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

REPLY BRIEF

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REPLY BRIEF OF THE UNITED STATES DEPARTMENT OF ENERGY

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 their reply brief in the above-captioned proceeding state as follows:

I - INTRODUCTION

A. Background Kansas City Power & Light Company's ("KCPL" or "the Company") rate increase application is premised upon its assertion that it cannot attract capital unless this Commission empowers it to impose higher rates – upon ratepayers whom no one doubts are already hard-pressed - which will enable it to gather additional revenues sufficient to produce a return on equity ("ROE") of 10.75%. (Hadaway Direct, 5 *et seq.*)

Typically, a rate increase application includes expert witness testimony and financial schedules that set out the procedures and methodologies that the applicant utility's financial witness has followed in order to knowledgeably and competently render a credible judgment of what ROE level is necessary. This Commission reasonably expects such testimony to include:

(1) financial materials gathered from *a wide range of credible financial sources which encompass relevant past, present and projected future activity within the industry*;

(2) adoption of those materials in application of *three widely accepted ROE methodologies:*
(a) the Discounted Cash Flow Methodology ("DCF") (see DOE Initial Brief, 5);
(b) the Risk Premium Methodology (see DOE Initial Brief, 11);
(c) the Capital Asset Pricing Model ("CAPM") (see DOE Initial Brief, 14);

(3) development of at least *one suggested ROE or ROE range from each methodology; and,*

(4) development of a single, final requested ROE or ROE range by the process of *drawing together the results of the three methodologies* in some credible manner.

B. The Data and Methodology Which Comprise KCPL's ROE Presentation Do Not Constitute Even a *Prima* Facie Showing That KCPL's Requested 10.75% ROE is Correct. There are a vast number of sources from which an expert witness may access and examine a virtually unlimited array of credible financial data and opinion. There are also many credible variations in the manner in which such an expert may apply, and then interpret the results of, each or some combination of the three accepted ROE methodologies. With all of this latitude as to data and methodology, an expert witness can almost always unearth at least some credible data, and devise at least one credible methodological exercise, which together comprise at least a *prima facie* credible justification for his client's ROE request.

Considered in this light, KCPL's ROE presentation herein is quite exceptional, indeed quite remarkable. This is so because that presentation demonstrates that the Company's ROE witness, Dr. Samuel Hadaway, *has not been able to unearth any credible financial data or opinion, and has not been able to devise even one credible methodological variation, which together comprise even a prima facie credible justification for KCPL being permitted the opportunity to earn an ROE of 10.75%.* The unmistakable indicia of Dr. Hadaway's are, in summary:

(1) Dr. Hadaway's risk premium study produced a recommended ROE range of 9.45% - 9.80%. This being vastly below KCPL's 10.75% request, Dr. Hadaway made a singular and self-serving departure from accepted methodology by adjusting this range with a regression analysis. He speciously asserted that this was necessary to account for a supposedly exaggerated increase in risk premiums caused by low interest rates. When even this remarkable methodological mutation was insufficient to enable Dr. Hadaway to contrive justification for KCPL's requested 10.75%, Dr. Hadaway said that he has "discounted" the risk premium methodology;

(2) Dr. Hadaway admitted that CAPM is a "more sophisticated" risk premium methodology and a "useful parallel approach" to "assure consistency" in ROE estimates, but asserted that CAPM understates cost of equity. Although he provided no evidence of this, he treated it as grounds sufficient for him to refuse to submit any CAPM study, and to recommend that this Commission disregard all other CAPM analysis;

(3) Dr. Hadaway chose a 6% growth rate for his DCF analysis. This growth rate is for a number of reasons neither well-founded nor credible. Because analyst's chosen growth rate virtually determines the outcome of any DCF study, Dr. Hadaway's DCF analysis is not credible;

(4) Dr. Hadaway has "discounted" his own risk premium study, refused to present a CAPM study, and so premised his DCF analysis as to render it valueless. In so doing, he has failed to adhere to the accepted procedure under which an ROE recommendation that is made to this Commission is based on calculations which flow from all three methodologies, and which draws together those methodologies to form a final ROE recommendation. (see, *e.g.*, (*Ameron AU*, MPSC Doc. No. ER-2010-0054, Commission's Report and Order, May 28, 2010 ("Ameron"), pp. 21 – 23)

Having failed to proffer any credible *prima facie* justification for its ROE request, the Company is trying to justify that request primarily if not exclusively by pointing out that other utilities have been granted ROEs of similar levels. In this, the Company is in effect asking this Commission to set its ROE not on the basis of what the Company can demonstrate that *it* requires, but on the basis of ROEs that certain other utilities have demonstrated that *they* require. This untenable suggestion, together with the Company's failures to present any Risk Premium, CAPM, or DCF analysis that credibly justifies its ROE request, render manifest the Company's inability to proffer any demonstration that its requested 10.75% ROE is even credible, much less correct.

C. Mr. Gorman's ROE Analyses and Recommended ROE Are Well-Founded and Correct.

Michael Gorman**,** the ROE witness whom DOE co-sponsored, recommended that KCPL be permitted to earn an ROE of 9.65%t. Unlike the Company, Mr. Gorman has succeeded in demonstrating that his recommended ROE figure is both credible and correct.

Mr. Gorman, unlike Dr. Hadaway, based his ROE recommendation on broad-ranging historical, current and forward-looking data that is generally available to investors. He performed and presented studies which are based on each of the methodologies. He took all of those methodologies into account in determining his ROE recommendation, by calculating their resultant ROE ranges and then drawing those ranges together by adopting their midpoint as his recommended 9.65% ROE. He went on to demonstrate, by comparing key financial ratios to

S&P's benchmark financial ratios, using Standard &Poor's new credit metric ranges, that a 9.65% ROE will support an investment grade rating for KCPL.

II - ARGUMENT: THE COMPANY HAS NOT MADE EVEN A *PRIMA FACIE* DEMONSTRATION THAT ITS ROE RECOMMENDATION IS CORRECT.

A. Dr. Hadaway's Risk Premium Study is so Unpersuasive that He Himself "Discounts" It.

Dr. Hadaway measured risk premium at 3.23%, the difference between a group of utilities' authorized ROEs and their interest costs. He added this 3.23% risk premium to certain triple-B utility bond interest yields of 6.22% - 6.57%. (Hadaway Direct, Sch. 6) Had he stopped there, Dr. Hadaway's risk premium methodology would have been at one with the manner in which risk premium studies are traditionally and properly carried out. Moreover, he would have produced a recommended ROE range of 9.45% (3.23% + 6.22%) to 9.80% (3.23% + 6.57%), which is considerably lower than the 10.75% which the Company is seeking. Interestingly too, the midpoint of this range is 9.625%, and that is very nearly the same as Mr. Gorman's well-grounded recommendation of 9.65%.

But neither 9.625% (nor 9.65%) was high enough to justify the Company's requested 10.75%. This led Dr. Hadaway to introduce a brand new step into risk premium methodology. This next step was a regression analysis, which Dr. Hadaway claimed was necessary to account for some supposed inverse relationship between low interest rates and risk premiums.

By this novel and unsubstantiated alteration, Dr. Hadaway contrived to increase his risk premium-based recommendation ROE by fully .9%, and thereby to bring his ROE recommendation up to the level that the Company has requested. But this very large and unsupported increase would raise Dr. Hadaway's recommended range only to 10.35% to 10.70%, *still* not high enough to reach the Company's requested ROE. Thus, even Dr. Hadaway's remarkable mutation in normal risk premium methodology was insufficient to enable him to contrive justification for KCPL's requested 10.75%. This may explain why Dr. Hadaway then chose to "discount" his own risk premium study. (Hadaway Rebuttal 23; Hadaway Surrebuttal 5, 9) The Department respectfully suggests that the Commission should choose to do the same.

B. Dr. Hadaway's Refusal Even to Provide a CAPM Analysis is Not Acceptable, and His Recommendation that the Commission Ignore CAPM Has No Support in the Record.

Dr. Hadaway acknowledged that CAPM is a "sophisticated" methodology which provides a "useful parallel approach" with the DCF to "assure consistency" in cost of equity estimations. (Hadaway Direct, 14-15) He maintained, however, that recent events have pushed Treasury bond interest rates to artificially low levels, and that this has caused CAPM estimates to understate cost of equity. (Hadaway Rebuttal, 23) He concluded from this that CAPM is "currently unreliable." (Hadaway Rebuttal, 16)

On this basis and no other, Dr. Hadaway completely excluded CAPM from his ROE analysis, (Hadaway Rebuttal, 21, 23, 44) and asserted that this Commission, too, should completely disregard CAPM. (Hadaway Rebuttal, 23) Obviously, Dr. Hadaway failure to present a CAPM analysis, and his assertion that the Commission should ignore CAPM, are unacceptable unless some credible evidence establishes that CAPM does indeed understate cost of capital. In fact, there is no such evidence. Mr. Gorman's and Mr. Murray's CAPM analyses certainly do demonstrate that CAPM produces ROEs that are far lower than KCPL would like. But the fact that CAPM produces lower ROEs than KCPL would like does not demonstrate or even intimate that CAPM understates cost of capital. Thus, the record provides no credible justification for Dr. Hadaway's refusal to present a CAPM analysis, and none for his assertion that the Commission itself should ignore CAPM. The Department respectfully suggests that it is not acceptable for Dr. Hadaway simply to refuse to present *any* CAPM study. Decisions as whether or not CAPM should be considered are for this Commission, and not for Dr. Hadaway.

With Dr. Hadaway having "discounted" the Risk Premium methodology and rejected outright the CAPM, his support for the Company's 10.75% ROE request must stand entirely upon his DCF study. If that is unpersuasive, the Company has no credible basis at all for its claim to an ROE of 10.75%. In fact, Dr. Hadaway's DCF is not merely unpersuasive. It is fatally flawed.

C. Dr. Hadaway's DCF Analysis Is Fatally Flawed Because It is Driven By An Exaggerated and Unsupported 6% Growth Rate.

The growth rate that an analyst develops and adopts for a DCF analysis to all intents and purposes determines the resultant ROE recommendation. (see DOE Initial Brief, 6) No DCF-based ROE is better founded or more credible than that growth rates. Dr. Hadaway developed and adopted a growth rate that is neither well-founded nor credible.

Record support for Dr. Hadaway's proffered 6% growth rate is remarkable for its paucity. The rate is based entirely on historical rather than forward-looking data. (Industrials' Initial Brief, 18) It is premised entirely on Dr. Hadaway's individual and singular view, and calculation, of Gross Domestic Product ("GDP") growth rates. (Gorman Surrebuttal, 12) Dr. Hadaway acknowledged in cross-examination that he created this pivotal growth rate entirely on his own, independent and apart from any material that has been adopted, published or presented elsewhere. (Transcript, 2479-2480, 2490) As such, Dr. Hadaway's growth rate is not available to investors, and can neither influence nor indicate of the return that they demand. Moreover, Dr. Hadaway's growth assessments have been rejected by at least five other regulatory entities. (Gorman Rebuttal, 9; Gorman Surrebuttal, 11) Dr. Hadaway's fatally flawed growth rate, which virtually determines the results of his DCF, renders his DCF analysis all but valueless.

D. The Company Would Have the Commission Grant It a 10.75% ROE Solely Because That ROE is Similar to ROEs That Other Commissions Have Granted to Other Utilities.

Lacking data or methodology to support its 10.75% ROE request, the Company intimates that this Commission ought to grant it that 10.75% ROE simply because certain other utilities in certain other jurisdictions have been granted a "national ROE average" of 10.32%. (Company Initial Brief, 144, 150) In this, the Company is in effect asking this Commission to ignore its overarching and transparent inability to proffer any data and methodology that would justify an award of 10.75%, and to grant it an ROE of 10.75% for no reason except that some other commissions have granted something near that to some other utilities. The Company further argues that the Commission should consider this 10.32% "national ROE average" as the midpoint in a +/-.50 "zone of reasonableness," and consider awarding it not just this "national ROE average" 10.32%, but an ROE range that runs as high as 10.82%. (Company Initial Brief, 144 – 146, 151) Oddly, while recommending that the Commission consider an ROE range of 9.82% - 10%. 82%, the Company concedes that Mr. Gorman's recommended ROE of 9.65% is "at least within striking range" of a "zone of reasonableness." (Company Initial Brief, 146)

The assertion that KCPL's ROE ought to be determined on the basis of ROE's that have been granted to others is untenable in the present circumstances.

While the legal standards do permit consideration of ROEs which other entities are granted, (see Staff's fine presentation of these, Staff Initial Brief, 128-132) the Industrial Intervenors have aptly pointed out that such ROEs must be given only limited weight. (Industrial Intervenors' Initial Brief, 2) For, when State Commission X seeks to set a return for Utility X, it may take notice of the return that State Commission Y has set for Utility Y. But Commission X cannot know what general policies or specific factors Commission Y has considered in developing that return. Thus, Commission Y's determination offers Commission X only minimal guidance.

Moreover this Commission and all other commissions allow each individual utility to earn only the ROE that that individual utility is able to demonstrate that it should be permitted to earn. How do those utilities make such demonstrations? Obviously, they do so by means of ROE presentations which are based on the methodologies (or methodologies similar to them) that have been the subject here. That means that the other utilities whose ROEs KPL would have this Commission follow have been able to apply those ROE methodologies in such fashion as to justify ROEs for *themselves*. It follows that the Commission should grant a similar ROE level to KCPL only if KCPL is able similarly to apply those ROE methodologies in such fashion as to justify an ROE of 10.75 % or higher for *itself*. As demonstrated above, that is exactly what KCPL is flatly unable to do.

E. Summary - KCLP's 10.75% ROE Recommendation Can Be Accorded Little Weight.

KCPL asks the Commission to ignore the CAPM methodology and to "discount" the Company's own risk premium analyses. This departs markedly from the normal practice of having each witness present three analyses, one based on DCF, one on risk premium, and one on CAPM, and leaving it to this tribunal to determine, on the basis of a complete record, which analysis or combination of analyses produce the best ROE estimate. (see Ameron, *supra.*, 21 – 24)

Moreover, Dr. Hadaway's refusal to provide any CAPM study, together with his "discounting" of his own risk premium studies, leave only his DCF study to support KCPL's ROE request. Dr. Hadaway's DCF study fails to do that, because his unsupported and exaggerated 6% growth rate so infects that analyses as to render it meaningless. In sum, all of Dr. Hadaway's methodological applications are so flawed that they must be accorded little or no weight. And, because *KCPL's 10.75% ROE request is based entirely on those incurably flawed applications,* it too must be accorded little or no weight.

III - MR. GORMAN'S ROE RECOMMEDATION SHOULD BE ADOPTED.

Mr. Gorman, unlike Dr. Hadaway, based his analyses upon wide-ranging historical, current and forward-looking information about cost of capital and economic conditions. His work is based on proper implementation of each of the three ROE methodologies. He identified and based his DCF study on a growth rate and other financial information that is actually available to investors. KCPL's Initial Brief proffers no meritorious criticism of Mr. Gorman's presentation.

As to Mr. Gorman's DCF presentation, KCPL's Initial Brief asserts that the analysis is based on a growth rate which is too low, because it relies on recent low rates of GDP growth and inflation. (Company Initial Brief, 148) This is belied by the fact that Mr. Gorman's growth rate is tied to economists' 10-year projections and estimates of what *investors* believe growth rates will be. (Gorman Direct, 20) It must also be observed that the Company wants very much for this Commission to ignore or ascribe as little weight as possible to the fact that recent rates of rates of GDP growth and inflation have in fact been quite low. KCPL's wish to find some way to demonstrate the Nation's present inflation rate is not as low as might be supposed is such that it felt compelled to point out that the inflation rate *in China* is 5%, and that "companies like McDonald's" are "already announcing price increases." (Company Initial Brief, pp. 148-149)

As to Mr. Gorman's risk premium presentation, the Company's brief asserts that the study is based on a risk premium that is too low because it is "artificially affected" by current low interest rates, which supposedly have driven risk premiums higher than normal risk premium methodology can measure. As discussed in DOE's initial brief and above, this criticism presupposes that there is some lock-step inverse relationship between low interest rates and risk premiums, and thus a consequent a need to modify accepted risk premium methodology to account for that relationship. And, as has also been discussed, there is no evidence that there is in fact any such relationship, or any need to modify risk premium methodology to account for it.

As to Mr. Gorman's CAPM presentation, KCPL expresses no criticism whatsoever. This is somewhat odd, because KCPL has called upon this Commission to ignore CAPM entirely.

Mr. Gorman's ROE recommendation drew upon, and then drew together, results produced by all three methodologies. His direct and consistent application of these methodologies is undoubtedly one of the reasons why this Commission has recently cited his ROE testimony approvingly. (Ameron, *supra.*,p. 21-23) His DCF analysis produced a 9.88% ROE, his Risk Premium analysis produced 9.68%, and his CAPM analysis produced 9.40%, for a range of 9.40% - 9.88%. He drew these analyses together and adopted their midpoint, 9.65%, as his ROE recommendation. (Gorman Direct, 37) Finally, he compared the key credit rating financial ratios for KCPL at 9.65% to S&P's benchmark financial ratios, using S&P's new credit metric ranges. (Gorman Direct, 38 *et seq.*) This demonstrated that his 9.65% ROE will support an investment grade rating for KCPL and thus meet fair compensation and financial integrity standards.

In this regard, it is worth noting that Staff's CAPM analysis produces recommended ROEs of 6.69% and 7.72%. (Staff Rate Design and Cost of Service Report ("Staff Rpt."), 11-24-10, 34 - 36), and constitutes a significant portion of the basis for Staff's assertion 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) In line with this, Staff Witness Murray pointed out a 2009 statement which indicated that Goldman-Sachs's implied cost estimate for the electric utility industry is closer to 7.7% than 9.1%. (Staff Initial Brief, 134) Moreover, Mr. Gorman's recommended 9.65% ROE falls between Staff's midpoint ROE recommendation of 9.0 % and KCPL's 10.50% (without "adder"). (Company Initial Brief, 145) The average of these three recommendations is 9.727%, just a tad over Mr. Gorman's recommended 9.65%. For all of these reasons, Mr. Gorman's 9.65% recommended ROE should be adopted.

IV - CONCLUSION

The Commission should grant the Company an ROE of 9.65%.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day placed the foregoing Reply 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 Regulatory Law Judges and to all of the parties by their attorneys of record.

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