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Witness: Samuel C. Hadaway
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Case No.: ER-2007-0291
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**MISSOURI PUBLIC SERVICE COMMISSION
CASE NO.: ER-2007-0291**

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

**Kansas City, Missouri
September 2007**

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

Case No. ER-2006-0291

1 **I. Introduction**

2 **Q. Are you the same Samuel C. Hadaway who submitted Direct Testimony and**
3 **Rebuttal Testimony in this proceeding?**

4 **A. Yes, I am.**

5 **Q. What is the purpose of your Surrebuttal Testimony?**

6 **A. The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimony**
7 **filed on August 30, 2007 by Missouri Public Service Commission Staff ("Staff")**
8 **witness Matthew J. Barnes and the Office of the Public Utility Counsel ("OPC")**
9 **witness Michael P. Gorman.**

10 **II. Response to Staff Witness Matthew J. Barnes**

11 **Q. Please summarize your comments on Mr. Barnes' Rebuttal Testimony.**

12 **A. I disagree strongly with Mr. Barnes' ROE recommendation. He continues to**
13 **recommend a midpoint base ROE of only 9.74 percent. Additionally, he refuses**
14 **to add any increment to his base ROE to account for KCPL's higher construction**
15 **risk. He also continues to use the same narrowly focused DCF approach that he**
16 **relied upon in Case No. ER-06-0314. For perspective, his current 9.74 percent**
17 **ROE recommendation is more than 150 basis points below the 11.25 percent ROE**
18 **the Commission ordered in the previous case, less than a year ago when long-term**

1 utility interest rates were 40 basis points lower than they are today. Although he
2 has expanded his comparable company sample from the one he used in the prior
3 case, he continues to rely solely on the traditional constant growth DCF model,
4 and he uses only near-term analysts' growth rates for the required long-term
5 growth estimate. These are among the same flaws that resulted in the
6 unreasonably low ROE he recommended in the prior case. As I demonstrated in
7 my Rebuttal Testimony, had Mr. Barnes employed more reasonable assumptions
8 and had he given any weight to his own capital asset pricing model ("CAPM")
9 analysis, his base ROE would have been at least 10.5 percent. With the addition
10 of the same construction risk adder that the Commission applied in Case No. ER-
11 06-0314, Mr. Barnes' should have supported a total ROE of at least 10.75 percent.
12 In the remainder of my Surrebuttal Testimony, I will discuss these issues in more
13 detail and briefly respond to Mr. Barnes' criticism of my recommendations.

14 **Q. At pages 4 and 5 of his Rebuttal Testimony, Mr. Barnes discusses the**
15 **Company's requested 50 basis point risk construction risk adder and does**
16 **not recommend any upward adjustment to ROE. He says that you did not**
17 **provide any evidence that supports a 50 basis point upward adjustment.**

18 **How do you respond to this criticism?**

19 **A.** In my Direct Testimony on page 5 and in my Schedule SCH-1, I explained and
20 demonstrated that KCPL's relative construction program is approximately one and
21 one-half times as large as that of the comparable company group (95 percent of
22 net plant versus 62 percent). This higher construction level and resulting higher
23 capital requirements cause KCPL's investors to face more uncertainty and

1 therefore to require a higher rate of return than is required for the comparable
2 company group. Based on the Commission's prior findings, Mr. Barnes' rejection
3 of the Company's request for a construction risk adder is inappropriate.

4 **Q. In his discussion of the risk increment, Mr. Barnes says that you didn't**
5 **mention KCPL's Regulatory Plan, which has mechanisms in place that**
6 **reduce KCPL's risk. How do you respond to those statements?**

7 A. Mr. Barnes implies that by virtue of the Stipulation and Agreement signed by
8 KCPL and certain other parties, and approved by the Commission (Case No. EO-
9 2005-0329), the Company's construction risk is reduced and no risk adder is
10 necessary. I disagree with this viewpoint. As I stated in my Rebuttal Testimony
11 in Case No. ER-2006-0314:

12 While the Company and many of the other parties were indeed
13 signatories to the Stipulation, it did not limit any party's ability in
14 this case or any future rate case to challenge the prudence of
15 KCPL's expenditures or to disagree with KCPL's assessment of its
16 rate base or cost of service. I understand that nothing in the
17 Stipulation limits the rights of a non-signatory party to take any
18 position on an issue. Similarly, I understand that nothing in the
19 Stipulation restricts the ability of the Commission to make a
20 finding of fact or conclusion of law on any issue. Therefore,
21 neither the Stipulation nor the process that led to its negotiation
22 and approval has eliminated the financing, construction, and
23 ultimate regulatory risks that the Company faces. Capital market
24 participants recognize these ongoing risks and require adequate
25 compensation for these risks.

26 These same comments apply to Mr. Barnes' current recommendations. In
27 summary, the Stipulation, in and of itself, has not eliminated the construction
28 risks facing the Company and these risks increase the Company's required rate of
29 return.

30 **Q. What were Mr. Barnes' specific comments on your ROE analysis?**

1 A. Mr. Barnes only offered two criticisms of my ROE analysis. First, at page 2 of
2 his Rebuttal Testimony, he says that I "arbitrarily" dismissed the results of my
3 "traditional" constant growth DCF model analysis. Second, on pages 3 and 4, he
4 criticizes my inclusion of long-term gross domestic product ("GDP") growth and
5 my use of a multistage version of the DCF model.

6 **Q. Did you arbitrarily dismiss the results of your traditional constant growth**
7 **DCF analysis?**

8 A. No. I stated in the summary at the beginning of my Direct Testimony (page 5,
9 lines 21-23):

10 As I will explain in more detail later, results from the traditional
11 constant growth DCF model fail to meet basic checks of
12 reasonableness and, therefore, are not included in my
13 recommended range.

14 Later in that testimony, I explained exactly why the traditional constant growth
15 DCF results were not included in my recommended range (page 35, lines 22-23
16 and page 36, lines 1-2):

17 [T]he traditional constant growth model indicates an ROE range of
18 only 9.4 percent to 9.5 percent. Because this result falls 100 basis
19 points or more below my risk premium checks of reasonableness,
20 it is excluded from my final DCF range.

21 Given my analysis and explanation of the traditional constant growth DCF results,
22 it is difficult to understand why Mr. Barnes would mischaracterize my testimony.
23 The 100 basis point test of reasonableness that I applied is, in fact, quite similar to
24 the zone of reasonableness test the Commission has applied in prior cases.

25 **Q. How do you respond to Mr. Barnes' criticism of your use of GDP growth and**
26 **the multistage DCF model?**

1 A. At page 3, lines 18-21, Mr. Barnes says that the GDP growth rate is overstated for
2 KCPL because the Company "is a mature electric utility that has already
3 experienced multi-stage growth throughout its lifetime, therefore; Staff believes
4 the constant growth DCF model is the appropriate model to use in this proceeding
5 [sic]." Mr. Barnes' reasoning is illogical and his conclusions are incorrect. Use
6 of the GDP growth rate in the DCF model is, in fact, supported for mature
7 companies that are expected to perform at about the same level as the overall U.S.
8 economy. This is one of the reasons that the GDP growth rate is a good proxy for
9 investors' long-term growth expectations as required in the DCF model. As an
10 integral part of the U.S. economy's infrastructure, utilities almost by definition
11 must grow at about the same rate as the overall economy. While Mr. Barnes'
12 criticism of GDP growth might be appropriate for a declining industry such as
13 manual typewriters or black and white televisions, his reasoning for utilities is
14 incorrect.

15 His criticism of the multistage growth DCF model is similarly misplaced.
16 The multistage approach is appropriate for electric utilities because the industry is
17 in transition. It has been fundamentally changed from a completely regulated
18 industry to one that is more openly affected by competition since the passage of
19 the Energy Policy Act of 1992 and FERC's various open-access orders beginning
20 in 1996 with Order 888. Even in states where retail choice has not been adopted,
21 the utility companies must compete in deregulated wholesale markets. Moreover,
22 financial markets facing the entire industry have been affected by the
23 restructuring and consolidation that has occurred. Under these circumstances, the

1 industry's characteristics are not consistent with the DCF constant growth
2 assumption and other approaches must be considered.

3 **II. Response to OPC Witness Michael P. Gorman**

4 **Q. Beginning at page 4, line 18, Mr. Gorman disagrees with your**
5 **recommendation that forecasts for higher capital costs over the next year**
6 **should be considered in this case. How do you respond?**

7 A. I find Mr. Gorman's criticism peculiar because he relied on forecasted interest
8 rates in both his risk premium and CAPM analyses. While we might disagree
9 about the specific level of future interest rates, we both considered them in our
10 ROE estimates. As a result, Mr. Gorman's criticisms in this area are misdirected.

11 **Q. Why should the Commission consider higher forecasted interest rates?**

12 A. It is important to consider the capital cost environment that the Company will face
13 while rates from this case are in effect. As I stated in my Direct Testimony (at
14 39):

15 Caution should be exercised in interpreting the quantitative DCF
16 and risk premium results, because they are significantly influenced
17 on recent historically low points in the interest rate cycle. The
18 interest rate risk associated with projections for higher rates over
19 the coming year should be considered explicitly.

20 **Q. Beginning at page 5, line 20, Mr. Gorman challenges your claim that KCPL's**
21 **construction program is significantly larger than the average for your**
22 **comparable group. What is your response?**

23 A. Mr. Gorman provides a summary table on page 7 that attempts to make the point
24 that the Company's construction program is comparable to that of the proxy
25 group, and, therefore, no additional construction risk exists for the Company. The
26 first line of Mr. Gorman's table is taken directly from my Schedule SCH-1. It

1 shows that the Great Plains' construction program relative to its existing net plant
2 is substantially higher than that of the comparable group. Mr. Gorman purports to
3 update the data in Schedule SCH-1 (from 2005 to 2006) and claims the updated
4 data (on the second line of the table) show a smaller gap between the Company
5 and the proxy group. From this observation he claims that, in effect, there is no
6 significant difference between the two.

7 Mr. Gorman's claim is simply wrong. The second line of his summary
8 table on page 7 shows that there is a sizeable gap between the Company's
9 construction program and that of the proxy group. Mr. Gorman's own
10 calculations show the Great Plains' capital spending program to be over 27
11 percentage points higher than the proxy group (84% of net plant for Great Plains
12 versus 66% for the proxy group).

13 Furthermore, the data for Great Plains need to be refined. As noted in
14 Rebuttal Schedule MPG-1, Mr. Gorman gathered his data from the Value Line
15 sheets for each company, including Great Plains. Using this approach, he
16 computes the total capital spending for Great Plains over the 2007-2012 period to
17 be \$2,587.80 million. At page 4, lines 2-4 of Mr. Cline's Direct Testimony in ER-
18 2007-0291, he indicates that total capital expenditures (including Plan-related
19 expenditures and "normal course" capital expenditures) over the 2007-11 period
20 are expected to exceed \$2.5 billion. Although the Company has not disclosed
21 projected capital expenditures for 2012, Mr. Cline's testimony indicates that
22 projected spending for 2007-2011 alone reasonably approximates the level cited
23 by Mr. Gorman for 2007-2012. Even under conservative assumptions for solely

1 "normal course" spending for 2012, the Company's projected capital expenditures
2 for the full 2007-12 period would be higher than the level quoted by Mr. Gorman.

3 **Q. Beginning at page 8, line 1, Mr. Gorman implies that you ignored mitigation**
4 **of construction risk that he claims is provided by the Company's Regulatory**
5 **Plan. Please respond.**

6 A. My response to Mr. Gorman is the same as I stated for Mr. Barnes. While the
7 regulatory plan provides a sound approach for maintaining the Company's
8 investment grade bond rating, it does not eliminate the uncertainties of future
9 regulatory treatment or the effects on shareholders from the continuing need to
10 raise external capital. Also, the Plan's potential substitution of cash flow
11 "Additional Amortizations" for earnings may not benefit shareholders at all.
12 Therefore, Mr. Gorman's (and Mr. Barnes') claim that construction risk is
13 mitigated and should not be compensated for in ROE is incorrect.

14 **Q. Beginning at page 9, line 1, Mr. Gorman claims that, if done "properly,"**
15 **your analyses would indicate a much lower ROE. Are these claims accurate?**

16 A. No. In fact, as the following table shows, utility capital costs have increased since
17 January 2007 when my Direct Testimony was filed.

Table 1
Interest Rate Trends

Month	Baa Utility Rates	Average Utility Rates
Jan-07	6.16%	5.97%
Feb-07	6.10%	5.91%
Mar-07	6.10%	5.87%
Apr-07	6.24%	6.01%
May-07	6.24%	6.03%
Jun-07	6.55%	6.35%
Jul-07	6.49%	6.28%
Aug-07	6.51%	6.29%

Sources: Mergent Bond Record (Utility Rates);
www.federalreserve.gov (Treasury Rates).

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Q. At page 10, Mr. Gorman presents a table with your ROE results "adjusted" for alternative input assumptions. Are Mr. Gorman's assumptions reasonable?

10 A.

No. In creating these "adjusted" results, Mr. Gorman used several unreasonable assumptions.

11

12

Q. What are those unreasonable assumptions?

¹ A designation of "Baa" by Moody's is equivalent to a designation of "BBB" by Standard & Poor's. Both of these designations are also commonly referred to as "triple-B" ratings.

1 A. The most apparent error in Mr. Gorman's analysis is his failure to include recent
2 lower utility stock prices. Declining stock prices directly increase the dividend
3 yield in the DCF estimate of ROE. In my Direct Testimony, I utilized stock
4 prices from the end of 2006 and the average dividend yield for my comparable
5 group was approximately 4.2 percent (see the bottom of column 3, page 2 of
6 Schedule SCH-6). Now, with lower utility stock prices, dividend yields are in the
7 range of 4.4 percent to 4.5 percent. All other things being equal, an "adjustment"
8 to my DCF results shows an increase of 20 to 30 basis points from the higher
9 dividend yield alone. In his one-sided adjusted results, Mr. Gorman used the stale
10 dividend yield data from my Direct Testimony.

11 I also disagree with Mr. Gorman's selection of a near-term GDP growth
12 forecast in his "adjustments." While Mr. Gorman and I agree that GDP growth
13 should be included in the DCF analysis, we disagree on the appropriate level of
14 GDP growth. I use a long-term forecast of 6.6 percent, while he uses a shorter-
15 term estimate of 5.1 percent. His estimate is based on projected inflation over the
16 next five and ten years of only 2.1 percent (Gorman page 11, lines 13-15). This
17 low level of inflation is not consistent with long-term inflation in the U.S.
18 economy or even with recent inflation. Since 2005, according to the GDP
19 Implicit Price Deflator index prepared by the Bureau of Economic Analysis, U.S.
20 Department of Commerce, the average GDP inflation rate has been in the range of
21 3.1 percent or about 100 basis points higher than in Mr. Gorman's forecast. If all
22 the data are "adjusted" for current conditions and if a realistic view of the long-

1 term GDP growth rate is applied, the current level of ROE is at or above the range
2 I presented in my Direct Testimony.

3 **Q. On page 14, Mr. Gorman contends that your equity risk premium of 4.42**
4 **percent is "overstated" and that a risk premium of 3.1 percent is more**
5 **appropriate. Do you agree?**

6 A. No. Mr. Gorman's claim is not supported by the facts. As I explained in my
7 Rebuttal Testimony, Mr. Gorman's position can only be supported by his ignoring
8 the well-know inverse relationship between risk premiums and interest rates.
9 When interest rates rise, risk premiums become smaller. When interest rates
10 decline, risk premiums become larger. Mr. Gorman himself has endorsed this
11 correlation in the past. As I mentioned in my Rebuttal Testimony, Mr. Gorman
12 testified in a Central Power & Light Company case before the Public Utility of
13 Commission of Texas in 1996 (Docket No. 14965) at page 15, lines 10-13, that:

14 The results of my study indicate an inverse relationship between a
15 bond's real return and the equity risk premium. This result is
16 consistent with the findings of published studies which indicate
17 equity risk premiums move inversely with interest rates.

18 A simple review of the risk premium data from Schedule SCH-15 of my
19 Rebuttal Testimony further emphasizes this fact. Since 2003, annual risk
20 premiums have ranged between 4.28 percent and 4.87 percent, without any
21 adjustments. The average risk premium has been 4.52 percent. Based on my
22 statistical analysis in my Rebuttal Testimony, I used a risk premium of 4.25
23 percent. The flaw in Mr. Gorman's position is that there has not been a risk
24 premium as low as 3.1 percent since 1994, when interest rates were much higher.

1 Mr. Gorman's use of a 3.1 percent risk premium as an "adjustment" to my analysis
2 is not reasonable.

3 **Q. Does this conclude your Surrebuttal Testimony?**

4 A. Yes, it does.

In the Matter of the Application of Kansas City
Power & Light Company to Modify Its Tariff to
Continue the Implementation of Its Regulatory Plan)
Case No. ER-2007-0291)

STATE OF TEXAS)
) ss
COUNTY OF TRAVIS)


1. My name is Samuel C. Hadaway. I am employed by FINANCO, Inc. in Austin, Texas. I have been retained by Great Plains Energy, Inc., the parent company of Kansas City Power & Light Company, as an expert witness to provide cost of capital testimony on behalf of Kansas City Power & Light Company.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of Kansas City Power & Light Company consisting of twelve (12) pages, all of which having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Samuel C. Hadaway
Samuel C. Hadaway
of September 2007

Subscribed and sworn before me this 14th day of September 2007.


Notary Public

My commission expires: 12/11/2010

