Exhibit No.:	
Issue:	Rate of Return on Equity
Witness:	Samuel C. Hadaway
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Kansas City Power & Light Company
Case No.:	ER-2012-0174
Date Testimony Prepared:	October 8, 2012

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2012-0174

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
October 2012

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

Case No. ER-2012-0174

1 **I. <u>INTRODUCTION AND SUMMARY OF RECOMMENDATIONS</u>**

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

3 A. My name is Samuel C. Hadaway. My business address is FINANCO, Inc., 3520
4 Executive Center Drive, Suite 124, Austin, Texas 78731.

5 **Q. Are you the same Samuel C. Hadaway who prefiled Direct and Rebuttal**
6 **testimony in this matter?**

7 A. Yes. I previously filed direct and Rebuttal Testimony on behalf of Kansas City
8 Power & Light Company ("KCP&L" or the "Company") in this matter.

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

10 A. The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimony
11 concerning the return on equity ("ROE") filed by Missouri Public Service
12 Commission Staff ("Staff") witness David Murray. To the extent that I have
13 responded, in my Rebuttal Testimony to the arguments set forth by Mr. Murray, I will
14 note my previous responses and not comment further on those arguments.

15 **Q. Have the parties changed their initial ROE recommendations?**

16 A. Yes. Based on the updated analysis I presented in my Rebuttal Testimony, the
17 Company reduced its requested ROE from10.4 percent to 10.3 percent. Mr. Murray
18 did not adjust his recommendation; he continues to recommend an ROE of 9.0
19 percent.

II. RESPONSE TO STAFF WITNESS MURRAY

Q. What is the primary focus of Mr. Murray's Rebuttal Testimony?

A. Mr. Murray's primary focus remains entirely on the growth rate for the discounted cash flow ("DCF") models. Mr. Murray reiterates his ongoing position that all DCF growth rate estimates, other than his, are too high and, therefore, all the other parties' ROE estimates, which are consistently higher than his, are incorrect. Mr. Murray restates his same discredited historical "evidence" about utility growth rates from the 1960s to 1990s, concluding that investors should expect a growth rate of approximately 2.50%. *See* Murray Rebuttal Testimony at pages 11-12. Mr. Murray also restates his belief that if Gross Domestic Product ("GDP") growth is used, that rate should come from currently low government GDP estimates, which he concludes would support a growth rate of 4.3 percent. *See* Murray Rebuttal Testimony at page 13. Finally, apparently to show that even a 4.3 percent growth rate might be too high, Mr. Murray offers what he calls a Great Plains Energy "internal DCF analysis," which contains a growth rate of slightly over 2 percent. *See* Murray Rebuttal Testimony at page 15. This range of growth rates, 2 percent to 4.3 percent, with Mr. Murray's 4.1 percent projected dividend yield would produce a constant growth DCF range of 6.1 percent to 8.4 percent. My response to Mr. Murray's growth rates and the ROEs implied by his views is the same as in my Rebuttal Testimony: His views and the results of his analysis do not meet the "common sense" test that the Staff's Revenue Requirement/Cost of Service Report ("Staff Report") initially called for. Mr. Murray's analysis is not reliable and his recommendations should be rejected.

1 **Q. Did Mr. Murray's growth rate discussion add any new information to the debate**
2 **about what the long-term DCF growth rate should be?**
3 A. No. As I explained in my Rebuttal Testimony on page 13, lines 9 through 19:

> 4 Mr. Murray's 3.5 percent rate is below the average rate of inflation in
> 5 the U.S. economy over the past 60 years (3.7%) and only barely above
> 6 the annual change in the GDP price deflator (3.4%). See Schedule
> 7 SCH-11. I have consistently shown in my GDP growth estimates
> 8 (Schedules SCH-4 and SCH-11) that the current GDP forecasts from
> 9 the various government agencies use estimates of permanently low
> 10 inflation and lower real growth rates that do not reflect the long-term
> 11 U.S. economy. For Mr. Murray to rely on these low GDP growth rate
> 12 forecasts, which are the product of the most severe economic
> 13 downturn since the Great Depression of the 1930s, and then to select
> 14 an even lower growth rate for his multi-stage DCF analysis is
> 15 indicative of a biased and unrealistic approach.

16 Additionally, in his Rebuttal Testimony Mr. Murray again attempts to misuse
17 valuation data from "fairness opinions" and asset impairment tests to estimate
18 investors' growth expectations. These are the very same kind of data from Mr.
19 Murray's analysis that the Missouri Public Service Commission ("Commission")
20 flatly rejected in prior Ameren Missouri rate case proceedings. *See* Case No. ER-
21 2011-0028, Report and Order at 69-70 (July 13, 2012); Case No. ER-2010-0036,
22 Report and Order at 20 (May 28, 2010). Mr. Murray's historical growth rate
23 calculations are incorrect, and his use of analysts' and accountants' discount rates,
24 which are often confidential and entirely unknown to the investing public, is
25 inappropriate. As the Commission has in past cases, it should continue to reject Mr.
26 Murray's inappropriate analysis.

27 **Q. At pages 5-6 of his Rebuttal Testimony, Mr. Murray says that four of your**
28 **comparable companies should have been excluded. How do you respond?**

1 A. First, Mr. Murray acknowledges on page 5, lines 18-19 that he is "not focusing on Dr.
2 Hadaway's proxy group for purposes" of his Rebuttal Testimony. As such, he
3 provides no analysis or explanation of why our respective proxy groups are so
4 different. Additionally, it is Mr. Murray who has a different proxy group; Mr.
5 Gorman, Mr. Kahal, and I use the same group.
6 I disagree with the reasons Mr. Murray states for removing the four
7 companies, because his reasons are *ad hoc* and could lead to "selectivity" criticism.
8 While it is generally not possible to pick a perfect proxy group, to the extent that
9 reasonable selection criteria are applied consistently and a reasonably large group is
10 chosen, the results should not be significantly affected by additional details like those
11 noted by Mr. Murray. Finally, as I explained in my Rebuttal Testimony DCF update,
12 I evaluated the comparable group based on the most recent data and eliminated two of
13 the four companies that Mr. Murray complains about. Those companies, Edison
14 International and Vectren, were removed because they no longer met my selection
15 criteria. Mr. Murray's comparable company comments are misplaced and should be
16 disregarded.
17 **Q. At page 9 of his Rebuttal Testimony, Mr. Murray offers an example based on**
18 **your GDP growth rate and the dividend yield for the S&P 500 Index. How do**
19 **you respond to this example?**
20 A. In his example, Mr. Murray adds my initial GDP growth rate estimate (5.8%) to the
21 recent S&P 500 dividend yield (2.24%) to obtain a "yield plus growth" DCF estimate
22 for the S&P 500 of 8.04 percent. While his math is correct, his logic is entirely
23 wrong. The simple, constant growth DCF model, which Mr. Murray uses for this

1 purpose, should not be applied to the S&P 500 index. Many of the companies in the
2 index currently pay little or no dividends, but they have (relative to GDP) very high
3 expected growth rates. Under these circumstances, the DCF model cannot be applied
4 without assuming a multi-stage growth approach, or by assuming that current
5 analysts' growth rates are expected to be blended, at some point in the future, with
6 lower perpetual growth rates and with, currently unknown, higher future dividend
7 yields. A correct application of the DCF model and principles of finance to
8 companies in the S&P 500 is much more complex than Mr. Murray's GDP growth
9 plus current yield approach. His S&P 500 analogy is, therefore, inappropriate and
10 misleading. As a result, Mr. Murray's conclusion at page 9 that his example
11 illustrates how my methodologies "defy" basic principles of finance should be
12 disregarded.

13 **Q. What other parts of Mr. Murray's GDP discussion do you disagree with?**

14 A. I additionally disagree with the second portion of Mr. Murray's GDP discussion,
15 which appears on pages 9-10 of his Rebuttal Testimony. In this discussion, Mr.
16 Murray mistakenly claims that GDP growth "… is often used for a company or an
17 industry in its 'growth phase,' i.e., experiencing 'supernormal' growth." In fact, the
18 opposite is true. In my Direct Testimony at page 38, I provided the following
19 quotation from the well respected Brigham and Houston textbook:

20 Expected growth rates vary somewhat among companies, but
21 dividends for <u>mature firms</u> are often expected to grow in the future at
22 about the same rate as nominal gross domestic product (real GDP plus
23 inflation). On this basis, one might expect the dividend of an <u>average,</u>
24 <u>or "normal," company</u> to grow at a rate of 5 to 8 percent a year.
25 (Eugene F. Brigham and Joel F. Houston, *Fundamentals of Financial*
26 *Management*, 11th Ed. 2007, page 298 [emphasis added].)

1 In addition to his misstatements about "supernormal" growth versus expected
2 growth for "mature" firms, Mr. Murray again refers to his flawed historical growth
3 rate studies to support his contentions.

4 **Q. On page 19, Mr. Murray criticizes your risk premium study. How do you**
5 **respond to these criticisms?**

6 A. Mr. Murray's criticisms of my analysis are misplaced. First, he says that my use of
7 allowed ROE data to interpret the market's required rate of return is of questionable
8 value. His opinion in this regard is exactly opposite of the Commission's opinion in
9 the July 2011 Ameren Missouri Report and Order:

> 10 The Commission mentions the average allowed return on equity
> 11 not because the Commission should, or would slavishly follow the
> 12 national average in awarding a return on equity to Ameren
> 13 Missouri. However, Ameren Missouri must compete with other
> 14 utilities all over the country for the same capital. Therefore, the
> 15 average allowed return on equity provides a reasonableness test for
> 16 the recommendations offered by the return on equity experts.
> 17 (Case No. ER-2011-0028, Report and Order at 67, ¶ 12).

18 Additionally, Mr. Murray is incorrect in his criticism of my risk premium adjustment,
19 which accounts for the inverse relationship between risk premiums and interest rate
20 levels. My data, spanning the 1980-2011 timeframe, clearly demonstrate this inverse
21 relationship. *See* Schedules SCH-6 and SCH-13 at page 3 and Hadaway Rebuttal
22 Testimony at page 21, Graph 2). During periods of high interest rates, regulators
23 have allowed and investors have come to expect, lower risk premiums. Similarly,
24 during periods of low interest rates, risk premiums tend to be expanded. Mr.
25 Murray's criticism of this fundamental relationship is simply a further effort to reduce
26 ROE in lockstep with current, artificially low interest rates. Finally, Mr. Murray is
27 incorrect in his criticism of my use of projected interest rates. I use both actual and

1 projected rates in my risk premium analysis because investors are fully aware of both.
2 The risk premium approach is an effort to gauge the cost of equity by reviewing debt
3 costs and the relationship between debt costs and the cost of equity. Interest rate
4 forecasts are an integral part of what investors expect and, therefore, such forecasts,
5 along with existing actual interest rates, provide additional information about what
6 investors expect their ROE to be. Mr. Murray's criticisms should be dismissed.

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

8 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Kansas City Power & Light)
Company's Request for Authority to Implement) Case No. ER-2012-0174
A General Rate Increase for Electric Service)

AFFIDAVIT OF SAMUEL C. HADAWAY

STATE OF TEXAS)
) ss
COUNTY OF TRAVIS)

Samuel C. Hadaway, being first duly sworn on his oath, states:

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, to serve as an expert witness 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 Seven (7) pages, 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

Subscribed and sworn before me this 24th day of September, 2012.

AMRITA SINGH
Notary Public
STATE OF TEXAS
My Comm. Exp. 01-14-2016

Notary Public

My commission expires: 01 /14 /2016