Staff-7

Exhibit No.:	
Issues:	*Rate of Return/Cost of Capital*
Witness:	*Matthew J. Barnes*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*ER-2007-0291*
Date Testimony Prepared:	*September 20, 2007*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

MATTHEW J. BARNES

KANSAS CITY POWER AND LIGHT COMPANY

CASE NO. ER-2007-0291

Jefferson City, Missouri
September 2007

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Q. Please state your name.

A. My name is Matthew J. Barnes.

Q. Are you the same Matthew J. Barnes who filed direct and rebuttal 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 provide your expert opinion on what you considered to be a fair and reasonable rate-of-return on the Missouri jurisdictional electric utility rate base for Kansas City Power & Light Company (KCP&L or Company)?

A. Yes, I did.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Dr. Samuel C. Hadaway and Mr. Michael Gorman. Dr. Hadaway sponsored rate-of-return direct and rebuttal testimony on behalf of KCP&L. Mr. Gorman sponsored rate-of-return direct and rebuttal testimony on behalf of the Office of the Public Counsel (OPC).

EXECUTIVE SUMMARY

Q. Can you please identify the issues you will address in your surrebuttal testimony?

A. In rebuttal testimony, Dr. Hadaway addresses issues in my direct testimony ranging from the Company's request for a 50 basis point increase in return on equity (ROE) due to KCP&L's construction risk to Staff's use of the single-stage Discounted Cash Flow Model (DCF). OPC witness Mr. Michael Gorman addressed Staff's recommended ratemaking capital structure, which he believes is too heavily weighted with common equity.

I have addressed the following issues in my surrebuttal testimony:

1. Company's request for a 50 basis point increase in ROE;
2. DCF growth rate analysis;
3. Capital asset pricing model (CAPM);
4. Capital structure;

RESPONSE TO DR. HADAWAY'S REBUTTAL TESTIMONY

Q. On page 8, lines 15 through 17, of his rebuttal testimony, Dr. Hadaway claims you should have made an explicit upward adjustment to your ROE because of KCP&L's construction program. What is your response?

A. I do not believe an adjustment should be added to my recommended ROE because of KCP&L's construction program. My comparable group's average credit rating of BBB already reflects the risk relative to KCP&L's construction program because KCP&L's credit rating is currently BBB. A credit rating takes into account business and financial risk. Therefore, if one selects a reasonable proxy group with similar credit ratings, then no further adjustment is needed. The comparable group's stock prices already reflect similar business and financial risk.

It is also worthy to note that KCP&L entered a Stipulation and Agreement in Case No. EO-2005-0329, for an Experimental Regulatory Plan, which was approved by the

Commission that provides for additional amortization to meet certain credit ratios to allow the opportunity to keep the Company's credit rating at investment grade. Without the possibility of additional amortization to meet the credit ratios, it is possible that credit rating agencies would lower KCP&L's credit rating during the construction phase. The Experimental Regulatory Plan was meant to reduce the risk the Company may face during the construction phase. Adding an additional 50 basis points to ROE because of construction risk calls into question the need for the Experimental Regulatory Plan. It is also worthy to note that the credit rating agencies have not lowered KCP&L's credit rating since the commencement of its construction program.

Q. On page 9, lines 1 through 7 of his rebuttal testimony, Dr. Hadaway disagrees with Staff's "stand-alone analysis of Great Plains Energy because a single-company analysis is not statistically reliable (as is demonstrated by the 8.0 percent to 8.8 percent ROE he obtains from that analysis). The 3.69 percent growth rate for Great Plains Energy he uses in that analysis is a further indication of why analysts' near-term growth projections are not a proper estimate of long-term growth in the DCF analysis." How do you respond?

A. Staff did not recommend the Commission adopt Staff's results from its company-specific analysis of Great Plains Energy (GPE). Staff provided this analysis for informational purposes so the Commission can review the results of a company-specific analysis of GPE to compare it to the comparable group analyses.

Q. On page 9, lines 16 through 18 of his rebuttal testimony, Dr. Hadaway says, "He also presents an Institutional Broker's Estimate System ("IBES") growth rate average (6.37 percent), but he does not use this estimate in his analysis." How do you respond?

A. Dr. Hadaway is incorrect when he states that Staff did not use IBES' growth rate of 6.37 percent in their analysis. The growth rate of 6.37 percent is captured in Staff's projected growth rate range of 5.34 percent to 6.50 percent, which is then added to the dividend yield of 3.80 percent to arrive at an ROE range of 9.14 percent (5.34 + 3.80) to 10.30 (6.50 + 3.80) percent.

Q. Dr. Hadaway says you should have relied on your CAPM results instead of relying exclusively on your DCF results. What is your response?

A. Staff uses the CAPM as a check of reasonableness for the DCF results. Staff's CAPM results are 9.92 percent based on the geometric mean and 11.33 percent based on the arithmetic mean. The geometric mean takes into account compounding interest over one holding period. The arithmetic mean takes into account an average return over numerous holding periods, as if one bought and sold securities year-to-year. It is assumed that investors invest in utility stocks for the long-term. Therefore, it is logical to estimate the returns using the geometric mean and not the arithmetic mean.

Q. Please provide a simple example to illustrate why you don't believe investors use arithmetic means when determining the amount of risk premium they will require on a given stock or a portfolio of stocks.

A. Suppose that an investor makes a $1 stock investment over a three-year period. If an investor pays $1 for a stock in year 1 and in year 2 the stock increases to $1.50, then the investor would have a 50 percent growth rate. In year three, the price of the stock decreases by 50 percent to $0.75. If an investor performed a simple arithmetic average of these two returns, then that investor would think that he/she received 0 percent [(50 percent + -50 percent)/2] growth in their investment over the three-year period.

However, in reality, the investor actually had a 25 percent decline in his/her investment over this three-year period. This is why using the arithmetic mean is questionable.

Q. Do you have any academic support for Staff's use of the geometric mean?

A. Yes. The first is *Investment Analysis & Portfolio Management*, seventh edition, 2003, written by Frank K. Reilly and Keith C. Brown. Reilly and Brown stated the following:

> The geometric mean is appropriate for long-run asset class comparisons, whereas the arithmetic mean is what you would use to estimate the premium for a given year (e.g. the *expected* performance next year).

The second textbook is *INVESTMENT VALUATION: Tools and Techniques for Determining the Value of Any Asset*, 1996, written by Aswath Damodaran. Dr. Damodaran stated the following in his textbook:

> The geometric mean generally yields lower premium estimates than the arithmetic mean. In the context of valuation, where cash flows over a long time horizon are discounted back to the present, the geometric mean provides a better estimate of the risk premium. Thus, the premium of 5.50% (the geometric mean of the premium over Treasury bonds) is used throughout this book for calculating expected returns.

RESPONSE TO MICHAEL GORMAN'S REBUTTAL TESTIMONY

Q. Mr. Gorman states that Staff's capital structure consists of an equity ratio that is too high. How do you respond?

A. Staff's capital structure was based on March 31, 2007, actual known and measurable data that did not include the Company's debt issuance in May and September. Staff noted in Direct Testimony that it would update the capital structure through September 30, 2007, once data is known and measurable. Staff has not traditionally used projected data to determine the rate-of-return for a company.

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your surrebuttal testimony.

A. My recommended cost of common equity, which is in the range of 9.14 percent to 10.30 percent, would produce a fair and reasonable rate of return of 7.97 percent to 8.73 percent for KCP&L's Missouri jurisdictional electric utility rate base.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power and Light Company for Approval to Make Certain Changes in its Charges for Electric Service To Implement Its Regulatory Plan.	)))))	Case No. ER-2007-0291

AFFIDAVIT OF MATTHEW J. BARNES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Matthew J. Barnes, being of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 6 pages to be presented in the above case; that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Matthew J. Barnes

Subscribed and sworn to before me this 19th day of September, 2007.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

Notary Public