*Exhibit No.:*
*Issue:* *Rate of Return*
*Witness:* *Matthew J. Barnes*
*Sponsoring Party:* *MoPSC Staff*
*Type of Exhibit:* *Rebuttal Testimony*
*Case No.:* *ER-2007-0291*
*Date Testimony Prepared:* *August 30, 2007*

# MISSOURI PUBLIC SERVICE COMMISSION

# UTILITY SERVICES DIVISION

# REBUTTAL TESTIMONY

# OF

# MATTHEW J. BARNES

# KANSAS CITY POWER AND LIGHT COMPANY

# CASE NO. ER-2007-0291

**Jefferson City, Missouri**
***August 2007***

**TABLE OF CONTENTS**

**OF THE REBUTTAL TESTIMONY OF**

**MATTHEW J. BARNES**

**KANSAS CITY POWER AND LIGHT COMPANY**

**CASE NO. ER-2007-0291**

**REBUTTAL TESTIMONY**

**OF**

**MATTHEW J. BARNES**

**KANSAS CITY POWER AND LIGHT**

**CASE NO. ER-2007-0291**

Q. Please state your name.

A. My name is Matthew J. Barnes.

Q. Are you the same Matthew J. Barnes who filed direct testimony in this proceeding for the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am. I filed direct testimony on July 24, 2007 on the cost of capital and capital structure recommendation being used by Staff in this case.

Q. In your direct testimony, did you recommend a fair and reasonable rate of return on the Missouri jurisdictional electric utility rate base for Kansas City Power and Light Company (KCP&L or Company)?

A. Yes, I did.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Dr. Samuel C. Hadaway and Michael Gorman. Dr. Hadaway sponsored rate-of-return testimony on behalf of KCP&L. Mr. Gorman sponsored rate-of-return testimony on behalf of the Office of the Public Counsel (Public Counsel or OPC). I will address the issues of the cost of common equity to be applied to KCP&L for ratemaking purposes in this proceeding.

**EXECUTIVE SUMMARY**

Q. What is Staff's recommended rate-of-return for KCP&L?

A. Staff recommends a rate-of-return for KCP&L of 7.97 percent to 8.73 percent with a mid-point of 8.35 percent.

Q. Is there any consistency between the parties concerning capital structure?

A. Yes. All parties used a consolidated capital structure. However, there is no agreement on the amount of long-term debt, preferred stock, and common equity in the capital structure as of this time due to the fact that Dr. Hadaway and Mr. Gorman used pro forma data for September 30, 2007.

Q. Why did Staff not use pro forma September 30, 2007, information in direct testimony?

A. Staff has consistently used actual known and measurable data to recommend a rate of return for a utility company. Staff does not agree nor disagree with the capital structure Dr. Hadaway and Mr. Gorman used. Once September 30, 2007, data is known and measurable, the capital structure for KCP&L may be very similar to what the other two witnesses used in this case and the capital structure that the Commission authorized in KCP&L's last rate case, Case No. ER-2006-0314. Staff will update their capital structure and embedded cost of debt in True-up Direct that is due for filing November 2, 2007.

**DR. HADAWAY'S RECOMMENDED COST OF COMMON EQUITY FOR KCP&L**

Q. Please summarize Dr. Hadaway's recommended cost of common equity for KCP&L.

A. Dr. Hadaway's recommended cost of common equity is based on two variations of the DCF model and a check of reasonableness using three "risk premium" analyses. Dr. Hadaway arbitrarily dismissed his "traditional" constant growth DCF model

results because of "historically low dividend yields and pessimistic analysts' growth forecasts." [Hadaway Direct, page 6.] One of the reasons the cost of equity has been low is because interest rates have been at a historical low. The decline in the cost of equity is reflected in the constant growth DCF model, which is used extensively in the regulatory communities and the investment communities.

Dr. Hadaway's "traditional" constant growth DCF model analysis results in a cost of common equity estimate of 9.40 percent, which is within Staff's proposed return on common equity range of 9.14 percent to 10.30 percent, as compared to his recommendation of 11.25 percent.

Q. Instead of accepting the lower results of his "traditional" constant-growth DCF model, what did Dr. Hadaway do?

A. Instead of accepting the lower results of his "traditional" constant-growth DCF model, Dr. Hadaway instead looked to other variations of the DCF model to justify an end-result oriented cost of common equity recommendation of 11.25 percent. He used a two-stage DCF analysis that incorporated a long-term nominal GDP growth rate. If one were to assume that substituting the average nominal GDP growth for the growth of the electric utility industry in either the two-stage or constant growth DCF, the assumption that KCP&L is going to grow at the same rate as the economy is overstated. KCP&L is a mature electric utility that has already experienced multi-stage growth throughout its lifetime, therefore; Staff believes the constant growth DCF model is the appropriate model to use in this proceeding.

Q. Does Staff recommend the Commission adopt Dr. Hadaway's multi-stage DCF model?

A. No. Staff recommends the Commission not adopt Dr. Hadaway's multi-stage DCF model. In fact, the Commission should completely ignore Dr. Hadaway's use of a multi-stage DCF model as this does not apply to a mature established company or utility such as KCP&L, and instead rely on his traditional constant growth DCF model that initially produced an ROE of 9.40 percent, which is within Staff's range of 9.14 percent to 10.30 percent. Staff believes the single-stage constant growth DCF model is the appropriate model to use for a mature utility company when determining a reasonable return on equity.

Q. Did Dr. Hadaway make any adjustments to his return on equity (ROE) recommendation?

A. Yes, Dr. Hadaway makes a 50 basis point adjustment upward from 10.75 percent to 11.25 percent "because KCP&L faces considerably higher construction and other operating risks than the average company in the reference group." [Hadaway Direct, page 4] Dr. Hadaway does not provide any evidence that supports a 50 basis point upward adjustment for KCP&L.

Q. Does Dr. Hadaway mention anything in his direct testimony about the Stipulation and Agreement signed by KCP&L and approved by the Commission?

A. No. Dr. Hadaway does not mention the Stipulation and Agreement included as part of KCPL's Regulatory Plan in his direct testimony. The Regulatory Plan was approved by the Commission on July 28, 2005, and was designated as Case No. EO-2005-0329.

Q. Does the Stipulation and Agreement in Case No. EO-2005-0329 signed by KCP&L and approved by the Commission have any mechanisms in place that reduce the risk of the Company?

A. Yes. In the Stipulation and Agreement there is an amortization mechanism in place that allows for additional cash flow to meet certain credit metrics intended to allow the Company the opportunity to maintain an investment grade credit rating during the construction phase.

Q. What are the credit metrics?

A. The credit metrics are Funds From Operations (FFO)/Average Total Debt and FFO/Interest Coverage. The credit metrics and the calculations are attached as Appendix E and F to the Stipulation and Agreement in Case No. EO-2005-0329.

Q. Is there another witness that describes the amortization in the Stipulation and Agreement?

A. Yes. Please see Staff witness Steve M. Traxler's direct testimony that describes the amortization and credit metrics in more detail.

**MR. GORMAN'S RECOMMENDED COST OF COMMON EQUITY FOR KCP&L**

Q. Please summarize Mr. Gorman's rate of return recommendation.

A. Mr. Gorman recommends an ROE in the range of 9.5 percent to 10.7 percent with a mid-point of 10.1 percent. Mr. Gorman's low end of his range is based on a two-stage DCF model. The high end of his range is based on the average of his constant growth DCF, risk premium, and CAPM analysis. Mr. Gorman's low end is within Staff's range and his high end is 40 basis points higher than Staff's high end of 10.30 percent.

Q. Mr. Gorman's low end of 9.5 percent was determined by his use of the two-stage DCF model. Do you agree with his methodology?

A. No. For the same reason that was mentioned previously, using a two-stage DCF analysis to determine the ROE for KCP&L is inappropriate as it is a mature company

and is in a mature industry and is expected to continue constant growth into the future, therefore; the constant growth DCF model is the appropriate model to use for KCP&L. Mr. Gorman uses an average growth rate of 6.70 percent for his constant growth DCF analysis, yet he uses the same growth rate as the first stage of growth in his two-stage DCF analysis. This is inconsistent as the constant growth DCF model assumes a company will grow at a constant rate into the future. Mr. Gorman's two-stage DCF model assumes that the same growth rate that he used in his constant growth DCF model will now only grow 6.70 percent for the next three to five years and 5.10 percent thereafter.

Q. Does Mr. Gorman give equal weight to his growth rate in his constant DCF model?

A. Yes. Mr. Gorman gives equal weight to the growth rates he used to determine his growth rate of 6.70 percent in his constant DCF model. Giving equal weight skews his result higher because of the extreme values used in the calculation. In other words, the extreme values pull his growth rate upward more than it pulls downward. Staff admits that their growth rates are also equally weighted, but the difference is a range is developed by using the low-end growth rate and the high-end growth rate to smooth the extreme values in the sample to derive a constant growth rate range of 5.34 percent to 6.50 percent.

Q. Mr. Gorman's risk premium analysis indicates a return on equity of 11.1 percent. Please explain why his risk premium method is inappropriate to use in this proceeding.

A. Mr. Gorman relies on other regulatory commissions' authorized ROE's against bond returns to determine the return on equity using the risk premium model. Staff believes the use of other regulatory commission's authorized ROE's is not a good component

to use in the risk premium model, because the authorized ROE may not be reflective of the investor's required return on equity and other commissions may authorize a higher return on equity than the indicated actual cost of equity for a variety of reasons. Traditional finance risk premium analysis measures either implied required returns on common equity against expected bond returns or actual returns on common equity against actual bond returns.

Q. Please summarize the parties' ROE recommendations.

A. The following table lists the recommendation of each party:

| | Staff | OPC (Gorman) | KCP&L (Hadaway) |
|---|---|---|---|
| ROE | 9.14%-10.30%; 9.72 Mid-point | 10.10% | 11.25% |

**SUMMARY AND CONCLUSIONS**

Q. Please summarize the conclusions of your rebuttal testimony.

A. My conclusions regarding the cost of common equity are listed below.

1. The use of a multi-stage DCF model by Dr. Hadaway and Mr. Gorman for a mature utility is inappropriate. The Commission should adopt the single-stage DCF model as the appropriate model to determine the ROE for KCP&L;

2. My cost of common equity of 9.14 percent to 10.30 percent would produce a fair and reasonable rate of return of 7.97 percent to 8.73 percent for KCP&L.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

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

AFFIDAVIT OF MATTHEW J. BARNES

STATE OF MISSOURI )
) ss.
COUNTY OF COLE )

Matthew J. Barnes, being of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 7 pages to be presented in the above case; that the answers in the following Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Matthew J. Barnes

Subscribed and sworn to before me this 30th day of August, 2007.

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

Notary Public