equity.

<u>Mr. Dunn's Recommended Capital Structure for MPS</u>

Q. Please summarize Mr. Dunn's capital structure recommendation for MPS.

A. Mr. Dunn proposes the use of MPS's book divisional capital structure for the test year, which he claims is composed of 52 percent long-term debt and 48 percent common equity.

Q. How does UtiliCorp determine the allocated capital structure for MPS?

A. The full explanation of UtiliCorp's capital allocation system is contained in Mr. Dunn's direct testimony on page 14, line 26 through page 17, line 8. However, I will provide a brief summary of their capital allocation system.

UtiliCorp assigns capital structures to divisions by establishing a capital structure that they believe is appropriate for the line of business being financed. Apparently, UtiliCorp intends to make the allocated capital structure similar to the "capital structures of similar publicly traded companies, in this case, electric utility companies." (Dunn Direct, p. 15, ll. 1-2).

Mr. Dunn claims that UtiliCorp performed a proxy analysis to determine the proper capital structure ratios to be applied to MPS. Mr. Dunn claims that this analysis, which was not provided with Mr. Dunn's direct testimony, is based on a group of companies that perform "activities of which are confined as nearly as possible in a single line of business (i.e. without diversification)." (*Id.* ll. 11-12). Mr. Dunn claims that this analysis is "very similar to the 'comparative company' analysis used in most regulatory reviews." (*Id.* ll. 16-17).

Mr. Dunn claims that the current target common equity ratio for MPS is 47.5 percent and has been at that level for the past five years. Mr. Dunn also claims that the actual common equity ratio of MPS will not always be 47.5 percent, but will "closely move around the target ratio." (*Id.* p. 16, l. 13). Mr. Dunn further states that the "actual capital structure of MPS is the product of conventional accounting and financial methods." (*Id.* p. 16, ll. 8-9)

Mr. Dunn notes that the Commission, in its Report And Order On Remand in the partially settled Case No. ER-93-37 on April 4, 1997, adopted the result of UtiliCorp's capital allocation process. However, in UtiliCorp's most recent rate case (Case No. ER-97-394) for MPS, the Commission stated in its Report And Order that:

> Based on substantial evidence of record, the Commission finds that the consolidated capital structure proposed by the Staff accurately reflects the correct capital structure of UtiliCorp itself, and therefore MPS, during the actual test year. (page 6).

Staff has used the consolidated capital structure as of June 30, 2001.

Q. Does Mr. Dunn provide any further alleged support for the reasons why he believes that UtiliCorp's capital allocation system is reasonable?

A. Yes. On page 17, line 10, through page 18, line 14 of his direct testimony, Mr. Dunn states additional reasons why he feels that UtiliCorp's capital allocation system is reasonable. Mr. Dunn claims that the average common equity ratio of 46.24 percent for his proxy group of "electric utility" companies justifies UtiliCorp's capital allocation system because it is similar to that of the common equity ratio that is allocated to MPS. Mr. Dunn concludes that: "The MPS capital structure is realistic and is the result of a rational allocation system and this Commission has so found." (*Id.* p. 18, ll. 13-14).

Q. Do you have any concerns with Mr. Dunn stating that "this Commission has so found" when justifying the use of an allocated capital structure for MPS?

A. Yes, I do. This statement can be misleading because although he is correct that the Commission did decide to use the allocated capital structure system in the partially settled Case No. ER-93-37, the Commission adopted the consolidated capital structure of UtiliCorp in the most recent, fully litigated Case No. ER-97-394. Additionally, in its Report And Order in Case No. ER-90-101, the Commission set rates for MPS based on UtiliCorp's consolidated capital structure. Therefore, a blanket statement that the "Commission has so found" that an allocated capital structure is reasonable is entirely misleading.

Q. What are your concerns with the use of an allocated capital structure system, such as the one UtiliCorp uses for MPS?

A. I have explained many of my concerns with the use of an allocated capital structure system in my direct testimony on page 21, line 10 through page 22, line 16. However, I will reiterate some of these concerns for convenience.

Because the debt and equity are generated from the parent company, UtiliCorp, MPS relies on UtiliCorp to finance its investment in MPS assets. Because MPS does not issue its own debt or equity, I relied upon the actual capital structure for UtiliCorp to calculate the rate of return for MPS. If MPS were a subsidiary of UtiliCorp and it issued its own debt capital, then the MPS capital structure would be a reliable capital structure because MPS would have its own capital structure. Staff has recommended subsidiary capital structures in the past, most recently in St. Louis County Water, Case No. WR-2000-844, where the subsidiary issues its own debt. However, this is not the scenario with MPS. It is a separate division of UtiliCorp by virtue of a management decision, and does not have direct access to debt markets. Because MPS is a division of UtiliCorp, its allocated capital structure is determined by internal forces, management and accountants and, therefore, cannot be relied upon as accurate for costing capital.

Further, as I previously stated in my direct testimony, the use of MPS's allocated capital structure with an embedded cost of debt based on UtiliCorp debt issuances, results in a mismatching of costs. In order to determine an overall cost of capital for MPS, the traditional weighted average cost of capital (WACC) calculation usually requires four components: the embedded cost of long-term debt, the embedded cost of preferred stock, the embedded cost of short-term debt and the cost of common equity. When calculating an embedded cost of debt for a division of a company that does not issue its own debt, it is necessary to determine the embedded costs of the debt issuances from the consolidated company. These embedded costs are a function of the bond rating (BBB for UtiliCorp) of the parent company. The bond rating of UtiliCorp is a function of its capital structure, among other things. If one were to use an embedded cost of debt that is a function of the parent company's capital structure, but apply it to a capital structure that is different than that reflected by the bond rating, then the embedded cost of debt may be too high or too low based on the allocated capital structure.

In essence, when using an allocated capital structure with the embedded cost of debt of the parent company, there is a mismatching of costs. Using actual capital structure alleviates this problem because the embedded cost of debt is a function of the credit rating, which is a function of the contributing capital structure.

Q. Do you have any further evidence that undermines the credibility of the capital allocation system that is used for MPS?

A. Yes. In my direct testimony, I performed a comparative company analysis to determine the appropriate cost of common equity to be applied to MPS. As Mr. Dunn stated in his direct testimony on page 15, lines 9 through 17, this type of analysis is very similar to the type of analysis that UtiliCorp performed internally five years ago to determine the targeted allocated capital structure for MPS. However, my current "proxy" analysis shows a much lower common equity ratio than the one UtiliCorp determined for MPS five years ago.

The average common equity ratio for my proxy group of companies was 38.66 percent (Schedule 21 of my direct testimony), almost 10 percentage points below the requested 48 percent common equity ratio in UtiliCorp's allocated capital structure, which is based on a proxy group analysis. Although I do not know how UtiliCorp selected their proxy group of companies for their analysis five years ago, I do know that the selection criteria (Schedule 12 of my direct testimony) I chose was objective, which removes the possibility that I could have selected companies with the intention of trying to achieve a low common equity ratio.

In fact, the 38.66 percent average common equity ratio in my proxy group includes companies that have credit ratings that are above BBB (Schedule 21 of my direct testimony), which is the credit rating of UtiliCorp. As a general rule of thumb, companies in the same segment of an industry that have higher credit ratings will tend to have higher common equity ratios than companies that have lower credit ratings. This generality should only be considered for purposes of this discussion. If I were to remove the four companies in my proxy group that have a credit rating higher than that of UtiliCorp, then the remaining three companies that have BBB credit ratings would have an average common equity ratio of 33.53 percent, which is even lower than the average for the entire group.

Q. Can you consider your seven companies a representative sample of the entire electric utility industry?

A. No. I would not say that the seven companies in my comparable group of companies is a representative sample of the electric utility industry, but I believe they are a representative sample of the segment of the electric utility industry that is most comparable to MPS.

Q. What are the average common equity ratios for a representative sample of the electric utility industry?

A. The September 2001 C.A. Turner Utility Reports indicates an average common equity ratio of 37 percent for the 37 "electric" companies that it analyzes. It also indicates an average common equity ratio of 36 percent for the 46 "combination electric and gas" companies that it analyzes. Although this could be considered as a representative sample of these industries, it should be noted that the companies C.A. Turner analyzes can be quite diverse and may receive as little as 4 percent of their revenues from electric operations. However, in light of the fact that many of the companies followed by C.A. Turner, such as Dynegy and UtiliCorp, are involved in risky endeavors such as energy marketing and trading, the equity ratios indicated by this sample could be considered conservative if applied to a regulated utility. I will explain the rationale behind this concept later in my rebuttal testimony.

Additionally, the The Value Line Investment Survey, December 2001, indicates that the average common equity ratio for electric utilities in the central region of the country is 41.4 percent. It reports an average common equity ratio of 43.3 percent for the east region. Finally, it reports an average common equity ratio of 39.1 percent for the west region. All of these figures confirm that if an allocated capital structure were to be used, an appropriate allocated common equity ratio should be in the range of 36 percent to 43 percent, not at the level of 48 percent recommended by Mr. Dunn. However, if the actual capital structure of the parent or subsidiary is reasonable and verifiable, then this capital structure should be used because it more accurately reflects the cost of capital. Nevertheless, if the Commission chooses an allocated capital structure system, then it should be based on the proxy group that I have chosen, which has a common equity ratio of 38.66 percent, because this group most accurately reflects the risk characteristics of MPS and is consistent with the other broader electric utility averages.

Q. Assuming that you agreed with UtiliCorp's use of an allocated capital structure for MPS, is the current allocated capital structure applied to MPS consistent with basic financial theory?

A. No. A review of Schedule 7 in my direct testimony reveals that UtiliCorp's common equity ratio has ranged from a low of 34.91 percent in 1999 to a high of 42.46 percent in 1998. This information is based on year-end financial information provided in UtiliCorp's yearly Annual Reports. Because UtiliCorp's allocated capital structure proxy group analysis was done five years ago, I would presume that UtiliCorp has been allocating common equity over the past five years to MPS based on the 47.5 percent target they set. The fact that UtiliCorp is allocating a common equity ratio to MPS that is higher than the consolidated common equity ratio of UtiliCorp, which includes international operations, and more importantly, energy merchant and services operations, is not congruent with commonly understood financial theory. It is the higher risk business ventures, such as energy marketing and trading or wholesale power generation, that should have high allocated common equity ratios.

As indicated in UtiliCorp's SEC 425 filing on December 19, 2001, the energy merchant operations of Aquila, Inc. (Aquila) are expected to consist of 62 percent of the net income of UtiliCorp on a pro forma basis after the reacquisition of Aquila shares as of September 30, 2001. In light of the fact that the riskier, energy merchant operations make up a large portion of UtiliCorp's business, it is reasonable to conclude that the consolidated operations of UtiliCorp are higher in risk than MPS. Therefore, MPS should actually have an allocated common equity ratio lower than that of the actual consolidated common equity ratio of UtiliCorp.

The rationale of having less equity applied to a lower-risk, regulated business is that in order for a regulated, low-risk business venture to maintain a given credit rating it will not have to maintain as much common equity as a higher-risk, competitive business venture.

Q. Do you have any evidence that supports your position on less equity being required to support a credit rating for a business with relatively little risk, such as MPS?

A. Yes. On October 19, 2001, Standard & Poor's affirmed the ratings of UtiliCorp United, Inc. (BBB/Stable/A-2) and its affiliates. This affirmation followed the firm's announced deal to purchase Midlands Electricity PLC with a financial partner. This acquisition was filed for approval with the Commission under Case

No. EO-2002-215. Todd A. Shipman, CFA of Standard & Poor's made the following comments regarding the affirmation of UtiliCorp's credit rating:

> The ratings on UtiliCorp reflect its average business position and gradually improving financial profile. The regulated utility operations are supported by sales and earnings stability derived from international geographic and economic diversity. The credit profile of UtiliCorp's unregulated operations is weaker than the company's core utility business, but UtiliCorp placed a public offering of a 19.9% ownership stake in its Aquila Inc. energy marketing and trading subsidiary in 2000 and intends to spin off the rest of Aquila to its shareholders by the end of 2001.
>
> The operations of UtiliCorp after the spin-off of Aquila will be dominated by a collection of relatively low-risk, regulated utility assets. However, the improvement in the company's business profile is likely to be offset by an increase in its financial risk so that the overall creditworthiness of UtiliCorp will not improve. To the extent that the plans for Aquila are not accomplished as currently envisioned by the company, Standard & Poor's expects UtiliCorp to adjust the level of financial risk to remain consistent with its business risk so that its creditworthiness is held constant.
>
> The stable outlook reflects the expected improvement in UtiliCorp's business risk profile upon the completion of its spin-off of Aquila to its shareholders, offset by the expectation that financial leverage will increase in proportion to the decrease in business risk. (Standard & Poor's *Utilities & Perspectives,* October 29, 2001, p. 10)

Although some of the information mentioned in the above quotation is outdated as a result of UtiliCorp's announcement of its intention to reacquire the portion of Aquila that had been spun-off, there are some key comments in this credit rating affirmation that support my assertion that an allocated capital structure for MPS should have less common equity than the consolidated common equity ratio of UtiliCorp. As indicated above, the credit profile of "UtiliCorp's unregulated operations is weaker than the company's core utility business." Mr. Shipman is implying that the unregulated operations, such as those of Aquila, tend to raise the overall level of risk for UtiliCorp on a consolidated basis. Assuming that Aquila had been entirely spun-off, as UtiliCorp originally intended to do, Mr. Shipman states that the operations of UtiliCorp would have been "dominated by a collection of relatively low-risk, regulated utility assets." However, if this occurred, Mr. Shipman projected that "the improvement in the company's business profile is likely to be offset by an increase in its financial risk so that the overall creditworthiness of UtiliCorp will not improve." Clearly, Mr. Shipman feels that the regulated operations, such as MPS, are of less risk to UtiliCorp. Otherwise, he would not state that UtiliCorp would maintain its current credit rating if it increased the debt on its books because of its improved business risk profile.

It is quite clear that Mr. Shipman felt that because UtiliCorp was tending toward a predominantly regulated, low-risk business, its balance sheet could withstand having more debt and, as a result, a lower common equity ratio. This statement provides further support that a regulated operation such as MPS should not have a common equity ratio allocated to it that is either equivalent or higher than the common equity ratio of the riskier, consolidated parent company of UtiliCorp.

Q. Notwithstanding the above discussion about the proper capital structure to use for MPS, what are the current implications of using the consolidated capital structure of UtiliCorp versus the allocated capital structure for MPS?

A. According to Staff's revenue requirement reconciliation on December 11, 2001, the use of UtiliCorp's actual capital structure as of June 30, 2001, actually results in $2,138,964 of additional revenue required than that which would be achieved under Mr. Dunn's proposed allocated capital structure. As explained on page 18, line 23 through page 19, line 5 of my direct testimony, this is a result of UtiliCorp's improved balance sheet, which now has a higher common equity ratio. Although the use of UtiliCorp's actual capital structure currently produces a higher revenue requirement for MPS than that of the allocated capital structure, it is quite possible that this will change, whether higher or lower, during the true-up period. Of course, this will have to be evaluated at the time the true-up information becomes available.

Mr. Dunn's Comparable Companies

Q. Do you have any concerns about the companies Mr. Dunn selected for his proxy group that would make the application of his proxy group cost of common equity to MPS questionable?

A. Yes. First, in light of Mr. Dunn's concerns about the smaller size of MPS, I think he should exclude Ameren and NiSource, Inc. because their market capitalization is over $5 billion. Actually, the market capitalization of these companies is higher than that of UtiliCorp, which was $3.1 billion as of August 6, 2001 (The Value Line Investment Survey: Ratings & Reports, October 5, 2001). Mr. Dunn claims that he "eliminated companies that were many times larger than the typical electric utility company." (Dunn Direct, p. 29, ll. 10-11). I would presume that he would do so in order to choose a subset of electric companies that are not so large as to make them incomparable to MPS. I presume that his vague criterion of eliminating companies that "were many times larger than the typical electric utility company" would be the means of assuring his subset of companies is comparable to MPS and, therefore, there would not be any need for adjustments. I chose my objective criterion of eliminating companies with total capitalization of greater than $5 billion in order to ensure that I did not select "larger" companies.

Second, not only is Ameren a larger electric utility, but it also operates in the state of Missouri. The same is true for Kansas City Power & Light, another comparable company used by Mr. Dunn. It is has been Staff's position that any Missouri jurisdictional utility companies should be eliminated because they are directly impacted by decisions of this Commission.

Third, Mr. Dunn used IPALCO, which was the target of an acquisition by AES Corporation (AES). AES agreed to acquire IPALCO sometime during the middle of 2000. Consequently, IPALCO's stock price could have been influenced by the announcement of this acquisition, thereby making the results of the DCF calculation for this company questionable.

Finally, Mr. Dunn uses a few companies in his comparable group that do not receive a majority (less than 50 percent) of their revenues from electric operations. According to the September 2001 C.A. Turner Utility Reports, Allete received 41 percent of its revenues from electric operations, NiSource, Inc. only received 14 percent of its revenues from electric operations and OGE energy received 40 percent of its revenues from electric operations. Although Cleco Corporation and Wisconsin Energy receive more than 50 percent of their revenues from electric operations, they do not meet my more stringent criterion of having at least 70 percent of revenues from electric operations.

After eliminating all of the companies that I have concerns with, only one company, DPL, Inc., remains in Mr. Dunn's comparable group that meets my standards of comparability.

<u>Mr. Dunn's Recommended Cost of Common Equity for MPS Based on His Comparable Companies</u>

Q. Please summarize Mr. Dunn's recommended cost of common equity for MPS?

A. Mr. Dunn used the discounted cash flow (DCF) model to calculate a "benchmark, industry cost of capital." (*Id.* p. 27, l. 19). He then used this "data, a calculated risk adjustment, and judgment" in finalizing his recommendation. (*Id.* l. 22). Mr. Dunn calculated a dividend yield of 4.80 percent, of which 0.30 percent was the result of the addition of flotation costs, and then he chose a growth rate of 7 percent to arrive at his estimated minimum cost of common equity for the proxy segment of 11.80 percent. Mr. Dunn claimed that because MPS has greater risk than the proxy group and because of "the probability of some unexpected negative events," a return on equity in "the range of 11.75 to 12.25 percent is appropriate." Mr. Dunn further states, "a return toward the upper limit of the range would be appropriate to reflect the greater risk of MPS." (*Id.* p. 52, ll. 22-26).

Q. Does Staff agree with Mr. Dunn's 30 basis point adjustment to the dividend yield to consider flotation costs?

Q. No. In the Report And Order On Remand in Case No. ER-93-37 (Missouri Public Service, a Division of UtiliCorp United Inc.) issued on April 4, 1997, the Commission stated "an upwards adjustment for flotation costs is not warranted since MoPub does not issue common stock." Staff agrees with this position.

Q. Do you agree with Mr. Dunn's conclusions that MPS should receive the higher end of his recommended cost of common equity range (11.75 percent to 12.25 percent) because it is more risky than the proxy group that he used?

A. No, I do not.

Q. On page 49, line 9 through the end of page 52 of Mr. Dunn's direct testimony, Mr. Dunn discusses issues related to his heading "MPS Specific Risk." Do you agree with Mr. Dunn's assessment that he uses to justify his recommendation of a return on equity toward the upper end of his range?

A. No. Although Mr. Dunn states this on page 49, line 11 of his direct testimony, it should be emphasized that Mr. Dunn recognizes the fact that the business risks he identifies are "similar to other electric utility risks." Therefore, although he is trying to quantify if MPS is more exposed to these business risks than his proxy group, he does recognize that these risks are common to all electric utilities. It is important to clarify this because the analysis of the proxy groups' cost of common equity through the DCF analysis already captures these risks by means of the price investors are willing to pay for the proxy companies' stocks.

Although I do not agree with Mr. Dunn's approach to measuring the risk differential between his chosen proxy group and MPS, I do agree a risk adjustment is warranted if the average credit ratings of the proxy group are different from that of the company subject to the recommended cost of common equity. However, I feel that the approach that I explained on page 29, lines 19 through 23 and page 30, lines 1 through 12 of my direct testimony is superior and free from arbitrary judgment as compared to the approach used by Mr. Dunn. The approach I used allows for a specific quantification of the adjustment that should be made to the cost of common equity, whereas Mr. Dunn's approach requires a vague recommendation that the upper end of his range should be used. Of course, it is important to emphasize that a risk premium adjustment is contingent on the selection of a proxy group that is as similar as possible to the subject company's business.

Q. Do you agree with Mr. Dunn's assessment that MPS should receive a risk premium adjustment because of "The Firm Size Phenomenon" (Ibbotson Associates, Inc.'s Stocks, Bonds, Bills, and Inflation: 2000 Yearbook)?

A. No. First, the purpose of selecting a group of **comparable** companies is to avoid the need for these types of disputable risk adjustments. This is exactly why I chose to limit my comparables to those companies with total capitalization of less than $5 billion (see Schedule 12 of my direct testimony). Mr. Dunn included two companies, Ameren and NiSource, in his proxy group that are large capitalization companies, meaning that their market capitalization is over $5 billion. If Mr. Dunn were concerned about "The Firm Size Phenomenon," then I believe he should have excluded these large capitalization companies, eliminating the need for a "small size" adjustment.

Second, it appears that most of the research on this alleged phenomenon is based on the comparison of small stocks and large stocks, which means that these companies are publicly traded. MPS is not a publicly traded company. It is a division of a company, UtiliCorp, which is publicly traded. Therefore, applying an analysis on publicly traded companies to that of a division of a larger publicly traded company is highly questionable.

Q. Do you have any concerns with Mr. Dunn's recommended growth rate range?

A. Yes, I do. Based on his proxy companies (I discussed my concerns with above), Mr. Dunn chooses to recommend a growth rate of 7 percent for MPS. This is not a realistic growth rate for a regulated electric utility. One element of growth for a company is its growth in revenues. As I stated in my direct testimony, according to Standard & Poor's Global Utility Rating Service, January 2000, UtiliCorp's "annual electric sales and customer growth have averaged about 2 percent and are expected to continue at that growth rate for the foreseeable future. Sales growth will be supported by expected modest increases in customer base." This can be considered as a good proxy of the projected customer and sales growth rate for MPS. Essentially, if Mr. Dunn were correct in his projected growth rate of 7 percent, then MPS would have to cut expenses by at least 5 percent to achieve this growth rate. A further indicator that Mr. Dunn's expected growth rate is not reasonable is the fact that the Department of Energy's "Annual Energy Outlook 2002" states "electricity demand is expected to grow by 1.8 percent per year from 2000 through 2020." It is important to consider these growth rates when estimating the possible growth of MPS because MPS is a captive entity that is limited in customer growth by its certificated area of service. This means that other than any additional customers that may be added to MPS's system in the future, the only other means of revenue growth is through increased consumption of electricity. Of course, as I stated before, some growth in earnings can come from the reduction of expenses. In light of the above estimates on electric sales growth/demand, I believe that my 3.5 to 4.5 percent growth rate is much more reasonable than Mr. Dunn's 7 percent.

Q. Do you have any additional concerns with Mr. Dunn's growth rate of 7 percent?

A. Yes, I do. On page 34, line 14 through page 41, line 2 of his direct testimony, Mr. Dunn discusses historical and projected growth rates for his comparable companies. Based on this analysis, Mr. Dunn chooses a growth rate of 7 percent for MPS. Mr. Dunn chose this growth rate based on his evaluation of his comparable companies that indicates "that the rates of growth are trending up and that the five year average growth in earnings has been almost 6 percent." Based on this comment it appears that Mr. Dunn only gave weight to historical earnings per share and disregarded historical dividends per share and historical book value per share when evaluating historical growth rates. On page 35, line 28 through page 36, line 10 of his direct testimony, Mr. Dunn explains why he feels that earnings should be given the most weight. He explains that dividends are no longer as relevant to the growth in value as are growth in earnings. However, Mr. Dunn does not explain why he feels that historical growth in book value per share should be given less weight than earnings per share.

Q. Do you agree with Mr. Dunn's comment on page 36, lines 6 through 8, that "dividend growth will be replaced by earnings growth as the stock price driver?"

A. I believe this comment may hold some truth for companies that do not pay any or low dividends. However, one of the primary reasons investors still buy certain utility stocks is for the payment of a dividend. In light of the current interest rate environment, where the federal funds rate is now at 1.75 percent and all taxable money market funds are averaging a historically low return of 1.64 percent as of December 19, 2001 (CBS MarketWatch), a dividend yield in the range of 5 to 7 percent could be considered quite attractive to investors. While it is true that many companies in the utility industry are retaining more of their earnings for investment opportunities, it would appear that the retention of these earnings by certain utility companies is for investment in the deregulated aspects of the industry. As quoted in the Wall Street Journal on

December 21, 2001, "before deregulation, most utilities were slow-growing companies that paid handsome dividends, says Wellington Management Co. portfolio manager Mark Beckwith, who runs the $700 million Vanguard Utilities Income Fund. After deregulation, many of these companies made the decision to stop growing dividends and instead to grow their deregulated business. But without that dividend, they made their stocks a lot more vulnerable to volatility." Therefore, if the objective of Mr. Dunn's analysis is to evaluate the cost of common equity for a company that is operating in a deregulated environment, then the disregard of dividend growth may be an appropriate decision; but in this case, we are evaluating a regulated utility, MPS, that does not need to retain earnings to invest in unregulated operations. This is why it is imperative to choose electric utility companies (greater than 70 percent of revenues from electric operations) that have not diversified their operations to such an extent as to make them incomparable to the regulated operations of MPS. Dividends are especially attractive to investors during a bear market because high dividend paying stocks will allow for an offset against some of the losses an investor may take in the decline of stock prices.

Q. Do you feel that your proxy companies are more comparable to a regulated electric utility, such as MPS, where there may not be as much of a need to retain earnings for unregulated business ventures?

A. Yes. The average dividend yield of my proxy group is 5.73 percent. Mr. Dunn calculated an average dividend yield for his comparable companies of 4.5 percent before the additional .3 percent for flotation costs. Because Mr. Dunn's dividend yield only makes up 33 percent of his overall cost of common equity recommendation, this would seem to support Mr. Dunn's position that growth in dividends is not as important to investors as the growth in earnings, but I believe that this position became self-fulfilling by his selection of comparable companies that have low dividend yields and high-growth projections. A comparable group of electric utilities that have a higher dividend payout would be more consistent with the business philosophy of a conservative, regulated electric utility. Because the dividend yield is a major component of my cost of equity calculation, I do not feel it is appropriate to disregard the historical growth in dividends per share.

Q. Do you have any concerns with Mr. Dunn's evaluation of Value Line and Thompson Financial/First Call estimates of growth rates for his comparable companies?

A. I do not have any objection to Mr. Dunn's use of these sources for determining a consensus projected growth rate for his comparable companies. However, I feel that the fact that four of the companies in his group have at least 10 percent growth expectations may give even more credence to the questionable status of these companies as comparable to MPS.

Instead of recognizing that these growth rates are not typical for a regulated electric utility and, therefore, should not be used, Mr. Dunn instead chooses to rely on these projections along with the five-year historical earnings per share growth rate to justify his selection of a 7 percent growth rate for MPS. In fact, Mr. Dunn relies on these high-growth projections to explain that investors have higher expectations for the electric industry than they did in the past. Mr. Dunn further corroborates this expectation on page 39, lines 2 and 3, where he states that Thompson Financial/First Call expects growth for the entire electric industry to be in the range of 11 to 12 percent.

While I agree that growth expectations for the electric utility industry are higher than they were in the past, I disagree that this results in higher expected growth for a regulated utility such as MPS. It is not the regulated electric utilities that are fueling the growth expectations of the electric utility industry; it is the high-growth, deregulated merchant generators and energy marketing and trading operations that are fueling the growth in a deregulated environment. In fact, UtiliCorp recognizes this fact in its 2000 Annual Report when it states, "most regulated utilities achieve lower earnings growth that is well below the financial goals we have set for UtiliCorp the past several years." UtiliCorp uses this statement as an explanation as to why they may not complete further utility mergers.

If anything, Mr. Dunn should have reduced his estimated growth rate for MPS to take into consideration that projections of growth for diversified electric utility companies contain an element of deregulated earnings growth. The fact that many electric utility companies have recently decided to pursue deregulated business ventures may justify the use of historic growth rates as a better proxy for a regulated utility such as MPS.

Q. On Schedules 5, 6 and 7 of Mr. Dunn's direct testimony, Mr. Dunn calculates an average of the one-year growth rates for the period 1990 to 1999. Do you have any concerns with how he calculated these growth rates?

A. Yes, I do. Mr. Dunn uses an arithmetic average to determine the historical growth rates for earnings per share (EPS), dividends per share (DPS) and book value per share (BVPS) for each of his comparable companies. This averaging technique averages all of the one-year growth rates to determine what the average growth was for a given period, in this case 10 years. The fallacy of relying on this type of averaging to determine an investors' expected growth is best illustrated by reviewing the average growth of earnings per share of Wisconsin Energy on Schedule 6 of Mr. Dunn's direct testimony. In this calculation, Mr. Dunn calculated the historical average rate of growth to be 17.55 percent. However, if you were to invest in this company in 1990 (1.85 EPS), and still held this stock in 1999 (1.88 EPS), you would have a hard time accepting someone claiming that your earnings increased by 17.55 percent because in fact earnings only increased by 3 cents during this period, which equates to less than a 2 percent growth in earnings. Perhaps a more extreme example to show the fallacies of this averaging technique is to consider an investment of $1 in a stock over a three-year period. If an investor pays $1 for a stock in year 1 and in year 2 the stock increases by 50 percent to $1.50, then the investor would have a 50 percent growth rate. However, in year three the price of the stock decreases by 50 percent to $.75. If an investor performed a simple arithmetic average of these two returns, then he would think that he received 0 percent [(50 percent + -50 percent)/2] growth in his investment over the three-year period. However, in reality the investor actually had a 25 percent decline in his investment over this three-year period. This is why the arithmetic methodology is questionable.

Q. Does Mr. Dunn include the 17.55 percent average earnings per share growth for Wisconsin Energy in his average historical earnings per share growth rate of 5.59 percent on Schedule JCD-6 of his direct testimony? If so, should he?

A. Yes, he did. I have already explained my concerns with how he calculated this growth rate. However, in light of the fact that Mr. Dunn chooses to exclude negative growth rates in his calculations, because apparently they haven't happened and, therefore, he must feel investors don't consider them, he should not include an abnormally high growth rate in his average growth rate calculations. If Mr. Dunn's opinion is that investors don't consider certain historical growth rates because they are not what investors expect for the future, then he should exclude the 17.55 percent arithmetic average earnings per share growth rate he calculated from his average because the Wisconsin Energy's average Thompson Financial/First Call and Value Line projections is 7.25 percent, which is over 50 percent less than the historical earnings per share arithmetic growth rate. If you were to exclude the 17.55 percent and negative 1.56 percent average earnings per share growth rate from the overall average growth rate in Mr. Dunn's Schedule JCD-6, the average growth rate would be 3.88 percent. This rate is 1.71 percent less than the 5.59 percent earnings per share growth rate in Schedule JCD-7 that Mr. Dunn used to support his recommended 7 percent growth rate.

Q. In light of your aforementioned concerns, did you calculate a cost of common equity using Mr. Dunn's alleged comparable companies?

A. Yes, I did. I decided to calculate an average historical growth rate for Mr. Dunn's comparables using both the historical Value Line EPS, DPS and BVPS figures and the arithmetic calculations that Mr. Dunn made on Schedules 5, 6 and 7 of his direct testimony. Using this methodology, I calculated an average historical growth rate of 3.81 percent. Although I have pointed out my concerns about some of the projected growth rates in Mr. Dunn's comparable group, his projected growth rates cannot be entirely ignored when determining a DCF cost of common equity. Therefore, I decided to average the two projected growth rates Mr. Dunn obtained from Value Line and Thompson Financial/First Call to arrive at an average projected growth rate of 7.60

percent. A simple average of the historical and projected growth rates results in a growth rate estimation of 5.7 percent. The sum of this growth rate with Mr. Dunn's calculated dividend yield, without flotation costs, of 4.5 percent results in an estimated cost of common equity of 10.20 percent, which is in the upper end of my range.

Q. Are you proposing that the Commission make its recommendation based on the estimation you provided in the previous answer?

A. No, as I have already documented in my rebuttal testimony, I do not feel that Mr. Dunn's "comparable group of companies" is comparable to a regulated electric utility such as MPS. The comparable companies that I selected according to my objective criteria are superior to that of Mr. Dunn's. This is corroborated by the fact that my comparable companies' average dividend yield is higher than Mr. Dunn's comparable companies' dividend yield. Additionally, my dividend yield makes up a larger portion of my recommended cost of common equity. Overall, the average characteristics, high dividend yield and slower-growth, of my comparable companies are more typical for a regulated electric utility company, such as MPS. Therefore, for the reasons explained in my rebuttal testimony, the Commission should rely on my comparable group and resulting cost of common equity recommendation.

Q. Do you agree with Mr. Dunn's assessment on page 2, line 21 through page 3, line 5 that indicates that investors are more interested in the new economy than the old economy?

A. I do not agree with Mr. Dunn's assessment of the current capital market conditions. As I explained in my direct testimony on page 12, lines 3 through 9, the NASDAQ, which is largely composed of small, technology types of businesses, was down 46.42 percent for the period of October 17, 2000 through October 16, 2001. This compares to the blue chip stocks in the Dow Jones Industrial Average that have fallen 7 percent during this same period. The S&P 500, which also contains some technology companies, has suffered a decline of 18.24 percent. It is obvious from the evaluation of the performance of these indexes that investors have not "lost interest in the old economy." I would argue that the recent technology meltdown since March of 2000 has actually given investors a wakeup call as to the risks of investing heavily in technology.

True-Up Audit Issues

Q. Are there any issues that may cause you to want to reconsider your recommended rate of return for the true-up period?

A. Yes. There are a couple of transactions, UtiliCorp's purchase of Midlands Electricity PLC and UtiliCorp's reacquisition of 20 percent of Aquila shares, that may have an impact on UtiliCorp's financial statements during the true-up period. I believe it is appropriate to evaluate whether my recommended rate of return is still appropriate for the trued-up period, which may include a reevaluation of my recommended cost of common equity range.

Summary and Conclusions

Q. Please summarize the conclusions of your rebuttal testimony.

A. I conclude the following:

1. The calculation of the cost of capital for MPS should be based on the actual capital structure of UtiliCorp United, Inc. as of June 30, 2001, as shown in Schedule 9 of my direct testimony;

2. My cost of common equity stated in Schedule 24, which is 9.43 percent to 10.43 percent, would produce a fair and reasonable rate of return of 8.49 percent to 8.98 percent for the Missouri jurisdictional electric utility rate base for MPS, a division of UtiliCorp United, Inc.

Q. Does this conclude your rebuttal testimony?

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 Rebuttal Testimony in question and answer form, consisting of ______ pages to be presented in the above case; that the answers in the foregoing Rebuttal 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
David Murray

Subscribed and sworn to before me this 9th day of January 2002.

Toni M Charlton

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28 2004