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Return on Equity/

Rate of Return

Richard Baudino

Surrebuttal

Public Counsel

ER-2006-00314

October 6, 2006

SURREBUTTAL TESTIMONY

OF

RICHARD A. BAUDINO

Submitted on Behalf of
the Office of the Public Counsel

KANSAS CITY POWER & LIGHT COMPANY

Case No. ER-2006-0314

October 6, 2006

**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)
Service to Begin the Implementation of Its)
Regulatory Plan)

Case No. ER-2006-0314

AFFIDAVIT OF RICHARD A. BAUDINO

STATE OF GEORGIA)
) ss
COUNTY OF FULTON)

Richard A. Baudino, of lawful age and being first duly sworn, deposes and states:

1. My name is Richard A. Baudino. I am Director of Consulting and am currently employed by the firm of J. Kennedy and Associates, Inc.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony consisting of pages 1 through 9.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.



Richard A. Baudino
Director of Consulting

Subscribed and sworn to me this 29th day of September 2006.

Barbara J. Trojanowski
Notary Public
Cobb County
State of Georgia
My comm. expires 01/26/09


Barbara Trojanowski
Notary Public

SURREBUTTAL TESTIMONY
OF
RICHARD A. BAUDINO
KANSAS CITY POWER AND LIGHT COMPANY
CASE NO. ER-2006-0314

1 **Q. PLEASE STATE YOUR NAME AND ADDRESS.**

2 A. Richard A. Baudino. My business address is J. Kennedy and Associates, Inc., 570 Colonial Park
3 Drive, Suite 305, Roswell, Georgia.

4
5 **Q. ARE YOU THE SAME RICHARD A. BAUDINO WHO SUBMITTED REBUTTAL**
6 **TESTIMONY ON BEHALF OF THE PUBLIC COUNSEL ON SEPTEMBER 8,**
7 **2006?**

8 A. Yes, I am.

9
10 **Q. IS THIS TESTIMONY ALSO BEING SUBMITTED ON BEHALF OF THE**
11 **PUBLIC COUNSEL?**

12 A. Yes.

13
14 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

15 A. The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimonies of Kansas City
16 Power and Light ("KCPL" or "Company") witness Dr. Samuel Hadaway and Missouri Public Service
17 Commission ("MPSC") Staff witness Matthew Barnes.

RESPONSE TO DR. HADAWAY

Q. ON PAGE 3, LINES 15 THROUGH 17, DR. HADAWAY CLAIMS THAT THE OTHER RETURN ON EQUITY WITNESSES IN THIS PROCEEDING "GIVE NO REAL CONSIDERATION TO THE UPWARD TREND IN INTEREST RATES THAT HAS OCCURRED OVER THE PAST 12 MONTHS." PLEASE RESPOND TO DR. HADAWAY'S ASSERTION.

A. Dr. Hadaway is incorrect and provides no foundation whatsoever for this assertion. The fact of the matter is that I and the other two ROE witnesses in this case used current stock price, earnings forecasts, and current interest rates in formulating our recommendations. Current utility company stock prices fully incorporate all investor perceptions and expectations regarding interest rates. Furthermore, my CAPM estimates fully reflect increases in interest rates since I used current interest rates in the calculation. I recommend that the Commission reject Dr. Hadaway's baseless criticism of me and the other ROE witnesses.

Q. ON PAGE 4 OF HIS REBUTTAL TESTIMONY, DR. HADAWAY PRESENTS TABLE 1 AND ASSERTS THAT RECENT COMMISSION-ALLOWED RETURNS SHOW THAT "THE OTHER PARTIES' ROE RECOMMENDATIONS ARE TOO LOW." PLEASE RESPOND TO THIS CONCLUSION.

1 A. First, Table 1 shows that Dr. Hadaway's recommended ROE of 11.5% is almost 100 basis points
2 higher than Commission-allowed returns in 2006. My recommended ROE of 9.9% is closer to the
3 average of 2006 Commission-allowed returns (10.57%) than Dr. Hadaway's recommendation.

4
5 Nevertheless, I am not suggesting that the Missouri PSC base its allowed return on equity for KCPL
6 on average allowed returns from other Commissions across the country. Rather, I recommend that
7 the Commission rely upon the testimony and analyses of the witnesses in this proceeding in
8 formulating its ROE allowance. As I stated in my Rebuttal Testimony, other Commissions may
9 include adjustments in their allowed returns on equity such as incentive mechanisms, performance
10 rewards and/or penalties, and other items that are unique to the individual cases in other jurisdictions
11 and may have nothing to do with a straight return on equity. Further, these equity returns may reflect
12 utilities that were more leveraged than KCPL, that faced greater business risks than KCPL (e.g.,
13 restructuring or deregulation), or had other circumstances that are not comparable to KCPL. Using
14 allowed returns also implies that the Commission should rely on decisions in other jurisdictions rather
15 than evaluate the specific evidence on return on equity in this proceeding. I disagree with this
16 approach and continue to recommend that the Commission base its allowed ROE for KCPL based on
17 the specific evidence and analyses in this proceeding.

18
19 Q. ON PAGE 15, DR. HADAWAY STATES THAT IF YOU HAD EXPANDED YOUR
20 DCF ANALYSES TO INCLUDE ALTERNATIVE APPROACHES TO ESTIMATING
21 THE GROWTH RATE, YOUR RESULTS WOULD HAVE BEEN HIGHER. DR.

1 **HADAWAY THEN PRESENTED "UPDATED" RESULTS OF YOUR DCF ANALYSES**
2 **THAT INCLUDE PROJECTED GROWTH IN GDP. PLEASE RESPOND TO DR.**
3 **HADAWAY'S STATEMENTS AND ALTERNATIVE DCF ANALYSES.**

4 A. Dr. Hadaway's so-called "updates" to my DCF analyses are inappropriate and should be rejected.

5
6 I stated in my Rebuttal Testimony why it was incorrect to incorporate forecasted growth in Gross
7 Domestic Product ("GDP") into a DCF analysis for electric utilities and that reasoning still stands.
8 Dr. Hadaway has presented nothing new that supports the inclusion of a GDP growth forecast in my,
9 or anyone else's, DCF analyses in this proceeding. Including GDP growth merely inflates the DCF
10 results. Once again, I recommend that the Commission reject the use of forecasted GDP growth in
11 the calculation of the DCF model results.

12
13 Q. **ON PAGE 17 OF HIS REBUTTAL TESTIMONY, DR. HADAWAY ELIMINATED**
14 **THE FIRST CALL/THOMSON BETAS YOU USED IN YOUR CAPITAL ASSET**
15 **PRICING MODEL ("CAPM") ANALYSES. DID HE SAY WHY HE DID THIS?**

16 A. No. Dr. Hadaway gave no reasons as to why he chose to eliminate the First Call/Thomson betas from
17 my analysis, other than the fact that they are on average lower than the Value Line betas. He failed to
18 explain why the Commission should rely solely on Value Line betas and should not consider other
19 publicly available beta estimates.

1 Q. ON PAGE 17, LINES 8 THROUGH 11, DR. HADAWAY CLAIMED THAT YOU
2 HAVE TRADITIONALLY RELIED ON VALUE LINE'S BETAS AND CITED
3 TESTIMONY IN A SOUTHWESTERN ELECTRIC POWER COMPANY ("SWEPCO")
4 PROCEEDING AS EVIDENCE OF THIS. PLEASE RESPOND TO DR.
5 HADAWAY'S POINT.

6 A. First, I need to point out that in my updated cost of equity analysis for SWEPCO in Docket No. U-
7 23327, Subdocket A, which was filed in July 2006, I included revised CAPM analyses that included
8 the First Call/Thomson betas. In that testimony I expressed the same concerns about Value Line's
9 betas. Dr. Hadaway failed to mention this in his Rebuttal Testimony.

10
11 I have traditionally used Value Line's betas in calculating my CAPM results in past cases. However,
12 as I explained in my Direct Testimony, I am concerned about the continuing high betas from Value
13 Line and decided to seek an alternative source for beta estimates. I did not abandon the Value Line
14 betas in this case, but supplemented my analyses with a widely available alternative source for betas
15 from First Call/Thomson. This enabled me to establish a range of CAPM results with two sets of
16 betas and this, in my view, added robustness to my CAPM presentation.

17
18 Q. ON PAGE 17, LINES 17 THROUGH 19, DR. HADAWAY STATED THAT HE
19 REPLACED YOUR HISTORICAL RISK-FREE RATE WITH A PROJECTED
20 TREASURY BOND RATE FOR 2007. IS IT APPROPRIATE TO USE
21 INTEREST RATE FORECASTS IN ESTIMATING THE COST OF EQUITY?

1 A. No. In my opinion it is appropriate to use current interest rates rather than forecasted rates. This is
2 because current interest rates incorporate all information available in the marketplace, including
3 investor expectations on the course of future interest rates. Those expectations carry some weight in
4 terms of the price investors are currently willing to pay for Treasury securities today. Interest rates
5 may be forecasted to rise, but there are great uncertainties associated with those forecasts. That
6 uncertainty is discounted in current bond prices and interest rates.

7
8 In my view, if investors knew for a fact that interest rates were going to rise almost 70 basis points
9 over the next twelve months, then they already would have adjusted the prices they are currently
10 willing to pay for Treasury securities and interest rates would quickly rise by 70 basis points. That is
11 because with certain knowledge, it is unlikely a rational investor today would knowingly accept a
12 certain future capital loss and not discount the price of his or her Treasury bond. Thus, current
13 Treasury yields are the best measure of investors' expectations of economic trends since they reflect
14 all current market information, including the possibility of higher (or lower) future interest rates.

15
16 I would also note that on September 22, 2006, CNNMoney.com reported that the yield on the
17 benchmark 10-year Treasury note had fallen to its lowest level in six months (4.60%). The article
18 stated the following: "With virtually no major economic guidance due Friday, investors continued to
19 focus on Thursday's reading on Mid-Atlantic business activity, which bolstered expectations that the
20 Federal Reserve will leave interest rates untouched *and possibly even initiate some cuts next year.*"
21 (italics added)

1
2 Q. ON PAGE 17, LINES 1 THROUGH 5, DR. HADAWAY ASSERTED THAT YOUR
3 AVERAGE CAPM RESULT "SHOWS THAT MR. BAUDINO'S 9.9 PERCENT ROE
4 RECOMMENDATION IS TOO LOW." PLEASE RESPOND TO THIS
5 CONCLUSION.

6 A. Dr. Hadaway's conclusion is incorrect. In my view, the DCF results show that the CAPM results are,
7 on average, too high, although the DCF results fall within the range of CAPM results.
8

9 Q. ON PAGE 18, LINES 4 THROUGH 6, DR. HADAWAY ACCUSED YOU OF
10 FAILING TO ACKNOWLEDGE KCPL'S CONSTRUCTION RISK AND THE NEED
11 TO COMPENSATE INVESTORS FOR THAT RISK. PLEASE RESPOND TO
12 THIS ALLEGATION.

13 A. I agree that KCPL has considerable construction requirements over the next few years. However, my
14 Rebuttal Testimony fully explains the factors that mitigate the Company's risk profile going forward,
15 one of which is the Regulatory Plan under which the Company operates. Dr. Hadaway failed to
16 mention the reduction in risk and enhancement of the Company's bond ratings that result from the
17 implementation of this Plan.
18

19 RESPONSE TO MR. BARNES
20

1 Q. ON PAGES 10 AND 11 OF HIS REBUTTAL TESTIMONY, MR. BARNES
2 STATED THAT YOUR USE OF DOUBLE DIGIT EARNINGS AND DIVIDEND
3 GROWTH RATES FROM VALUE LINE OVERSTATED YOUR GROWTH RATE
4 ESTIMATES. PLEASE RESPOND TO MR. BARNES' OBSERVATION IN THIS
5 REGARD.

6 A. In my opinion, the Value Line results are reasonable when taken as a whole. Although there are a
7 few double-digit growth rates as Mr. Barnes pointed out, they are offset by lower growth forecasts for
8 other companies in the group. This is particularly true with respect to forecasted dividend growth.
9 The average Value Line earnings growth rate for my comparison group, 5.83%, compares quite
10 closely to the consensus analysts' forecasts from Zack's and First Call/Thomson. Overall, I believe
11 my growth forecasts are reasonable and appropriate proxies for investor expectations based on
12 publicly available data.

13
14 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

15 A. Yes.