

Exhibit No.:
Witness: Michael Gorman
Type of Exhibit: Direct Testimony
Issue: Rate of Return
Sponsoring Party: The Office of Public Counsel
Case No.: ER-2007-0291

**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) Case No. ER-2007-0291
Certain Changes in its Charges for)
Electric Service to Implement Its)
Regulatory Plan.)

Surrebuttal Testimony of

Michael Gorman

On behalf of

The Office of Public Counsel

Project 8829
September 20, 2007



**Public
Version**

**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 Implement Its Regulatory
Plan.

Case No. ER-2007-0291

AFFIDAVIT OF MICHAEL GORMAN

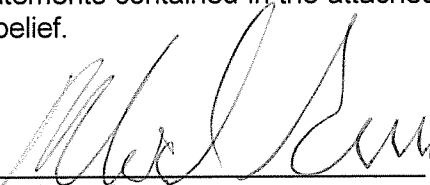
STATE OF MISSOURI)
) ss
COUNTY OF ST. LOUIS)

Michael Gorman, of lawful age and being first duly sworn, deposes and states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000. We have been retained by the Office of Public Counsel in this proceeding on its behalf.

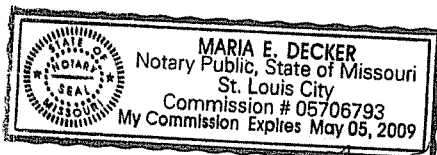
2. Attached hereto and made a part hereof for all purposes are my surrebuttal testimony consisting of pages 1 through 8.

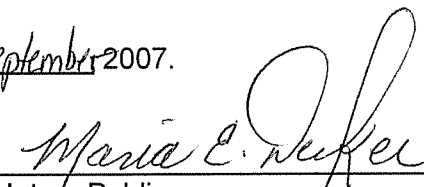
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.



Michael Gorman
Consultant

Subscribed and sworn to me this 20th day of September 2007.





Maria E. Decker
Notary Public

My commission expires May 5, 2009.

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Regulatory Plan.)	

Surrebuttal Testimony of Michael Gorman

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

2 A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway,
3 Suite 208, St. Louis, MO 63141-2000.

4 **Q ARE YOU THE SAME MICHAEL GORMAN THAT HAS PREVIOUSLY FILED**
5 **TESTIMONY IN THIS PROCEEDING?**

6 A Yes.

7 **Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

8 A I respond to certain aspects of the rebuttal testimony of Kansas City Power & Light
9 (KCPL or Company) witnesses Dr. Samuel Hadaway and Mr. Michael Cline. I will
10 also respond to certain portions of Staff witness Matthew Barnes' rebuttal testimony.

1 **RESPONSE TO DR. SAMUEL HADAWAY**

2 **Q PLEASE IDENTIFY THE ISSUES WITH YOUR RECOMMENDATIONS RAISED BY**
3 **DR. HADAWAY.**

4 A At pages 3 and 4 of Dr. Hadaway's rebuttal testimony, he summarizes his critique of
5 my recommended return on equity. Dr. Hadaway states that my recommendation in
6 this case is inconsistent with my recommendations in prior proceedings. He lists as
7 an example the fact that he believes I did not criticize his use of an inflated Gross
8 Domestic Product (GDP) growth rate in his DCF model in this case as I have done in
9 prior proceedings. Also, he asserts that I did not do an independent risk premium
10 study. But, rather, I simply extracted portions of his risk premium study. Finally, he
11 asserts that I minimized the results of my CAPM study in forming my recommended
12 return on equity for KCPL.

13 **Q IS DR. HADAWAY CORRECT THAT YOU DID NOT CRITICIZE HIS GDP GROWTH**
14 **RATE IN THIS PROCEEDING?**

15 A No. In my rebuttal testimony at 10-12, I explained the inconsistency of Dr. Hadaway's
16 reliance on an inflated GDP growth rate that inflated his DCF results. Specifically, Dr.
17 Hadaway's GDP growth rate is significantly higher than consensus market analysts'
18 projections and, therefore, does not reasonably reflect rational expectations of future
19 GDP growth. Rather, Dr. Hadaway's GDP forecast reflects only his own manipulation
20 of historical data to arrive at a projected GDP growth rate. Importantly, Dr.
21 Hadaway's projected GDP growth is heavily impacted by historical inflation, which is
22 significantly higher than expected future inflation. These are the same criticisms I
23 made of Dr. Hadaway's DCF studies in prior proceedings. As such, Dr. Hadaway's
24 argument is simply disingenuous and in error.

1 **Q IS DR. HADAWAY CORRECT THAT YOU DID NOT PERFORM AN INDEPENDENT**
2 **RISK PREMIUM STUDY?**

3 A No. My risk premium study is clearly described in my direct testimony at 21-24, and is
4 based on assessment of the market required return on equity relative to historical
5 bond yields. I would note, that without his return add-ons and data manipulations,
6 Dr. Hadaway's own risk premium studies would produce a return on equity estimate
7 similar to my risk premium study. Again, Dr. Hadaway's argument is without merit
8 and is in error.

9 **Q DR. HADAWAY ASSERTS THAT YOU DID NOT PLACE ENOUGH RELIANCE ON**
10 **YOUR CAPM STUDY. IS THIS A REASONABLE ASSESSMENT?**

11 A No. My CAPM study was relied on to form the high end of my estimated return on
12 equity range for KCPL in this proceeding. Dr. Hadaway's argument appears to simply
13 be based on his belief that higher is better. This argument clearly is result oriented
14 and does not produce an accurate estimate of KCPL's current cost of common equity.

15 **Q IS YOUR RECOMMENDED RETURN ON EQUITY COMPARABLE TO**
16 **AUTHORIZED RETURNS ON EQUITY FOR ELECTRIC UTILITIES AROUND THE**
17 **COUNTRY?**

18 A Yes. Authorized returns on equity have been declining over the last several years.
19 The average authorized return on equity for electric utilities was about 10.3% in 2006
20 and for the first six months in 2007.¹ This average authorized return on equity in
21 2006 was very comparable to my 10.1% recommended return on equity for KCPL in

¹ Regulatory Research Associates, Regulatory Focus, July 3, 2007.

1 this proceeding. As such, my recommended return is more consistent with industry
2 average authorized returns than Dr. Hadaway's inflated return on equity proposal of
3 11.25%.

4 **Q AT PAGE 8 OF HIS REBUTTAL TESTIMONY, DR. HADAWAY ASSERTS THAT**
5 **YOU DID NOT RECOGNIZE KCPL'S SIGNIFICANT CONSTRUCTION RISK IN**
6 **FORMING YOUR RETURN ON EQUITY RECOMMENDATIONS. PLEASE**
7 **RESPOND.**

8 A Dr. Hadaway's argument is again erroneous and without merit. As I explained in my
9 rebuttal testimony at 5-9, KCPL's construction risk is a part of its total investment risk,
10 which was considered in my return on equity recommendation. Importantly, it is Dr.
11 Hadaway that is not considering the construction risk and KCPL's regulatory plan that
12 is designed to mitigate its construction risk. Hence, Dr. Hadaway's proposed return
13 on common equity recommendation is inflated because he compensates KCPL for
14 risk that it shares with customers. Hence, Dr. Hadaway's argument is incorrect.

15 **Q DR. HADAWAY OFFERS SOME TECHNICAL RESPONSE TO YOUR**
16 **RECOMMENDED RETURN ON EQUITY AND THE FINANCIAL MODELS YOU**
17 **USED TO SUPPORT YOUR RETURN ON EQUITY AT PAGES 11 THROUGH 15.**
18 **DID DR. HADAWAY OFFER ANY LEGITIMATE ARGUMENTS IN SUPPORT OF**
19 **HIS ASSERTION THAT YOU UNDERESTIMATED KCPL'S COST OF COMMON**
20 **EQUITY?**

21 A No. All of Dr. Hadaway's arguments have already been responded to in my direct and
22 rebuttal testimony. I demonstrated that my constant growth DCF model contained a
23 growth rate that was not sustainable over a definite period of time, and therefore

1 overstated a fair return on equity for KCPL in this proceeding. I explained why a
2 two-stage DCF model was appropriate in this proceeding and produces reasonable
3 results. I also went into detail explaining why my risk premium studies were
4 reasonable and why I found the results of those studies to be appropriate. Dr.
5 Hadaway has not raised any new arguments that I have not already responded to.

6 **STAFF WITNESS MATTHEW BARNES**

7 **Q DOES MR. BARNES TAKE ISSUE WITH YOUR RELIANCE ON A TWO-STAGE**
8 **DCF MODEL?**

9 A Yes. He believes that I should not have relied on a two-stage growth DCF model
10 since utilities are a mature industry.

11 **Q IS MR. BARNES' CRITICISM OF THE VALIDITY OF THE TWO-STAGE DCF**
12 **MODEL REASONABLE?**

13 A No. Mr. Barnes' testimony is not based on an informed assessment of market and
14 industry information.

15 For example, as I noted in my direct testimony at 18, Great Plains Energy is
16 telling its investors that its earning growth rates will be abnormally high over the next
17 several years because its rate base is expected to grow 60% over the next several
18 years. This rate base growth, in turn, is expected to produce abnormally high
19 earnings growth rates over the same time period.

20 As I also noted in my direct testimony at 17-18, many other electric utilities are
21 also involved in large construction programs that will significantly increase rate base
22 and earnings over the next three to five years.

1 A constant growth DCF model requires a long-term sustainable growth rate
2 estimate. Analysts' earnings growth projections for the next three to five years reflect
3 the current abnormally high capital investment related and growth related earnings
4 rates.

5 As a result of abnormally high construction investment, earnings projections
6 for the next three to five years are not reasonable estimates of long-term sustainable
7 growth. Therefore, to reasonably estimate investors' investment expectations, a two-
8 stage model is necessary to reflect the projected high growth rate expected over the
9 next three to five years, followed by a decline to more normal lower sustainable
10 growth thereafter.

11 **Q IS MR. BARNES' ASSESSMENT OF YOUR RISK PREMIUM STUDY**
12 **REASONABLE?**

13 **A** No. It is difficult to determine what the investor required return has been over
14 historical periods. Also, return on equity estimates can be manipulated and inflated,
15 as I believe Dr. Hadaway's studies were in this case. Therefore, in employing a risk
16 premium study, it is important to make an independent and reasonable assessment
17 of historical required returns on equity for utility companies in order to accurately
18 estimate what the equity risk premium has been over time.

19 Regulatory commission authorized returns on equity do reflect an independent
20 assessment of the market required returns on utility equity investments.
21 Commissioners typically award utilities authorized returns on equity based on expert
22 assessments of the current cost of common equity. In my experience, regulatory
23 commissions weigh the evidence in making independent assessment of the current
24 cost of equity for utilities in awarding equity returns. As such, my risk premium study

1 relies on an unbiased estimate of utilities' historical and current cost of equity, which
2 can then be used to derive reasonable estimates of historic utility equity risk
3 premiums.

4 **KCPL WITNESS MICHAEL CLINE**

5 **Q DO YOU HAVE ANY COMMENTS CONCERNING KCPL WITNESS MR. MICHAEL**
6 **CLINE'S REBUTTAL TESTIMONY?**

7 **A** Yes. Mr. Cline has amended the Company's proposal for an increase to regulatory
8 plan amortization expense. Mr. Cline acknowledges that he should have included an
9 imputed amortization expense associated with operating leases. I agree. Also, Mr.
10 Cline acknowledges that the Company is modifying its projected capital program, and
11 expects to issue hybrid debt rather than traditional debt securities.

12 KCPL is proposing to issue a hybrid security that will receive 50% equity credit
13 in KCPL's credit review process by credit analysts.

14 He then proposes to modify the regulatory plan financial credit metrics to
15 reflect the issuance of ** ** of hybrid debt. This will lower the debt
16 interest expense and total debt factors used in the credit metric calculations. Mr.
17 Cline states that this will lower the amount of debt included in the Missouri
18 jurisdictional credit metrics by ** **.

19 With his adjustments to the credit metric calculation, Mr. Cline concludes that
20 KCPL will no longer need to increase the regulatory plan amortization expense, at the
21 Company's proposed 11.25% return on equity (Rebuttal 4-6) as originally proposed in
22 this proceeding.

1 **Q DO YOU AGREE WITH MR. CLINE'S HYBRID DEBT STATEMENTS IN HIS**
2 **REBUTTAL TESTIMONY?**

3 A Yes. Issuing hybrid debt securities that receive equity credit in the credit review
4 process, will improve KCPL credit metrics. These securities may also help KCPL to
5 minimize its cost of capital depending on whether the hybrid security replaces debt or
6 common equity.

7 **Q WOULD THE REVISION TO KCPL'S FINANCIAL PLAN TO ISSUE HYBRID DEBT**
8 **IMPACT THE AMOUNT OF REGULATORY PLAN AMORTIZATION EXPENSE**
9 **NEEDED AT YOUR PROPOSED 10.1% RETURN ON EQUITY?**

10 A Yes. At a 10.1% return on equity, and reflecting ** ** less jurisdictional
11 debt, the KCPL regulatory plan amortization expense would not need to be increased
12 from the last approved amount.

13 **Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

14 A Yes.