**BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI**

In the Matter of the Application of Kansas City )

Power & Light Company for Approval to Make )

Certain Changes in its Charges for Electric ) Case No. ER-2010-0355

Service to Continue the Implementation of )

Its Regulatory Plan )

**THE UNITED STATES DEPARTMENT OF ENERGY’S**

**INITIAL POSTHEARING BRIEF**

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COME NOW the United States Department of Energy and the United States Nuclear Security Administration (“DOE/NNSA” or “the Department”), by and through counsel, and for its initial brief in the above-captioned proceeding states as follows:

**I. Introduction**

**A. The Department’s Interests in This Proceeding**

DOE/NNSA owns and operates the Kansas City Site Office and an industrial facility located in Kansas City, MO. These consume approximately 160,000 mWhs of electric power annually, at a cost of approximately $6 million. For this reason, DOE/NNSA’s interests differ materially from those of the general public, and will be significantly impacted by the $92 million increase in electric rates which Kansas City Power & Light Company (“KCPL,” or “the Company”) seeks.

**B. The Department’s Witnesses**

**1.** **Mr. Michael Gorman** - In regard return on equity (“ROE”), DOE, together with the Midwest Energy Users Association (“MEUA”) and the Missouri Industrial Energy Customers (“MIEC”) presented direct, rebuttal, and surrebuttal testimony of Mr. Michael Gorman. Mr. Gorman is a managing principal with the firm of Brubaker & Associates, Chesterfield, Mo.

**2. Dr. Dennis Goins** - In regard to rate design/cost of service, DOE sponsored direct, rebuttal and surrebuttal testimony of Dr. Dennis Goins, who operates Potomac Management Group, Alexandria, VA.

**C. The Department’s Positions on the Issues**

**1. Return on Equity**

The Commission should adopt Mr. Gorman’s recommendation to grant the Company an ROE of 9.65%. Mr. Gorman’s has developed his recommendation on the basis of carefully considered application of each of the three well-established ROE methodologies oft relied on by this Commission. He has premised his application of each of those methodologies upon well thought out, thoroughly documented, and highly credible assumptions and calculations.

The Commission should reject Company witness Dr. Samuel Hadaway‘s recommendation to grant an ROE of 11.00%. This recommendation was developed by tendentiously, if not arbitrarily, disregarding two of the aforementioned well-established ROE methodologies. It is premised almost entirely upon application of the single remaining ROE methodology, and that application is based on a long term rate of growth which defies credibility, not only because of its exaggerated level, but because it has no basis except privately-implemented calculation.

**2. Interclass Revenue Allocation**

The Commission should order the Company to allocate any revenue increase that is granted in this case among all of the rate classes on an across-the-board basis, as per the terms of a document titled *Non-Unanimous Stipulation and Agreement as to Class Cost of Service/Rate Design*, which was filed on the Commission website on February 4, 2011. DOE witness Dr. Dennis Goins explained that this would be reasonable partly because current economic conditions are such that no rate class should receive an above-average increase, and also because the Commission has not yet decided how key cost items should be allocated among the rate classes, and in light of the fact that KCPL’s cost of service study is not reliable. (Goins Direct, 7)

DOE asked the Commission to reject KCPL’s effort to allocate off-system sales margins on a demand basis, and urged that such revenues continue to be allocated on an energy basis, as the Company has done in the past, (Goins Direct, 12 *et* seq.) and as the Commission required in a recent case. (*Ameron AU*, MPSC Doc. No. ER-2010-0054, Commission’s Report and Order, May 28, 2010, p. 84). The Stipulation and Agreement resolves this concern by applying an across-the-board revenue increase. As noted above, the Department requests the Commission to adopt the equal percentage method for allocating any revenue increase granted in this case.

**II. Discussion of the Issues**

**A. Return on Equity**

**1. Applicable Judicial and Commission Precedent**

The following discussion is premised upon fair rate of return principles established by the United States Supreme Court in *Federal Power Common. v. Hope Natural Gas Co.,* 320 U.S. 591 (1944) *and Bluefield Water Works & Improvements Co. v. P.S.C.*, 262 U.S. 679 (1923). In line with these precedents, this Commission has explained that its duty is to “use its judgment to establish a rate of return on equity (“ROE”) attractive enough…to allow the utility to fairly compete for the investors’ dollar…without permitting an excessive return that would drive up rates… .” This Commission has further explained that, in determining such a return on equity (“ROE”), its duty is to “consider the *expectations*…of investors (at the time that) they choose to invest their money in (the subject utility), rather than in some other investment opportunity.” (*Ameron AU*, *supra.,* p. 14) )

**2. The ROE Expert Witnesses**

To obtain guidance about the appropriate return on equity, the Commission considers the testimony of expert witnesses. Such witnesses in most cases present various versions of the methodologies described below. In this present proceeding, three expert witnesses presented pre-filed rate of return testimony which focus mainly on ROE. These witnesses are:

(a) for the Company, Dr. Samuel C. Hadaway (11%);

(b) for MIEU, MIEC, and the Department, Mr. Michael Gorman (9.65%);

(c) for the Commission Staff, Mr. David Murray (8.5% - 9.5%).

**3. The ROE Methodologies**

To enable Kansas City Power & Light (“KCPL,” or, “the Company”) to attract equity capital, the Commission must develop and permit an ROE level that can reasonably be depended upon to incent present stockholders to retain, and/or prospective investors invest in (purchase), the Company’s common stock. In order to develop such an ROE level, the Commission must determine at least the approximate percentage ROE that extant and potential shareholders require *at this time* to invest in or retain that common stock. It is not possible for any individual or group, no matter how knowledgeable, sophisticated, or sedulous, to determine such a ROE level in any direct manner. For this reason, several more or less standardized methodologies for indirectly determining ROE have been developed and have gained currency before this tribunal and many other State-level public utility regulatory entities. The three such methodologies that are generally-used before this Commission are Discounted Cash Flow (“DCF”), Risk Premium Analysis, and the Capital Asset Price Model (“CAPM”).

**4. The Witnesses’ DCF-Based ROE Analyses and Recommendations**

**a. The DCF Methodology**

All of the ROE witnesses implemented the DCF methodology as follows:

Begin by assuming that an investor who purchases a share of KCPL common stock does so on the assumption that *the dollar amount of* *that present price he pays is equal to the present value, the sum, of all of the return, in the form of dividends and/or capital appreciation that the investor expects to receive.* Proceeding from this assumption:

i. determine the present price of the stock;

ii. calculate the *present value* of the sum of all of the anticipated future dividends and appreciation that the investor expects to receive. To calculate this present value, assume that the purchaser/shareholder will own the stock in perpetuity and never sell it. In line with that, further assume, first that the investor will receive all future returns in the form of dividends, and, second, that those dividends will continue to flow to the investor perpetually, and forever.

Now, we are operating upon the assumption that *the present dollar price of the stock* is equal to the dollar value of *the sum of all future* *returns* which the investor expects to receive. In fact, however, it is inescapable that the sum of all future returns, in any credible circumstances, must greatly exceed the present price of the stock. How then, shall it be arranged to set the present price equal to the sum of all future returns?

The DCF methodology dictates that, in order to set the stock’s *present price* equal to the sum of all anticipated future returns, the value of those future returns must be *discounted* at some rate*.* The rate at which the present value of the future returns must be discounted in order to render it equal to the present price of the stock is calculated by comparing of the present price of the stock to the (larger) sum of all future expected returns. Under the DCF, the resultant *discount rate* constitutes the ROE which the investor presently.

There is no dispute herein as to the mathematical model, the equations, upon which the above-described DCF methodology and the necessary calculations thereunder shall be based. (compare Hadaway Direct, 16 *et seq., Gorman Direct, 13 et seq.,*(Staff Rate Design and Cost of Service Report, November 24, 2010 (“Staff Rpt.”), 27) There is also no dispute as to applicable capital structure), stock price, or dividend yield. There is no material dispute as to the proxy group upon which the experts’ necessary dividend yield calculations are based. Two of the witnesses used the same proxy group (see Hadaway Direct, 39; Hadaway Rebutal, 11) Staff used a different group, but that group’s dividend yield is only slightly lower than that of the group used by Dr. Hadaway and Mr. Gorman. The one disagreement as to how to use the proxy group involves only a “slightly” different overall DCF estimate. (Hadaway Rebuttal, 18)

**b. The Pivotal Issue of DCF Growth Rate**

As described above, DCF computation depends upon calculating the sum of future returns. In order to do that, a *growth rate* for such future returns must be calculated and then adopted in the DCF methodology. This growth rate calculation is pivotal and crucial in the DCF methodology. The higher the growth rate, the higher the calculated sum of the future returns. The higher the sum of the future returns, the higher the sum of the futures becomes, compared to the present price of the stock. The higher the present price of the stock, the higher the discount rate that must be applied to the sum of those returns in order to render that sum equal to the present price of the stock. And, because the growth rate drives the discount rate, and the discount rate constitutes the resultant recommended ROE, the higher the growth rate, the higher the recommended ROE. Thus, the growth rate or growth rates that underlie any DCF analysis are to all intents and purposes determinative of what the resultant DCF-based recommended ROE shall be. For this reason, the manner in which the growth rate is determined is crucial.

In times of less short and long term marketplace turbulence and uncertainty, it was considered an acceptable DCF methodology to determine what is called a “constant growth” rate, and adopt that single constant rate the sole growth rate for carrying out a DCF calculation. In this proceeding, however, all of the witnesses agree marketplace conditions are such that one such simple rate is insufficient. Thus, each of the witnesses has made and presented several DCF studies, each of which is based on a different growth rate or combination of growth rates.

**c. Mr. Gorman’s DCF-Based Presentation**

Mr. Michael Gorman, witness for the Midwest Energy Users Association, Missouri Industrial Energy Consumers, and the Department, presented a series of DCF models.

*DCF Calculation Based on “Constant Growth” Rate*

Mr. Gorman calculated a constant growth rate on the basis of an average of professional security analysts’ earnings growth estimates. (Gorman Direct, 18) From these he calculated an average growth rate of 5.68%, a median growth rate of 5.41%., and a resultant ROE range of 10.39% to 10.48%. (Gorman Direct, 20)

*DCF Calculation Based on “Sustainable” Growth Rate*

Mr. Gorman explained that neither this nor any “constant” growth rate can be sustained over a term longer than three to five years because, among other things, such “constant” growth rates significantly exceed the average consensus anticipated growth rate of 4.75% that is forecast for the Nation’s gross domestic product (“GDP”). (Gorman Direct 20-23, 26) In line with this, Mr. Gorman developed and adopted “sustainable” growth rate that is based on an “internal growth” methodology which measures the portion of utility earnings that is retained and reinvested. He based this on current market-to-book ratio and the *Value Line*’s three to five year projections. (Gorman Direct, 23) From this, he calculated average and median sustainable growth rates of 4.92% and 4.59%, respectively, and resultant ROEs of 9.74% and 9.38%, respectively. (Gorman Direct, 23-24)

*DCF Calculation Based on “Multi-Stage” Growth Rates*

Mr. Gorman’s presented a DCF model which reflected three growth stages: (1) short term, years one through five; (2) transition stage, years six to ten; (3) long term, year eleven through perpetuity.

For the first stage, he relied upon the “constant growth” rate described above.

For each of the years in the second or “transition” stage, years six to ten, he applied an equal annual factor to the constant growth rate. This gradually reduced the constant rate to a maximum sustainable growth rate of 4.75%, the above-discussed projected growth rate for the Nation’s gross domestic product. This multi-stage DCF calculation produced average and median ROEs of 9.78% and 9.86%, respectively. (Gorman Direct, 25-26)

*Mr. Gorman’s Final DCF-Based ROE Recommendation*

To produce his final DCF-based ROE recommendation, Mr. Gorman averaged the results of his constant growth, sustainable growth, and multi-stage growth DCF models to calculate an overall recommended DCF-based ROE of 9.88%. (Gorman Direct, 27)

**d. Dr. Hadaway’s DCF-Based Presentation**

Testifying for the Company, Dr. Samuel Hadaway produced three versions of DCF analysis. (Hadaway Direct, 39-44) His first version was based on two different constant growth rates. The first such rate was based on analysts’ estimates of five year utility earnings growth. This, he said, produced an ROE of 10.5 to 10.7%. (Hadaway Direct, 39 - 44) He also did a constant growth analysis based on projected GDP growth. This produced an ROE of 11.0%. (Hadaway Direct, 42-43) Finally, he conducted a two- stage version of a DCF study. This consisted of a first stage of three to five year dividend projections and then a second stage which was based entirely on long term projected growth in GDP. It produced an ROE of 10.80%. (Hadaway Direct, 43)

Dr. Hadaway’s methodology is unreliable. Apart from his first constant growth rate-bases DCF study, all of Dr. Hadaway’s studies, and all of his resultant ROE recommendations, are based on what he claims is a proper long-term projected growth rate of 6% for the Nation’s GDP. That unsubstantiated forecast growth rate, which he set at 6%, forms the basis for his DCF-based recommendations. (Hadaway Direct, 41) There may be some question as to whether a projected GDP growth rate ought to be used for measuring long term growth as it is used in DCF studies. But there is no question at all that, if a GDP growth rate shall indeed be used in any DCF study, that GDP growth rate must be well-founded and credible. The Department respectfully submits that Dr. Hadaway’s GDP growth rate is neither.

Mr. Gorman has persuasively pointed out, first, that Dr. Hadaway’s assertions as the level of anticipated future GDP growth are based entirely upon Dr. Hadaway’s own singular assessment of GDP growth rates, and his private calculations and outlooks thereupon. (Gorman Surrebuttal, 12) In line with this, Dr. Hadaway admitted during cross-examination that he himself created this growth rate entirely on his own, independent and apart from any material that has been adopted, published or presented anywhere else. (Transcript (“T”) - 2479-80, 2490)

Moreover, Dr. Hadaway’s growth rate, even if it were based upon some credible evidence, is not available to, and therefore cannot influence, investors. Moreover, Dr. Hadaway has presented no evidence that investors share his view. This renders Dr. Hadaway’s privately-developed growth rate quite irrelevant, because the ROE figure which the Commission must find is cannot merely be based on what Dr. Hadaway claims to think that GDP growth rate will be, but, rather, what it is fair and reasonable to assume that *investors* think it will be. Moreover, the record shows that Dr. Hadaway’s growth assessments have been rejected by at least five State-level regulatory Commissions. (Gorman Rebuttal, 9; Gorman Surrebuttal, 11)

Dr. Hardaway developed his final ROE recommendation entirely from an average of the results of his three above-described DCF studies. He included no other studies in this pivotal calculation. The results of two of those DCG studies are premised upon Dr. Hadaway’s unacceptable GDP growth rate. All of Dr. Hadaway’s studies, and all of his resultant ROE recommendations, must therefore be rejected. This is especially trenchant because, as will next be discussed, Dr. Hadaway has, for the purposes of determining recommended ROE in this proceeding, relied entirely upon his DCF analyses, and rejected both of the other traditional methodologies for determining utility ROE.

**5. The Witnesses’ Risk Premium-Based ROE Analyses and Recommendations**

**a. The Risk Premium Methodology**

Risk premium-based methodologies and models are based on the widely-accepted general observations that investors require a higher return to a assume greater risk, that common equity investments generally entail assumption of greater risk than bonds, and that, therefore, the amount by which common equity returns exceed bond dividends constitutes the “risk premium” that investors demand for investing in common equity rather than debt. (Gorman Direct, 28) Thus, if one measures this risk premium, and then adds the risk premium to a properly-measured return on debt, one may determine a proper ROE

**b. Mr. Gorman’s Risk Premium Analysis**

Mr. Gorman computed risk premium in two ways. First, he measured the difference between returns on utility common equity and returns on U.S. Treasury bonds. Here, Mr. Gorman calculated the resultant equity risk premium at 5.19%, He said that, of 25 observations which he considered, 19 indicated risk premiums within a range of 4.40% and 6.08%. He recommended that that range be adopted to measure current risk premiums, because risk premiums can vary depending on market conditions and changing investor risk perceptions. (Gorman Direct, 29, 31) Mr. Gorman then added a projected long-term Treasury bond yield of 4.7% to 4.40% to 6.08% risk premium range. This produced a common equity return in the range of 9.10% (4.70% + 4.40%) to 10.78%. (4.70% + 6.08%), with a midpoint of 9.94%. (Gorman Direct, 31)

Second, Mr. Gorman measured the difference between returns on utility common equity and yields on “A”-rated utility bonds. (Gorman Direct, 28) He found that the resultant average equity risk premium is 3.75%, and that risk premiums based on this analysis primarily fall within the range of 3.03% to 4.59%. (Gorman Direct, 29) He then added those equity risk premiums to a current average return 5.60% on “Baa” rated utility bonds. This produced an ROE range of 8.63% to 10.19%, with a midpoint of 9.41%. (Gorman Direct, 32) Mr. Gorman then averaged the aforementioned midpoints of 9.94% and 9.41% to produce an overall midpoint ROE estimate of 9.68% from his risk premium model. (Gorman Direct, 32)

**c. Dr. Hadaway’s Risk Premium Analysis**

Dr. Hadaway’s carried out his fundamental risk premium methodology by, first, comparing utilities’ authorized ROEs to contemporaneous projected and current long term utility interest rates, with the difference constituting the risk premium. This produced a risk premium of 3.23%. He then added his 3.23% risk premium to forecasted and current three months average triple-B utility bond interest yields of 6.22% to 6.57%. (Hadaway Direct, Sch. 6) Had he stopped there,

Dr. Hadaway’s risk premium methodology would have produced a recommended ROE range of 9.45% (3.23% + 6.22%) to 9.80%.

But Dr. Hadaway asserted that his 3.23% risk premium required further work to reflect present conditions. He said that there is a “well-documented” inverse relationship between risk premiums and interest rate levels. (Hadaway Direct, 44) This means that, when interest rates are relatively low, risk premiums are relatively high, and *vice versa*. Dr. Hadaway asserted that, in this era of low interest rates, this supposed phenomenon, unless its effect is represented in risk premium studies, causes traditionally-calculated risk premiums to be understated. He explained that, to represent the effect of this phenomenon, he used a regression analysis, which he called “negative interest rate change coefficient in conjunction with current interest rates,” to increase his calculated risk premium in line with current the low interest rates. (Hadaway Direct 44, Gorman Rebuttal, 11) This dubious premise, and the pivotal regression analysis which Dr. Hadawy has based upon it, constitutes Dr. Hadawy’s only basis for increasing his traditionally-calculated risk premium of by over thirty percent, from 3.23% all the way up to up to 4.25% and 4.39%. These inflated risk premiums, and these alone, enabled Dr. Hadaway to attain recommended ROEs of 10.82% to 10.61%. (Gorman Rebuttal, 11) Later, Dr. Hadaway felt compelled to lower this range to 10.05 - 10.24. (Hadaway Rebuttal, 23) This demonstrates that, even with this dubious procedure to assist him, Dr. Hadaway could not contrive to make his own ROE recommendations high enough to comport with the Company’s request. This difficulty also likely explains the reason why Dr. Hadaway at that point chose to “discount” his own risk premium study, and base his ROE recommendation entirely upon his DCF presentation. (Hadaway Rebuttal, Hadaway Surrebuttal. 5, 9)

Mr. Gorman asserted strongly that it is improper to assume, and then dramatically adjust for, some supposed lockstep inverse relationship between interest rates and risk premium. (Gorman Rebuttal, 13) He said that interest rates move in response to changes investor perception of the relative risk of bond investments relative to equities, and not simply in response to nominal changes in interest levels. (Gorman Rebuttal, 14; T-2866 *et seq.*)

**6. The Witnesses’ CAPM--Based ROE Analyses and Recommendations**

**a. The Capital Asset Pricing Model (“CAPM”) Methodology**

The CAPM methodology is premised upon the theory that the market does not compensate the investor for assuming “business” or “non-systemic” risks that the investor could avoid by owning a diversified investment portfolio. Rather, the market compensates the investor only for “non-diversifiable” risks that the investor can*not* avoid by diversification. To develop an ROE on this basis, the CAPM methodology aims to calculate, for an individual company’s stock, a risk premium that represents only the subject stock’s non-diversifiable risks (these are called “non-systemic” or “business” risks), and does not include that stock’s diversifiable risks.

To do this, the CAPM first identifies the subject stock’s specific risk factor. Such a risk factor is referred to in CAPM methodology as a *beta.*  Next, a risk premium for an appropriate market portfolio is identified. The *beta* is then multiplied by that market portfolio risk premium. The product measures and represents the individual stock’s non-diversifiable risks. That figure for the stock’s non-diversifiable risks is then added to a risk-free rate. The sum of the non-diversifiable risk rate plus the risk free rate constitutes the stock’s proper ROE. (*Ameron*, supra., 17; Gorman Direct, 33 -34) Thus, the CAPM formula is:

ROE = *(stock’s specific risk factor (beta) x market portfolio risk premium) + risk free rate*

**b. Mr. Gorman’s CAPM Analysis**

In his CAPM analysis, Mr. Gorman adopted a beta factor of .70, his proxy group average *Value line* beta, as the stock’s specific risk factor. (Gorman Direct, 34; Gorman Sch. MPG-15) He then developed two types of market risk premiums, one forward-looking, one historical. He estimated the forward-looking rate by estimating the expected return on the market as represented by the S&P 500 and then subtracting the risk-free rate from that estimate. He estimated the historical rate by adding an expected inflation rate to a long term historical arithmetic average of “real” market return, that is, achieved return above the rate of inflation. (Gorman Direct, 34-37) This produced an average market return of 8.6%. (Gorman Direct, 34-35)

Mr. Gorman then added to this a current consensus analysts’ inflation projection, as measured by the Consumer Price Index, of 2.0%. This produced an expected market return of 10.77%.

(Gorman Direct, 35, n. 18) Next, he subtracted a risk free rate of 4.7%, the *Blue Chip Financial Forecasts’* projected thirty year Treasury bond yield. He explained that this is a properly-adopted figure for the risk free rate because long-term Treasury bonds have an investment horizon similar to that of common stock and, as a result, investor-anticipated long-run inflation expectations are reflected in the required returns for both common stock and long term bonds. Subtracting this risk free rate of 4.7% from the 10.77% expected market return produced a market premium for KCPL shares of 6.7%. (Gorman Direct, 33-35)

Mr. Gorman also referenced an historical estimate of market risk premium which was published by Morningstar in *Stocks, Bonds, Bills and Inflation 2010 Yearbook*. This study estimated that the arithmetic average of achieved total return was 11.80%, and that return on long-term Treasury bonds was 5.80%. From this, Mr. Gorman calculated an equity risk premium of 11.80%, minus 5.80%, or 6.00%. (Gorman Direct, 35) Mr. Gorman demonstrated the reasonableness of his calculated market risk premiums by pointing out that Morningstar’s analyses indicate that market risk premium falls somewhere between 5.2% and 6.7%. (Gorman Direct, 36-37)

To complete his CAPM analysis, Mr. Gorman took a low-end market risk premium of 5.2%, a high-end market risk premium of 6.7%, and multiplied each by his .70 beta. This produced results of 3.64% to 4.9%. When Mr. Gorman added each of these each of these which, when added to his 4.7% risk free rate, produced a range of 8.33% to 9.38%. Mr. Gorman adopted the high-end calculation of 9.38%, which he rounded to 9.4%, as his risk premium-based ROE recommendation. (Gorman Direct, 37)

**c. Dr. Hadaway’s Views on CAPM, and His Failure to Present a CAPM Analysis**

Dr. Hadaway’s conceptual view of the CAPM methodology is quite favorable. He described the CAPM as a “more sophisticated” risk premium approach and stated that CAPM is “widely used” in “academic” cost of capital research jurisdictions. He neither questioned CAPM’s validity nor suggested that this tribunal does not accept it. With regard to CAPM’s role in calculation of ROE for regulated utilities, he said that CAPM provides a “useful parallel approach” with the DCF methodology, and that CAPM can be used to “assure consistency” in cost of equity estimations. (Hadaway Direct, 14-15)

Dr. Hadaway maintained, however, that “government monetary policies and recent flight to safety issues have pushed Treasury bond interest rates to artificially low levels.” He asserted that this has caused “CAPM estimates (to) understate the market cost of equity,” (Hadaway Rebuttal, 23) and that the CAPM methodology is therefore “currently unreliable.” (Hadaway Rebuttal, 16) On this basis, Dr. Hadaway now asserts that this Commission should accord absolutely no place for the CAPM methodology in its determination of ROE for KCPL. (Hadaway Rebuttal, 23)

In line with this, Dr. Hadaway further asserted that Mr. Gorman’s CAPM-based ROE recommendations are too low, because Mr. Gorman based his risk free rate on “the current artificially low government bond interest rate.” (Hadaway Rebuttal, 17,21) Here, Dr. Hadaway unaccountably ignored the fact that Mr. Gorman used not a current short term rate but a 30 year rate, and that such a long term rate is far more market-driven than government-influenced. (T- 2864-2865)

Despite this apparent error, the Department does not find this criticism by Dr. Hadaway of Mr. Gorman’s CAPM methodology altogether inapposite. There is, after all, no question that Dr. Hadaway is entitled to criticize Mr. Gorman’s or any other witness’s manner of application of the CAPM methodology. But Dr. Hadaway has gone far beyond the usual practice of questioning the manner in which CAPM, or any methodology, ought to be applied. For, in fact Dr. Hadaway completely excluded CAPM from his ROE analysis. (see, Hadaway Rebuttal, 21,23, 44) And, even beyond that, Dr. Hadaway asserts that the Commission should disregard “*any results from a CAPM analysis.”* (Hadaway Rebuttal, 23)

Here, the true source of Dr. Hadaway’s purported rejection of the CAPM methodology is starkly clear: The fact is that any analyst who applies the CAPM to KCPL in any reasonable manner will find CAPM produces ROEs are much lower that the Company finds acceptable. As KCPL counsel stated directly and on the record, Dr. Hadaway did not present a CAPM simply because “…he took a look at it and found that the rates (of return on equity) were too low and he rejected it.” (T-2452) And, indeed, Dr. Hadaway would have the Commission do exactly as he has done – completely ignore, and ascribe no value or weight to, the CAPM.

The Department respectfully submits that this would be unacceptable. The reliability of any ROE model can and does vary from case to case. Thus, a rate of return expert may, with best judgment to guide, find that circumstances are such that cold numerical rates or even ranges which he attains from calculations under the CAPM model, or any other, are somewhat higher or lower than individual circumstances would suggest they ought to be. (see, *e.g.*, T-2865-2866) An expert so situated is free to “tweak” his application of the model in any credible manner, and free, too, to suggest that the models’ results ought to be given less or more weight in the overall ROE calculation. But for an expert to do such calculations with a traditionally-accepted and widely-used model, find the numbers not to his liking, and then assert, for that reason and no other, that the model ought to be summarily and entirely cast aside is far beyond acceptable practice. Absent any presentation from KCPL on CAPM, the Commission should adopt Mr. Gorman’s, and accord it due weight in development of the Company’s ROE. In this regard, it is worth nothing that Staff’s CAPM analysis produces recommended ROEs of 7.72% and 6.69% (Staff Rpt., 34 – 36, Sch. 12), and constitutes a significant portion of the basis upon which Staff asserts that it is “not improbable that investors are only requiring returns on common equity in the 7% to 8% range for utility stocks.” (Staff Rpt., 36)

**7. The Witnesses Final ROE Recommendations**

**a. Mr. Gorman** - Mr. Gorman based his final ROE recommendation on the range of

all three of his studies, his DCF analysis which produced an ROE of 9.88%, his Risk Premium

analysis which produced an ROE of 9.68%, and his CAPM analysis which produced

a low-end ROE of 9.40%, for a range of 9.40% to 9.88% and a midpoint of 9.65%.

(Gorman Direct, 37) On the basis of these multiple, well-grounded analyses, he recommended an ROE for KCPL of 9.65%. (Gorman direct, 2, 37) In his rebuttal testimony, Mr. Gorman stated that he had developed a more recent ROE study which supported an ROE of 9.5% rather than 9.65%. (Gorman Rebuttal, 3) Later, and from the stand, he returned to his prior figure of 9.65%. (T-2470, 2852-2853) He then demonstrated that this return of 9.65% will support an investment grade rating for KCPL, by comparing the key credit rating financial ratios for KCPL at his proposed ROE to S&P’s benchmark financial ratios using S&P’s new credit metric ranges. (Gorman Direct, 38 *et seq.*)

**b. Dr. Hadaway** - Dr. Hadaway sought an ROE of 11.00%. (Hadaway Surrebuttal, 2) He stated that his risk premium analysis indicated a range of 10.61% to 10.83%. (Hadaway Direct, 5), that his DCF analysis indicated a range 10.5% to 11.00%, and that he estimated the midpoint cost of equity for his proxy group at 10.75%,. (Hadaway Direct, 5) (He provided no CAPM study at all.) Having developed this rate of 10.75%, recommended that the Commission grant the Company an additional ,25% “adder.” (Hadaway Direct, 10; Blanc Direct, 10) Thus, constitutes an ROE of 11%.

**c. Mr. Murray** - Mr. Murray prepared the portion of the Staff Report that addressed

rate of return. (Staff Rpt., 26 – 38, Murray Rebuttal, 1) Staff recommended and has continued to recommend an ROE in a range of 8.5% to 9.5%. (Staff Rpt. 39; Murray Surrebuttal, 5, Corrected Sch. 16; Murray True-Up Direct, 1) Mr. Murray asserts that the Goldman Sachs current cost of equity estimate for the utility industry was 7.7% to 11./1% for the utility industry in early 2009, and that it would now be closer to 7.1% than to 9.1%. (Murray Surrebuttal, 22) Mr. Murray also opined that allowed ROE’s for electric utilities have remained as high as they have until this time because of a reluctance on the part of regulators to depart from “stable long-run returns of utility capital” by allowing ROEs to descend at rates similar to those at which debt costs have fallen. (Murray Surrebuttal, 13)

**8. Argument: Dr. Hadaway’s ROE Recommendations Should Be Rejected**

Dr. Hadaway stated that his experience has demonstrated that risk premium methods provide a “good parallel approach” to DCF, and that “a combination of DCF and risk premium methods provides the most reliable approach” to calculating ROE. (Hadaway Direct, 15) He said that, in this proceeding, he planned to “rely on” the DCF methodology, and to “review” the risk premium-based methodologies. (Hadaway Direct, 21).

Dr. Hadaway has not adhered to his own description of what constitutes the best manner in which to calculate ROE. Although he made it clear that the best ROE determination is to be made by a combination of all three methodologies, DCF, risk premium and CAPM, he has since ignored the other parties’ and *his own* risk premium and CAPM analyses, and now seeks to persuade this tribunal to do the same. Obviously, this departs starkly from the practice of having each witness present three analyses, one based on the DCF, one based on risk premium, and one based on the CAPM, and leaving it to this tribunal to determine, on the basis of the resultant complete record, which single analysis or combination of analyses provides the best estimate of the cost of equity.

The Department respectfully suggests that it is entirely acceptable to perform studies that are based on the same methodology in different ways, or different inputs, or to argue that any such studies should be interpreted and influenced by all manner of other influences and opinions. But it is not acceptable simply refuse to present *any* study at all – as Dr. Hadaway has done with the CAPM methodology - and demand that the tribunal simply precede on the basis that the study, if it were presented, would suggest ROE levels that are so profoundly incorrect as to render the study not worth presenting. Such decision to completely ignore CAPM, or risk premium, or any other methodology, is for this Commission, and not Dr. Hadaway.

Moreover, Dr. Hadaway’s failure to provide any CAPM study, together with his “discounting” of his own risk premium studies, leave only his DCF studies to support his ROE recommendations. Dr. Hadaway’s DCF studies fail to do that. His updated DCF analysis shows ROE at between 10.20% and 10.80%, rather than the 10.61% to 10.83%. Thus, his lower range descended sharply between June and December of last year. (Hadaway Rebuttal, 22) More important still, and as described above, all but one of Dr. Hadaway’s DCF studies, and his overall DCF-based ROE recommendation, are based upon his unsupported and greatly flawed growth rate of 6%. As such, these studies cannot be credible and should be rejected.

The Commission should reject Dr. Hadaway’s ROE recommendation.

**B. Interclass Revenue Allocation**

Company witness Paul Normand prepared the Company’s cost of service study, which he premised upon a “Base-Interim-Peak” (“BIP”) methodology. (Normand Direct, 2 *et seq.*) The Office of Public Counsel (“OPC”) did not present a cost of service study, but OPC witness. Barbara Meisenheimer prepared interclass revenue allocations based on the Company’s BIP study. (Meisenheimer Direct, 3) Staff witness Michael Scheperle sponsored a cost of service study based on a methodology that was quite similar to that used by Mr. Normand. (Staff Rpt., , p. 7 *et* seq.; Scheperle Direct, 4 *et seq.*) Staff advocated that the first $13 million of any rate increase be allocated among the classes whose present contribution to total revenues is less than the Company’s cost to serve them. (Scheperle Direct, 2, 6) Mr. Maurice Brubaker, witness for Missouri Industrial Energy Consumers and others, prepared a cost of service study based on the “Average & Excess” (“A&E”) methodology. (Brubaker Direct, 3, 18 *et seq.*) DOE witness Dr. Dennis Goins prepared a cost of service study which was based on the well-recognized “4CP” methodology. (Goins Direct, 18) This witness exchanged extensive views as the pros and cons of these methodologies through three rounds of testimony.

Although there was much debate regarding the relative merits of these allocation methodologies, the Company itself proposed to allocate whatever increase it might receive among its customer classes on an across-the-board basis. (Rush Direct, 8) For the Department, Dr. Goins expressed agreement. He stated that he believed that it would be best at this time for the Commission not to choose any of these methodologies at this time, but rather to direct the Company to allocate revenues on an equal percentage “across-the-board” basis. He explained that this would be reasonable and prudent because current economic conditions are such that there ought to be no rate class should receive an above-average increase. Dr. Goins added that across-the-board treatment is also best at present because the Commission has not yet decided how key cost items (in particular fixed production costs) should be allocated among the rate classes, and because the Company’s cost of service study is not reliable. (Goins Direct, 7)

An undated document titled *Non-Unanimous Stipulation and Agreement as to Class Cost of Service/Rate Design* was filed on the Commission website on February 4, 2011. The terms of this stipulation include allocation of any revenue increase that is granted in this proceeding on an equal percentage, across-the-board basis, to all rate classes. This fair and logical approach to allocation of any rate increase should be adopted.

**C. Interclass Allocation of Off-System Sales Revenues**  Although it has up to this time carried out allocation of off-system sales (“OSS”) margins on the basis of class energy usage, KCPL has proposed in this filing to allocate among its Missouri customer classes on the basis of a demand allocator. (Goins Direct, 13) The Department respectfully opposes this, because this Commission adopted an energy usage-based OSS allocation methodology for a similar entity less than one year ago. (*Ameron, supra.,* 86-87) Moreover, and as Mr. Brubaker and Dr. Goins have agreed, that the Company has not provided any acceptable justification for this proposed departure from Commission precedent. (Brubaker Rebuttal, 3; Goins Direct, 6, 13) The Cost of Service Settlement and equal percentage increase for the rate classes resolves this concern as well. Once again, the Department respectfully asks the Commission to adopt the across-the board revenue increase to the customer classes in accordance with the Stipulation filed on February 4, 2011.

**III. Conclusion**

For the reasons above-stated, the Commission should adopt:

A. Mr. Gorman’s recommendation to grant the Company an ROE of 9.65%;

B. an across-the-board equal percentage revenue increase for each class of customers as set out in the *Non-Unanimous Stipulation and Agreement as to Class Cost of Service/Rate Design* which was filed on the Commission website on February 4, 2011;

Finally, the Department would respectfully add that Commission Staff has been extraordinarily industrious, thorough, and sedulous in its work in this proceeding, and has thus enabled itself to present many very well-founded proposed adjustments to the Company’s revenue-related requests. The Department urges the Commission to give all possible fair consideration to those proposed adjustments.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day filed the foregoing Initial Brief of the United States Department of Energy on the website of the Missouri Public Service Commission in accordance with all applicable procedures, and emailed a copy of the same to the Administrative Law Judge and to all of the parties by their attorneys of record.

Arthur Perry Bruderl

Dated: March 10, 2011