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

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

FILED[2]

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Missouri Public
Service Commission

SURREBUTTAL TESTIMONY

OF

JOHN C. DUNN

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OF THE STATE OF MISSOURI

SURREBUTTAL TESTIMONY OF JOHN C. DUNN
ON BEHALF OF
MISSOURI PUBLIC SERVICE
A DIVISION OF UTILICORP UNITED INC.
CASE NO. ER-2001-672

INTRODUCTION

Q. Please state your name and business address.

A. My name is John C. Dunn. My business address is 7400 West 110th Street, Suite 750, Overland Park, Kansas 66210. I have previously filed direct and rebuttal testimony in this case.

Q. What is the purpose of this surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimonies filed by David Murray of the Commission Staff ("Staff") and Mark Burdette of the Office of the Public Counsel ("Pubic Counsel").

Q. How will your testimony be organized?

A. My testimony will be divided into two major subsections. In the first part of this surrebuttal testimony, I will deal with the misstatements and misdirection contained in the rebuttal testimonies of both the Staff and Public Counsel and what I believe is the impact of those misstatements on proceedings such as this, including ultimately Missouri Public Service Commission ("Commission") findings on rate of return.

In the second subsection I will respond to their assertions contained in their rebuttal testimonies about capital structure, dividend growth, the comparability of my proxy group of companies, and the risk criteria used by the Staff in selecting a comparative group and used as a standard to criticize my risk selection criteria.

MISDIRECTING THE COMMISSION

Q. Mr. Dunn, by way of background what do you mean by misstatements and misdirection in the testimony which have a significant impact on proceedings such as this?

A. This is a rate proceeding. The utility, as is often the case, is requesting an adjustment in rates to provide a return which it believes is adequate to meet its needs to attract investment capital to its operations so that it may provide safe, adequate and reliable service to its customers. In most rate proceedings before the Commission, the Staff appears to take a position which is contrary to the utility position regardless of whether or not the Staff position is supported by factual data. In this case, I believe the Staff has done this on the rate of return issue. Furthermore, it does so with a wave of the hand and the assertion that "in my opinion it should be done this way rather than the right way."

Q. Can you provide an example?

A. Yes. At page 27 of his rebuttal, Staff witness David Murray concludes:

"2. My cost of common equity stated in Schedule 24, which is 9.43 percent to 0.43 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."

This assertion, which is incorrect, is based on prior inaccuracies contained in his rebuttal. When the Commission accepts these incorrect assertions, it results in findings and conclusions by the Commission which are incorrect and in conflict with the findings of other state regulatory commissions and the needs of the company for a reasonable rate of return.

Q. What about the Public Counsel's rebuttal?

A. Mr. Burdette makes similar claims on page 6 of his rebuttal.

Q. How will you respond to these mistakes?

A. To support my position, I will demonstrate, through text books and articles, how specific statements in the Staff testimony are wrong. They are not arguable. They are wrong. They do not comply with contemporary financial theory and analysis and they do not meet the test of common sense. Secondly, to further support my position that they are wrong, I will show, by a comparison of return findings by the Missouri Commission compared to other surrounding commissions in similar time frames, that Missouri is making findings on rate of return which, by the standards of all other commissions in the geographic area and nationwide, are lower and, in my opinion, inadequate.

Q. What specifically are the problems in these testimonies which misdirect the Commission?

A. I will show how the Staff methodology for selecting companies, the so-called "risk criteria" which it employs are not risk criteria. I dealt with this to a limited degree in my rebuttal testimony, but the Staff through its rebuttal appears to continue to use its criteria as "the standard," requiring additional comment. As I said in my rebuttal testimony, most of the Staff criteria have absolutely nothing to do with risk and, as a consequence, do not produce a comparable group of companies. Furthermore, even with this knowledge in hand, the Staff, through its rebuttal, evidences the intent to repeat the process case after case.

Also, the Staff compounds this problem by continuing in its rebuttal to ignore basic financial theory, and refusing to do a risk adjustment, in spite of the non-comparability of the Staff's comparative group. It has also continued through its rebuttal to propose a capital structure which has nothing to do with reality and which flies in the face of contemporary financial theory. It also completely ignores trends in the utility industry, particularly dividend growth trends, which exist in the marketplace and which are observable as of today. These matters are reported in the financial press and common knowledge. Finally, the Staff seems to assert that the overriding risk measurement comparative tool is bond ratings rather than all of the risk measurement comparative tools used in financial theory and established in financial theory as the proper methods to quantify risk. <u>Bond ratings measure the risk of bonds. Variability in return measures the risk of equity</u>. It is inappropriate to use bond ratings to attempt to estimate the risk of common stock.

Q. What impact do these misstatements have?

A. I believe it leads to errors in Commission decisions. To embody errors into Commission decisions, whether or not it results in a momentary lower than reasonable rate, is not to serve the customers in the State of Missouri in the long run. It may provide an ephemeral or transient benefit, but that benefit will be far outweighed by the long-term costs of inappropriate regulatory decisions based on these misstatements.

For the Commission to make reasonable decisions, it needs reasonable input. In my opinion, that reasonable input should be consistent with contemporary financial theory and the observable facts of the utility industry. The Staff should not have an agenda, but should be fact driven. Sometimes the pursuit of an agenda leads to errors, oversights, misstatements and misdirection.

RISK MEASUREMENT AND ADJUSTMENT

Q. Mr. Dunn, please be more specific with respect to the risk measurement approach which you have used and which has been rejected by the Staff as explained by Staff witness Murray starting at page 16 of his rebuttal.

A. To provide a framework, let me briefly describe how I made my discounted cash flow ("DCF") analysis. I first selected a group of proxy companies which are recognized as electric utilities. They are contained in the Value Line Electric Utility publication for the central United States. Secondly, I did a DCF analysis on those companies. Third, with the data from the DCF analysis, I arrived at a cost of common equity for those companies based on the discounted cash flow model. This is a standard proxy group analysis.

Q. Does that complete a standard proxy group analysis?

A. No.

Q. Why?

A. Because it is widely accepted that it is impossible to select a group of precisely comparable companies, particularly today with diversification in the utility industry.

Q. What did you do next?

A. I did a risk analysis comparing the risk of Missouri Public Service ("MPS") to the risk of the proxy group. That risk analysis was made based on calculations outlined in virtually every introductory and intermediate financial textbook in circulation today and in fact in circulation for the past twenty years. That risk analysis indicated that MPS equity investment was somewhat more risky than the proxy group of companies. That risk analysis consisted of a qualitative review and a risk quantification based on a calculation of the standard deviation and the coefficient of variation of returns. I then made a risk adjustment increasing the return from MPS to reflect the greater risk of MPS than the risk associated with the proxy group. This is the standard financial approach to develop a "risk adjusted return."

As stated by its rebuttal, the Staff has rejected this risk analysis and did not make any effort to properly risk-adjust its own return recommendation.

Q. What did the Staff do in its analysis?

A. It selected a group of companies which it called the comparative electric utilities. Later, I will describe why the Staff selection process was not based on developing a risk comparable group of companies but rather employed for the convenience of the Staff analyst. After selecting the companies, the Staff did a DCF analysis. It then did a CAPM calculation and a risk premium calculation. For some reason, although the three analyses were all done on the same companies, the Staff chose to reduce the DCF indication because of bond rating differences but did not adjust the other two results. It made the DCF reduction while at other points indicating it was the most accepted approach.

Without arguing about the mechanics of the Staff DCF analysis, if that DCF result was appropriate for the Staff group of companies, it may or may not be appropriate for MPS and no one knows if it is or not. This is because no comparison was made between MPS and the Staff group of companies. MPS equity could be wildly more or less risky than the Staff comparative companies and the incomplete Staff analysis would never reveal that fact. The Staff has simply made calculations and said this result goes with MPS because it thinks it does, not because it can prove it does. As a consequence, the Staff misdirects the Commission.

Q. Do you believe that the Staff analysis produced a return which is appropriate for MPS?

A. I do not. The Staff analysis produced a return recommendation biased to the downside for a group of companies which had calculably less equity risk than MPS. As a consequence, the return should have been increased to make it appropriate for MPS. The Staff skipped this last and most important step in its analysis. In other words, the Staff, through its rebuttal again rejects contemporary financial theory and practice in continuing to hold to a position where no accepted risk adjustment is appropriate. The Public Counsel makes the same mistake.

Q. Please explain.

A. On page 16 of his rebuttal testimony, the Staff witness states that he does not agree with my approach to measuring the risk differential between the proxy group and MPS.

Q. How do you respond?

A. The Staff is rejecting basic contemporary financial theories. I have selected three textbooks to demonstrate that fact. The first is Managerial Finance by J. Fred Weston and Eugene F. Brigham. On and following pages 376 of that textbook (an intermediate text), the authors indicate that the standard deviation and/or the coefficient of variation measure the extent to which actual outcomes are likely to vary from expected outcomes and are used as measures of risk.

In Financial Management and Policy by James C. VanHorne, 4th Ed., VanHorne indicates on page 31 that investors select investments on the basis of expected return and standard deviation. Standard deviation is the measure of risk which is used by investors to characterize an expected return as more or less risky.

Finally, in Fundamentals of Financial Management, 5th Ed., by Eugene F. Brigham, on pages 110 and following, the author states that to be useful, any measure of risk should have a definite value. One such measure is the standard deviation. He goes on to say another such measure is the coefficient of variation.

Q. Is this a widely held position in finance?

A. It is. As final follow-up, let me also quote from Regulatory Finance, Utilities' Cost of Capital by Roger A. Moran. At pages 46 and following, the author states that the objective of any investor is to realize a given rate of return on the funds he or she manages. The author goes on to state that risk is one of the primary criteria in evaluating an investment and the classic measure of risk is variability or variance in return or the square root of the variance, the standard deviation.

Q. Does the Staff witness reject this approach in his rebuttal?

A. Yes.

Q. Does the Staff witness offer an alternative?

A. The Staff witness suggests that a risk adjustment may be warranted if average credit ratings of the proxy group are different from the subject company.

Q. Does the Staff position employ contemporary finance theory?

A. No.

Q. How would you characterize the Staff's position?

A. It is unreasonable.

Q. Why?

A. The Staff wants to use bond ratings to adjust for equity risk differences. Bond ratings measure bond risk. Other metrics measure equity risk. Because bond ratings measure the risk of bonds not stocks, it is possible to have AAA bonds virtually without risk to be issued by a company with very high stock or equity risk.

Q. Are there any other obvious conflicts in the Staff position with either finance theory or the facts of the utility industry today?

A. Yes. On page 19 of his rebuttal, the Staff witness addresses my testimony with respect to the current trend in the utility industry which is to generally continue to pay historically established dividends, but not to increase those dividends as rapidly as they have been increased in the past. He indicates that my testimony may hold some truth for companies that do not pay any or low dividends but that the primary reason, or one of the primary reasons investors still buy certain utility stocks is for the payment of a dividend.

Q. Is the Staff assertion correct?

A. It is not.

Q. Is there any clear-cut data which indicates that utility companies are not increasing dividends as rapidly as they have been?

A. Yes. I quoted several sources in my rebuttal testimony. Since that testimony was filed, an article appeared in the January 15th issue of The Wall Street Journal. It compared utility dividend increases from 1992 through 2001. In 1993, the data represented by The Wall Street Journal indicates that approximately 45 utilities increased their dividends. In 2001, the same data indicates that only 15 utilities increased their dividend. The data also goes on to show one year dividend changes for utilities from 1992 through 2001. On the average, one-year dividend changes were positive though in many cases very small for 1992, 1993, 1994, 1995, 1997 and 1999. For 1996 and 1998, the one-year dividend changes were negative, and for the years 2000 and 2001, the one-year changes were substantially negative.

Q. What does this show?

A. This data combined with all of the material which I included in my direct testimony and rebuttal testimony clearly indicates beyond any reasonable doubt that utility dividend increases have slowed significantly – to less than one-half of the historic rate. Utilities do not "grow" dividends today as they have in the past.

Q. How does this impact the Staff recommendation?

A. The Staff used a DCF model heavily weighted toward dividend growth. The fact that the growth in the value of an equity investment is no longer adequately measured by dividend growth causes a significant understatement of the true cost of common equity.

Q. Does the Staff still maintain its position through its rebuttal?

A. Yes and, in my opinion, this is nothing more than misleading the Commission and perhaps leading the Commission towards a decision which is not only detrimental to a specific utility in this case, but also detrimental to utility customers across the state.

Q. Do you believe there is a connection between the Staff recommendations and the Commission decisions?

A. Yes I do. Recent history reflects that the Commission tends to give the Staff the benefit of the doubt and tends to adopt the Staff position on many, if not most issues in rate proceedings, particularly rate of return. I believe that the Staff, as a consequence, has a responsibility to provide the Commission with accurate information and not to take advantage of its position anticipating that the Commission will do what it (the Staff) wants.

Q. What is the evidence which demonstrates that the Staff has caused the Commission to make findings on rate of return which are less than appropriate?

A. The most recent rate of return decision by the Commission was in Case No. ER-2001-299, the latest Empire District Electric Company rate case. In that case, the company presented credible witnesses on the issue of rate of return and requested a return on equity of 11.5% to 12.0%. The Staff witness recommended a return of 8.5% to 9.5% and the Public Counsel witness recommended a return of 10.0% to 10.25%. The Commission finding in that proceeding was 10.0%.

Q. What can you conclude from this?

A. I conclude that the Staff's extremely low range which was wildly unrealistic and which the Commission rejected, nonetheless caused the Commission to move to the low end of the Public Counsel's range, which was still an unreasonable result.

Q. Have you made any objective tests of that return on equity finding of the Missouri Commission as compared to the findings of other regulatory commissions in the area at about the same time?

A. Yes sir I have.

Q. Please explain.

A. At about the same time the Commission was reaching its decision in the Empire District Electric case, the Kansas Corporation Commission was reaching a decision in a West Plains electric case. The decision of the Kansas Corporation Commission was on August 15, 2001, and the decision of the Missouri Commission in the Empire case was on October 2, 2001. In the Empire case, the Commission authorized a return on equity of 10%. In the West Plains Energy case, the Kansas Corporation Commission authorized a return on equity of 10.91%. It is clear that all other things equal, the Missouri Commission's finding at about the same point in time was much lower for a pure electric operation in Missouri as compared to a pure electric operation in an adjoining State.

Q. Are all things equal, that is are both companies virtually identical?

A. Not precisely. Empire District Electric Company was found by the Commission to have a common equity ratio of 37.76%. The Kansas Corporation Commission made a finding that West Plains Energy had an equity ratio of over 45%. The higher equity ratio for West Plains Energy indicates that at least in terms of financial risk, West Plains Energy was less risky than Empire District. Nonetheless, the Missouri Commission, with the misdirected guidance of the Staff and Public Counsel, made findings of a lower return on equity for Empire District Electric. Further, given the $3.5 Million mistake in that case which the Commission has refused to correct, the actual return is less than 10%.

Q. Are there any other findings at about the same point in time which indicate that the Commission, as guided by the Staff and Public Counsel, is making findings which are below the current zone of reasonableness?

A. Yes. In December, 2001, MidAmerica, an Iowa utility, settled an electric rate case and received a 12% threshold return on equity in a sharing grid. Simply, MidAmerica could earn up to a 12% return on equity before sharing excess return with its customers. This is a substantially higher return than that being recommended by the Staff in this case and significantly higher than found by the Commission in the Empire case. There is no finding insofar as I am aware of that MPS or Empire is significantly less risky than MidAmerica. In fact, the selection of Empire as a bottom of the barrel income stock by The Street.Com suggests that Empire is more risky than MidAmerica.

Q. Are there any other states which adjoin Missouri which have made return on equity findings?

A. Yes. There are two cases pending before an Administrative Law Judge in Illinois. One of those cases involves Ameren which also has properties in Missouri. The Staff in that case has proposed an 11.35% return on equity and the ALJ has recommended 11.35% as a return on equity. This is also substantially higher than that recommended by the Staff and substantially higher than that found by the Commission in the Empire District Electric case and higher than the Staff or Public Counsel has recommended in this case.

Q. Have you examined states other than the adjoining states to establish the relationship of Commission decisions on return on equity as compared to nationwide findings on return on equity?

A. Yes sir I have. The only case decided by the Commission on the issue of electric rate of return was the Empire District case in which the Commission authorized a 10% return on equity. Nationwide, there were seventeen electric cases decided by state commissions during 2001. On the average, the authorized return on equity for those seventeen cases as reported by Regulatory Research Associates was 11.08%. This averaged is much higher than the Empire finding of 10%.

Q. Do you believe the findings of other regulatory commissions should be definitive in evaluating the finding of the Missouri Commission?

A. I do not. I believe, however, that the findings of other commissions should be used as a rough gauge to determine the appropriateness of the Missouri Commission. It is information which helps to evaluate the findings of the Commission. Having consistently lower return authorizations than other states indicates to me that the Missouri Commission must be led to this position by the material provided by the Staff which it is reviewing in reaching its decisions. That material, since it is primarily supplied by the Staff, indicates the Missouri Commission tends to give great credence to the Staff recommendations in spite of the fact that in my opinion those recommendations are without proper foundation and do not incorporate current thinking in the field of finance.

Q. Are there any other connections which are worth observing between this case and the Empire District case?

A. Yes. The Commission Order in the Empire District case criticized the Empire rate of return witness for the historical period used in his analysis. The Commission concluded that the historical period was simply not current. In this case involving MPS, the Staff witness was confronted by the problem that the price of UtiliCorp common stock, the basis for at least part of the Staff recommendation, has dropped significantly since the preparation of the Staff analysis. Incorporating the more recent stock price in the Staff analysis would lead to a significantly higher return requirement than that recommended by the Staff. The Staff did not take the opportunity in rebuttal to correct this problem. This is more than just oversight and it clearly suggests a bias since the Public Counsel witness took the opportunity of rebuttal testimony to make several changes which lowered the Public Counsel recommendation.

CAPITAL STRUCTURE

Q. What is the capital structure issue?

A. The capital structure issue relates to whether the Commission, in calculating the rate of return, should use the capital structure assigned to MPS by UtiliCorp or if it should use the consolidated capital structure. I believe the Commission should use the assigned capital structure or, in the alternative, evaluate the assigned capital structure and adjust it if there is a real reason. Furthermore, I believe that using the consolidated capital structure is wrong. However, I believe that because this issue does not represent a significant amount of money in this case, it should be settled.

COMPARATIVE COMPANIES

Q. Is it fair to say at this point that every rate of return witness in this proceeding has criticized the others for their selection of comparable companies?

A. Yes. However, I have not described my proxy group as comparable companies. The Staff and Public Counsel have both indicated that they have selected a group of comparable companies and, as a consequence, can read directly from the comparable company group indicated return to MPS. I believe this is incorrect in principle, incorrect as a matter of sound financial analysis, and inappropriate in a regulatory proceeding such as this.

Q. In a theoretical context, does it make a difference if the comparable companies are different than the subject companies?

A. It does not if the proper analysis is performed. For many years, comparable utility analysis has been criticized on the basis that it is impossible to develop a precisely comparable group of companies. As a result, analysts changed their approach to analyzing a proxy group of companies and taking the indication of the proxy group and risk adjusting that indication to the subject company. This methodology precisely parallels the development of risk adjusted returns and risk adjusted targets which are fundamental to mainstream financial analysis for capital budgeting, investment decisions and the management of investment portfolios..

RISK CRITERIA

Q. Does the selection process or the risk criteria used in the analysis of all three witnesses on rate of return continue to be the subject of debate?

A. Yes. I have I believe correctly stated that the Staff and Public Counsel criteria for selecting companies is not appropriate and does not select a comparable group because the majority of the criteria are not risk related but rather a function of the convenience of the analyst. These criteria include publication in Value Line and adequate series of data and so on.

Q. The Staff has commented in its rebuttal testimony that you included a Missouri company in your analysis. Is that correct?

A. Yes. There is a Missouri company in my analysis.

Q. Does that in any way flaw your analysis?

A. No it does not.

Q. Why?

A. The essence of the DCF analysis is the incorporation of shareholder and investor input into the end result using the stock market prices as a significant part of the discounted cash flow model. Said differently, the stock market price as determined by shareholders is a determinate of the discounted cash flow model cost of equity. It is stock market price which determines the yield component of the DCF model and, not the Commission finding on return. The real price established by investors sets the return requirement not the

Commission order. If the DCF analysis is properly performed, a true shareholder capital attracting return is established regardless of the Commission authorization.

FLOATATION ADJUSTMENT

Q. Is there an issue about floatation adjustment?

A. Yes. The Staff witness, at page 15 of his rebuttal testimony, states that it does not agree with an adjustment for floatation costs. The basis of that position is that MPS is not a publicly traded company. This position points to a fundamental inconsistency in the Staff recommendation.

The Staff chooses the consolidated capital structure to calculate rate of return because in its opinion, that is the source of the equity. It is also clear that pre-offering costs and pressures are experienced at the consolidated capital level. However, in a stark inconsistency, the Staff refuses to accept or admit the existence of these costs for the wholly owned division which receives its capital directly from UtiliCorp without additional leveraging or change in any way. This is another example of when a fundamental tenet of financial analysis is twisted to meet some perverse end result. Other problems and inconsistencies flow from the original position.

THE ATTRACTION OF CAPITAL

Q. What is the issue related to capital attraction?

A. The entire purpose of the rate of return analysis, recommendations to the Commission and ultimately the Commission findings is to establish a return on equity and an overall rate of return which will enable the utility to attract capital on reasonable terms. Notably absent from the Staff rebuttal testimony, which was 27 pages in length, was any discussion of capital attraction or any effort to bring into focus capital attraction as the dominant objective of this process.

Q. Do you believe that capital attraction standards are being met in the Staff recommendation?

A. I do not. As the review of other Commission decisions and Staff recommendations in adjoining states clearly indicates, the Staff recommendation in this case is below the competitive level of return required to appropriately attract capital in the marketplace.

Q. Please explain.

A. Every utility that is attracting capital is doing so in competition with other electric utilities. In fact, it is doing so in competition with every other company which is attempting to attract capital. When a utility is authorized a return lower than the return of similar utilities in similar parts of the country, that utility's capital requirements will be funded after the capital requirements of utilities with more favorable financial parameters. If Company A is authorized 11% return and Company B a 10% return, Company A, all other things equal, will obtain its capital requirements from the marketplace first. If capital is available for that sector, Company B will then obtain its requirements. Furthermore, when Company B is funded, it may receive its capital allocations on a lower or less reasonable basis than that given to Company A, simply by virtue of the fact that Company B is offering a superior return for a similar level of risk.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter Missouri Public Service of Kansas City, Missouri, for Authority to File Tariffs Increasing Electric Rates for Service Provided to Customers in the Missouri Public Service Area.	)))))	Case No. ER-2001-672

STATE OF KANSAS)
) SS.
COUNTY OF JOHNSON)

AFFIDAVIT OF JOHN C. DUNN

John C. Dunn, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of John C. Dunn;" that said testimony was prepared by him and under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information and belief.

John C. Dunn

Subscribed and sworn to before me this 17th day of January, 2002.

Bernadine K. Farley
Notary Public

My Appointment Expires:

October 20, 2005

NOTARY PUBLIC STATE OF KANSAS
BERNADINE K. FARLEY
My Appt. Exp. 10/20/05