

BEFORE THE STATE CORPORATION COMMISSION  
OF THE STATE OF KANSAS

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DIRECT TESTIMONY  
OF  
WALTER S. HULSE III

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DOCKET NO. 06-MKEE-524-ACQ

1 **Q. Please state your name and business address.**

2 A. My name is Walter S. Hulse III, and I am employed by UBS Investment Bank  
3 (“UBS”), a global investment banking and securities firm based in Switzerland with  
4 U.S. headquarters in New York. My business address is 299 Park Avenue, 38<sup>th</sup>  
5 Floor, New York, NY 10171. My telephone number is (212) 821-2280 and my e-  
6 mail address is walter.hulse@ubs.com.

7  
8 **Q. Please describe your academic and professional background?**

9 A. I earned a Bachelor of Science degree in Economics from the Wharton School at the  
10 University of Pennsylvania. I am currently a Managing Director at UBS Investment  
11 Bank and the Head of the Global Utilities Group. Previously, I was director of the  
12 Mergers and Acquisitions Department at PaineWebber Group, Inc. prior to its merger  
13 with UBS. I also have been a Managing Director and Co-head of Global Energy and  
14 Power M&A at JP Morgan Securities, Inc., head of the Utility Corporate Finance  
15 Group at PaineWebber, and from 1994 to 1996, was Managing Director and Head of  
16 the Fixed Income Capital Markets Group at PaineWebber. Since joining PaineWebber

1 in August of 1986, I have spent a large part of my career focused on utility advisory  
2 assignments.

3  
4 **Q. Do you have any professional registrations?**

5 A. I am a registered securities representative (Series 7, Series 63) and general  
6 securities principal (Series 24) registered with the National Association of Securities  
7 Dealers.

8  
9 **Q. What is the purpose of your testimony?**

10 A. The purpose of my testimony is to address the assistance UBS provided to the  
11 management of Sunflower Electric Power Corporation ("Sunflower") and Mid-Kansas  
12 Electric Company ("MKEC"), an entity formed for the purpose of completing the  
13 proposed transaction, in evaluating the acquisition of and quantifying the valuation  
14 range for certain electric utility assets in Kansas ("Kansas Electric") offered for sale by  
15 Aquila, Inc. ("Aquila") and subject of the proposed transaction.

16  
17 **Q. What was UBS' scope of assistance and involvement with respect to the  
18 proposed purchase of the Kansas Electric properties by MKEC?**

19 A. In May 2005, Sunflower engaged UBS Investment Bank to assist its management in  
20 evaluating the potential purchase of Kansas Electric. UBS derived a valuation range  
21 for Kansas Electric to assist MKEC in (i) the competitive auction process conducted  
22 by Aquila to sell Kansas Electric, and (ii) securing financing for the transaction. In  
23 deriving a valuation range for Kansas Electric, UBS:

- 1           • reviewed publicly available business and historical financial information
- 2           relating to Kansas Electric;
- 3           • assisted MKEC in developing a detailed twenty-year financial projection model
- 4           ("Financial Model") of the Kansas Electric assets;
- 5           • conducted discussions with members of the senior management of Kansas
- 6           Electric, MKEC and Sunflower;
- 7           • reviewed publicly available financial and stock market data with respect to
- 8           certain other companies that UBS believed to be generally relevant;
- 9           • compared the financial terms of the transaction with the publicly available
- 10          financial terms of certain other transactions that UBS believed to be generally
- 11          relevant;
- 12          • reviewed the Purchase and Sale Agreement;
- 13          • conducted discussions with members of National Cooperative Services
- 14          Corporation ("NCSC" or the "Lender"); and
- 15          • reviewed the financing commitment letter provided by NCSC.

16

17 **Q. What role did UBS perform in preparation of the purchase analysis?**

18 A. UBS reviewed the Financial Model prepared by MKEC and evaluated it based on our

19 utility industry and financial advisory experience. In the course of our work, UBS

20 examined information gathered from the data room made available by Aquila, public

21 regulatory filings and independent consultant reports prepared for MKEC.

22 Additionally, UBS attended due diligence meetings with Aquila and Kansas Electric

23 management in Kansas and participated in breakout sessions relating to topics that

1 could affect Kansas Electric's valuation. UBS worked with MKEC from June through  
2 August as MKEC developed the Financial Model. The collaboration involved  
3 conference calls between MKEC and UBS staff and included two days spent by UBS  
4 on-site at Sunflower's headquarters for a review of the model and assumptions. Then,  
5 based on this work, UBS was able to assist MKEC to form a view on valuation and  
6 the ability to finance the transaction. Additionally, UBS assisted MKEC to perform  
7 sensitivity analyses on the valuation ranges generated.

8  
9 **Q. What was the basis of the Financial Model?**

10 A. The Financial Model was created by MKEC to better quantify the operations of  
11 Kansas Electric and examine the impact of various operating assumptions on its  
12 valuation. The Financial Model was developed by MKEC to provide an indication of  
13 value for Kansas Electric and assist MKEC in its efforts to submit a bid. Additionally,  
14 the Financial Model was developed to provide a basis for requesting financing from  
15 the National Rural Utility Cooperative Finance Corporation's ("CFC") affiliate NCSC.  
16 The Financial Model was developed based upon historical customer and financial  
17 information provided by Aquila in the Confidential Information Memorandum and on-  
18 line data room. The Financial Model incorporated additional information provided by  
19 Aquila, independent consultants, public documents and MKEC management. The  
20 assumptions in the Financial Model related to the financing terms and structure were  
21 developed with guidance from the CFC.

22

1 **Q. What methodologies did UBS use in the valuation analysis?**

2 A. In connection with deriving its valuation, UBS performed a variety of financial and  
3 comparative analyses that are summarized below.

4 a. *Fair Market Value Method* – This approach involves identification of a peer group  
5 of companies and comparable merger and acquisition transactions. To this end,  
6 UBS identified a group of twelve publicly traded companies with similar operating  
7 and geographic characteristics to Kansas Electric. Information on these peers was  
8 compiled by UBS based on public information available from SEC filings, annual  
9 reports published by the companies and subscription information services and  
10 databases, including Edgar Online, Inc., Capital IQ, and FactSet. Earnings  
11 estimates were provided by Thomson Financial /First Call, a research firm that  
12 compiles equity and fixed income research, corporate data, and earnings  
13 estimates. UBS relied on the data provided by these sources and did not  
14 independently attempt to verify the data. After the information on the selected  
15 companies was compiled, UBS calculated statistics for the peer group, including  
16 the mean, median, high and low enterprise value as a multiple of earnings before  
17 interest, tax, depreciation and amortization (EBITDA) over the prior twelve months  
18 (LTM). These multiples were then compared with the corresponding financial  
19 statistics generated by Kansas Electric at the acquisition price. UBS also  
20 identified twenty-two recent merger and acquisition transactions from 1999 to  
21 August 2005. This information was used to calculate the high, low, mean and  
22 median enterprise value multiple of EBITDA based on each transaction amount as  
23 disclosed. These multiples were then compared to the corresponding financial

1 statistics generated by Kansas Electric at the acquisition price.

2 b. *Discounted Cash Flow Method* – This method involved utilizing the projections of  
3 Kansas Electric's future earnings developed by MKEC based on historical  
4 performance and assumptions about how it would be operated under new  
5 ownership. The after tax cash earnings, net of any investments required to support  
6 the business and inclusive of any after tax operational synergies, represented the  
7 sustained value MKEC could achieve from the acquisition. To quantify this value,  
8 UBS used the MKEC projections to perform a discounted cash flow ("DCF")  
9 analysis and generated a valuation range for Kansas Electric. Specifically, UBS  
10 took the first ten years of MKEC's projections for Kansas Electric's financial  
11 performance to calculate the estimated present value of the standalone unlevered  
12 free cash flows that Kansas Electric could generate from January 1, 2006 through  
13 December 31, 2015 based on internal estimates of MKEC management. UBS  
14 calculated a range of terminal values for Kansas Electric by (i) applying an  
15 EBITDA exit multiple of 8.0 to 9.0 times Kansas Electric's fiscal year 2015 EBITDA  
16 and (ii) applying a perpetuity growth rate of 1.0% to 2.0% to Kansas Electric's  
17 fiscal year 2015 free cash flow. The cash flows and terminal values were then  
18 discounted to present value using discount rates ranging from 6.0% to 7.0%.

19 c. *Debt Service Coverage* – The transaction assumed MKEC would finance 100% of  
20 the acquisition cost with debt provided by NCSC. Therefore, an additional check on  
21 the final valuation was the ability of Kansas Electric to service the full debt load and  
22 meet tests for Debt Service Coverage ("DSC") and other measures of liquidity such  
23 as cash levels. For the purposes of this analysis, DSC equaled: (Net Margin +

1 Interest Expense + Depreciation) / (Interest Expense + Principal Amortization).

2

3 **Q. What valuation methods did UBS rely on in establishing a valuation range?**

4 A. UBS focused its analysis of an appropriate valuation range for MKEC on both the free  
5 cash flow and fair market value methods. Both methods capture in the financial  
6 projections MKEC's expectations of how Kansas Electric would perform under its  
7 ownership, including potential operational synergies. Based on MKEC's detailed free  
8 cash flow projection, UBS performed a DCF analysis, which utilized a weighted  
9 average cost of capital calculation for Kansas Electric. UBS further considered the fair  
10 market value method to support the valuation. Finally, DSC and liquidity were  
11 evaluated to test the ability of the entity to support the financing implied by the  
12 valuation. Given the unique nature of Kansas Electric, no analysis was undertaken to  
13 appraise the replacement value of all the individual assets.

14

15 **Q. Please describe the results of the valuation analysis?**

16 A. *Fair Market Value Method – Selected Public Companies*

17 MKEC proposed to acquire Kansas Electric for a Base Price of \$255.2 million plus  
18 an assumed working capital and other adjustment of \$36.8 million, which resulted  
19 in an implied enterprise valuation of \$292.0 million for Kansas Electric. UBS  
20 compared selected financial information for Kansas Electric with corresponding  
21 financial information of the following 12 publicly traded companies in the utility  
22 sector of the energy and power industry:

23 

- Alliant Energy Corp.

- 1           • Ameren Corp.
- 2           • Black Hills Corporation
- 3           • Cleco Corp.
- 4           • The Empire District Electric Company
- 5           • Great Plains Energy Inc.
- 6           • NorthWestern Energy Corp.
- 7           • OGE Energy Corp.
- 8           • Westar Energy, Inc.
- 9           • Wisconsin Energy Corp.
- 10          • WPS Resources Corp.
- 11          • Xcel Energy

12          UBS reviewed among other things, enterprise values, calculated as equity value,  
13          plus debt, less cash, as a multiple of the latest 12-month earnings before interest,  
14          tax, depreciation and amortization, commonly referred to as EBITDA. UBS then  
15          compared the multiples derived for the selected companies based on a closing  
16          price for the peer companies' common stock on August 22, 2005 with  
17          corresponding multiples implied for Kansas Electric based on a transaction  
18          consideration equal to an implied enterprise value of \$292.0 million. Estimated  
19          financial data for the selected companies were based on publicly available  
20          research analysts' estimates. This analysis indicated the following mean, median  
21          high and low multiples for the selected companies, as compared to the  
22          corresponding multiples implied for Kansas Electric based on the transaction  
23          consideration of \$292.0 million:



Enterprise Value as Multiple of:	Mean	Median	Hi	Low	Implied Multiples based on \$292.0 million Consideration
LTM EBITDA	8.4x	8.1x	10.3x	6.7x	8.0x

#### *Fair Market Value Method – Selected Precedent Transactions Analysis*

UBS reviewed implied enterprise values in the following 22 selected transactions involving companies in the utilities sector announced between February 1, 1999 and August 22, 2005:

Acquiror	Target
• MidAmerican	PacifiCorp
• Duke Energy Corp. (DUK)	Cinergy Corp. (CIN)
• Exeion Corp. (EXC)	Public Service Enterprise Group (PEG)
• PNM Resources Inc. (PNM)	TNP Enterprises Inc. (-)
• Ameren Corp. (AEE)	Illinois Power Co. (-)
• Saguaro (-)	Unisource Energy Corp. (UNS)
• Oregon Electric Utility (-)	Portland General Electric Co. (-)
• Ameren Corp. (AEE)	Cilcorp Inc. (-)
• Energy East Corp. (EAS)	RGS Energy Group Inc. (RGS)
• Potomac Electric Power Co. (POM)	Conectiv (CIV)
• National Grid Transco PLC (NGT LN)	Niagara Mohawk Holdings Inc. (NMK)
• FirstEnergy Corp. (FE)	GPU Inc. (GPU)
• AES Corp. (AES)	Ipalco Enterprises Inc. (IPL)
• Powergen PLC (PWG LN)	LG&E Energy Corp. (LGE)
• PECO Energy Co. (PE)	Unicom Corp. (UCM)
• Carolina Power & Light (CPL)	Florida Progress Corp. (FPC)
• Energy East Corp. (EAS)	CMP Group Inc. (CTP)
• Dynegy Inc. (DYN)	Illinova Corp. (ILN)

- Lowe Capital Partners (-) TNP Enterprises Inc. (TNP)
- New Century Energies Inc. (NCE) Northern States Power Co. (NSP)
- UtiliCorp United (Albany) St. Joseph's Power & Light (SAJ)
- New England Electric System (NES) Eastern Utilities Associates (EUA)

UBS reviewed enterprise values as a multiple of the latest 12-month EBITDA. UBS then compared the latest 12-month EBITDA multiples derived from the selected transactions with the corresponding multiple implied for Kansas Electric based on the transaction consideration of \$292.0 million. Multiples for the selected transactions were based on publicly available information at the time of the announcement of the transaction. This analysis indicated the following implied mean, median, high and low latest 12-month EBITDA multiple for the selected transactions, as compared to the corresponding multiple implied in the transaction for Kansas Electric based on the consideration of \$292.0 million.

Enterprise Value as Multiple of:					Implied Multiples based on \$292.0 million in consideration
LTM EBITDA	Mean	Median	Hi	Low	
	7.9x	7.7x	10.9x	6.1x	8.0x

This is consistent with the qualitative characteristics of Kansas Electric relative to the peer group and recent transactions. Kansas Electric's rural client base would suggest a lower valuation than the typical peer, while the high degree of compatibility with MKEC's operations would suggest an offsetting inclination towards a greater value.

*Discounted Cash Flow Analysis*

UBS performed a discounted cash flow analysis on the Financial Projections developed by MKEC to calculate the estimated present value of the stand-alone

1 unlevered after-tax free cash flows that Kansas Electric could generate over fiscal  
 2 years 2006 through 2015 based on internal estimates of how Kansas Electric could  
 3 be operated by MKEC. UBS calculated a range of terminal values for Kansas Electric  
 4 by applying two methods. One method for calculating terminal values applied a  
 5 multiple of EBITDA to Kansas Electric's fiscal year 2015 estimated EBITDA. The  
 6 EBITDA multiple terminal values were calculated using a range of EBITDA multiples  
 7 from 8.0x to 9.0x. A second method applied perpetuity growth rates of 1.0% to 2.0%  
 8 to Kansas Electric's fiscal year 2015 estimated unlevered, after-tax free cash flows.  
 9 The cash flows and terminal values were then discounted to present value using  
 10 discount rates ranging from 6.0% to 7.0%. This discounted cash flow analysis  
 11 indicated the following implied valuation range, as compared to the transaction  
 12 consideration of \$292.0 million:

	<b>Implied Enterprise Value Range for Kansas Electric</b>	<b>Transaction Consideration (Implied Enterprise Value)</b>
Value:	\$345 to \$393 million	\$292.0 million
Multiple of		
2006E EBITDA:	8.9x to 10.2x	7.6x
LTM EBITDA:	9.4x to 10.8x	8.0x

16 Based on the valuation analyses described above, MKEC's agreement to  
 17 purchase Kansas Electric from Aquila for a Base Price of \$255.2 million plus an  
 18 assumed working capital and other adjustment, that resulted in an implied  
 19 enterprise value of \$292.0 million is supportable. The purchase price results in a  
 20 valuation of 7.6x Enterprise Value/2006E EBITDA or 8.0x Enterprise Value/LTM  
 21 EBITDA. This valuation is within the range established by our analysis and level of  
 22 electric utility transactions executed since January 2004.

1 **Q. Please discuss the reasonableness of the purchase price.**

2 A. UBS developed a valuation range focusing on a detailed free cash flow analysis and  
3 quantified a valuation range based upon the value at which similar companies are  
4 trading in the public markets as well as the value at which recent merger and  
5 acquisition transactions have occurred. UBS believes the fair market method  
6 produces valuation metrics that most reasonably indicate what a buyer is willing to  
7 pay and a seller is willing to receive because the analysis is based upon actual  
8 market levels and transactions. Accordingly, the price MKEC and Kansas Electric  
9 have agreed to is in-line with the average and median multiple of EBITDA of  
10 comparable transactions from 1999 to 2005, is below the level of transactions since  
11 January 2004, and is also below the average trading level of a peer group of  
12 companies.

13

14 Furthermore, the free cash flow valuation analysis indicates that additional value can  
15 be created from the acquisition through operational savings, which would increase the  
16 overall value of Kansas Electric.

17

18 Finally, at the Purchase Price Kansas Electric can sustain debt financing equal to  
19 100% of the price and achieve a DSC equal to 1.63 and increasing above that level  
20 going forward. Additionally, CFC performed its own independent evaluation of the  
21 transaction and based on its review, the CFC board approved a loan to MKEC of  
22 \$320 million, \$23.5 million more than the Purchase Price after accounting for \$4.5  
23 million of transaction fees and expenses.

1

2 **Q. Does this conclude your testimony?**

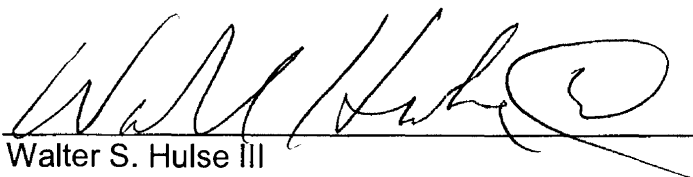
3 **A. Yes.**

**VERIFICATION OF WALTER S. HULSE III**


STATE OF NEW YORK

COUNTY OF NEW YORK

Walter S. Hulse III, being first duly sworn, deposes and says that he is Walter S. Hulse III referred to in the foregoing document entitled "Direct Testimony of Walter S. Hulse III." before the State Corporation Commission of the State of Kansas and that the statements therein were prepared by him or under his direction and are true and correct to the best of his information, knowledge and belief.

  
Walter S. Hulse III

**SUBSCRIBED AND SWORN** to before me this 14<sup>th</sup> day of November, 2005.

  
Notary Public

My Appointment Expires:

SARAH A. ANTONELLI  
Notary Public, State of New York  
No. 31-4742678  
Qualified in New York County  
Commission Expires 12/17/05