

# EXHIBIT

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Issue(s):

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Case Number:

Date Testimony Prepared:

Return on Equity/

Rate of Return

Richard Baudino

Direct

Public Counsel

ER-2006-00314

September 7, 2006

## REBUTTAL TESTIMONY

OF

**RICHARD A. BAUDINO**

**FILED**

NOV 13 2006

Missouri Public  
Service Commission

Submitted on Behalf of  
the Office of the Public Counsel

**KANSAS CITY POWER & LIGHT COMPANY**

**Case No. ER-2006-0314**

September 7, 2006

OPC Exhibit No. 202  
Case No(s). ER-2006-0314  
Date 10-16-06 Rptr XF

**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 )

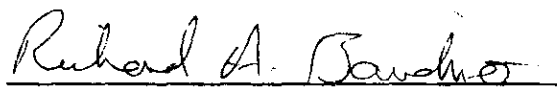
**Case No. ER-2006-0314**

**AFFIDAVIT OF RICHARD A. BAUDINO**

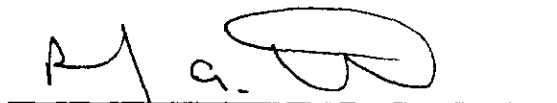
STATE OF GEORGIA    )  
                              ) ss  
COUNTY OF FULTON    )

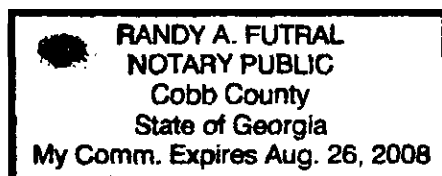
Richard A. Baudino, of lawful age and being first duly sworn, deposes and states:

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 rebuttal testimony consisting of pages 1 through 13.
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 7<sup>th</sup> day of September 2006.

  
Randy Futral  
Notary Public



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

I. INTRODUCTION

1  
2  
3 Q. PLEASE STATE YOUR NAME AND ADDRESS.

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

6 Q. ARE YOU THE SAME RICHARD A. BAUDINO WHO SUBMITTED DIRECT  
7 TESTIMONY ON BEHALF OF THE PUBLIC COUNSEL ON AUGUST 8, 2006?

8 A. Yes, I am.

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

11 A. Yes.

12  
13 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

14 A. The purpose of my Rebuttal Testimony is to respond to the Direct Testimony of Kansas City Power  
15 and Light ("KCPL" or "Company") witness Dr. Samuel Hadaway.

16 Q. ON PAGE 5, LINE 22 THROUGH PAGE 6, LINE 11, DR. HADAWAY  
17 CONCLUDED THAT THE CONSTANT GROWTH DCF MODEL DOES NOT REFLECT

**THE CURRENT COST OF EQUITY. PLEASE RESPOND TO DR. HADAWAY'S  
ASSERTION.**

A. I disagree with Dr. Hadaway. Other than his unsupported statement on page 6, he provided no basis for the assertion that analysts' forecasts do not reflect current expectations for increasing capital costs. Securities analysts, like investors, presumably have all current economic information available to them when they derive their growth forecasts, including interest rate forecasts. All of this macroeconomic information as well as firm-specific information should be included in their earnings and dividend growth forecasts. Dr. Hadaway provided no basis for his conclusion that analysts' forecasts are "pessimistic" because of missing information on interest rate forecasts. I recommend that Dr. Hadaway's unsubstantiated assertion on pages 5 and 6 be rejected.

**Q. PLEASE SUMMARIZE DR. HADAWAY'S DCF ANALYSES.**

A. Dr. Hadaway employed three versions of the DCF model. His constant growth version of the model produced a range of results of 9.3% to 9.4%. However, Dr. Hadaway did not include these results in his recommended ROE range because he concluded that these results failed to meet certain tests of reasonableness.

Dr. Hadaway also employed a non-constant growth version produced a range of results of 10.6% to 10.8%. The first stage of the growth rate utilized Value Line's projected dividends. The second stage of the growth rate was the long-term growth rate in GDP of 6.60%.

Dr. Hadaway's third approach consisted of a constant growth form of the model using long-term growth in GDP of 6.60% as the expected growth rate. This model resulted in a ROE range of 11.2% to 11.3%.

1 Dr. Hadaway describes these models and summarizes their results on pages 29 through 32 of his  
2 Direct Testimony.

3 **Q. DO YOU AGREE WITH DR. HADAWAY'S FORMULATION OF THE FIRST**  
4 **CONSTANT GROWTH MODEL?**

5 A. No. There are two major problems with Dr. Hadaway's constant growth DCF model. First, Dr.  
6 Hadaway included long-term GDP growth in the calculation of his recommended long-term growth  
7 rate. It is inappropriate to include long-term GDP growth of 6.60% in the expected long-term growth  
8 rate for electric utilities. Dr. Hadaway presented no evidence that investors base their current growth  
9 rate assumptions *for electric utility companies* on the historical growth in GDP (6.60%).  
10 Interestingly, this projection is substantially greater than any of the electric utility dividend and  
11 earnings growth projections used by both Dr. Hadaway and myself. This suggests that the GDP  
12 growth rate is an outlier and should be rejected, rather than included in a DCF analysis specific to a  
13 group of electric utilities.

14 I believe that a more reasonable assumption is that investors will use the information specific to  
15 electric utilities in forming their growth rate expectations. I would agree that GDP growth is a factor  
16 that may directly and/or indirectly affect forecasted growth rates for electric utilities. However, it is  
17 the earnings and dividend growth forecasts for the individual companies that should be used in the  
18 DCF analysis. There is no good reason to believe that today's investors expect earnings and dividend  
19 growth for electric utilities to equal the historical growth rate in GDP. Indeed, all of the growth  
20 forecasts specific to electric utilities indicate otherwise. Including GDP growth has the effect of  
21 inflating Dr. Hadaway's final results.

1 Second, Dr. Hadaway failed to account for forecasted dividend growth in his expected DCF growth  
2 rate. Dividend growth is an important factor that investors consider in formulating both near-term  
3 and long-term expected growth. The March 4, 2005 Value Line profile of the electric utility industry  
4 (east) noted the following:

5 "For a period of several years, beginning in the mid-1990s, many electric utilities  
6 eschewed dividend increases in favor of investing in nonregulated operations or  
7 M&A activity with another utility ... Many of these nonregulated investments  
8 turned sour, or time proved that some of the acquiring utilities in mergers had  
9 overpaid. As a result, some companies had little choice but to cut or suspend their  
10 common dividends.

11 Utilities began to take another look at raising the dividend after the federal  
12 government cut the tax rate on dividends in 2003. Some were still getting their  
13 finances in order as part of their "back to basics" strategies, so noteworthy dividend  
14 boosts didn't start to occur until 2004.

15 \* \* \* \*

16 The good news of dividends has continued in early 2005. A few companies that cut  
17 or suspended the dividend in the late 1990s or early 2000s have reinstated it,  
18 increased it, or stepped up the growth rate."

19  
20 In my view, this Value Line report supports my contention that dividend growth should be considered  
21 in the formulation of expected growth at this time.

22 In fact, Dr. Hadaway used expected dividend growth in the first stage of his two-stage DCF analysis.  
23 As I showed earlier in my Direct Testimony, expected dividend growth is lower than expected  
24 earnings growth. Excluding dividend growth would tend to overstate Dr. Hadaway's DCF results.

25 Q. DR. HADAWAY INCLUDED SEVERAL QUOTES ON PAGE 30 OF HIS DIRECT  
26 TESTIMONY THAT HE USED TO SUPPORT THE INCLUSION OF GDP GROWTH

1       **IN HIS DCF ANALYSES. DO THESE QUOTES SUPPORT THE USE OF GDP**  
2       **GROWTH FOR ELECTRIC UTILITIES?**

3       A. No. These quotes refer to growth rates for all firms on average and do not apply specifically to  
4       electric utility companies at this point in time. In fact, the quote from Brigham, Gapenski, and  
5       Ehrhardt acknowledges that expected growth rates vary from company to company. By extension, I  
6       would also apply this observation to different industries as well. In general, electric utilities have  
7       higher dividend yields and lower expected growth rates than the "average" company in the stock  
8       market. Thus, applying a generic GDP growth rate to an electric company with a higher dividend  
9       yield would overstate the investor's expected return on equity for that company. I should also add  
10      that nowhere in the textbook cited by Dr. Hadaway did the authors suggest that growth in GDP  
11      should be applied to electric utility companies.

12      On page 30, lines 24 through 30, of Dr. Hadaway's Direct Testimony, the quote from the article by  
13      Chan, Karceski, and Lakonishok states that analysts' forecasts "tend to be overly optimistic". This  
14      suggests that the use of analysts' growth forecasts may actually overstate the investors' required  
15      return on equity. Thus, using a GDP growth rate that is greatly in excess of analysts' earnings growth  
16      forecasts for electric utilities is highly inappropriate.

17      **Q. ON PAGE 32, LINES 7 THROUGH 10, DR. HADAWAY STATED THAT HE**  
18      **DID NOT INCORPORATE HIS FIRST SET OF CONSTANT GROWTH DCF**  
19      **RESULTS INTO HIS RECOMMENDATION. PLEASE COMMENT ON DR.**  
20      **HADAWAY'S DECISION.**

21      A. Dr. Hadaway should have incorporated these DCF results, modified to exclude long-term GDP  
22      growth, into his recommended return on equity. I disagree with Dr. Hadaway's reasons for excluding  
23      these results from his recommendation.

1 The reason Dr. Hadaway gave for rejecting the constant growth DCF was that the results were 150  
2 basis points or more current risk premium checks of reasonableness. This is not a sufficient reason  
3 for rejecting the constant growth model using current analysts' forecasts. It is important to note that  
4 risk premiums change over time depending on the historical period chosen and on current economic  
5 conditions. It is risky to assume, as Dr. Hadaway does, that investors require risk premiums today  
6 based on historical periods of time.

7 Further, Dr. Hadaway gave no weight to the 2003 tax reduction on dividends that I describe on pages  
8 6, 7 and 31 of my Direct Testimony. As I stated on page 7, this tax reduction suggests that investors  
9 will require lower risk premiums for utility stocks compared to bonds. Dr. Hadaway failed to  
10 consider this point in his testimony and analysis.

11 **Q. REFERRING TO DR. HADAWAY'S TWO-STAGE DCF MODEL, DO YOU AGREE**  
12 **WITH HIS APPROACH?**

13 A. No. Dr. Hadaway greatly overstated the results of his analysis by incorporating long-term GDP  
14 growth as the long-term growth component in the two-stage model. For reasons I have stated  
15 previously, long-term GDP growth of 6.60% should be rejected as a proxy for utility company  
16 dividend and earnings growth.

17 **Q. REFERRING TO PAGE 35 OF DR. HADAWAY'S DIRECT TESTIMONY, WHAT**  
18 **IS YOUR OPINION OF A REASONABLE RANGE OF DCF RESULTS?**

19 A. The constant growth (GDP Growth) results and the multistage growth model results should be  
20 rejected for the reasons I discussed earlier. The most reasonable set of results comes from his  
21 traditional constant growth DCF model, which ranged from 9.3% to 9.4%. However, even these



1 results are overstated because they inappropriately include GDP growth. Excluding GDP growth  
2 from the calculations results in a range of 8.6% to 8.7%.

3 Based on my analysis in this case, the constant growth model of the DCF indicates a return on equity  
4 of approximately 10%. Thus, Dr. Hadaway's DCF results excluding GDP growth appear too low at  
5 this time. Given these revised results and the inflated results of his other two DCF approaches, Dr.  
6 Hadaway's DCF analyses are of little use to the Commission in this proceeding.

7 **Q. PLEASE SUMMARIZE DR. HADAWAY'S RISK PREMIUM ANALYSES.**

8 A. In Exhibit SCH-7, Dr. Hadaway structured a risk premium analysis that compared authorized electric  
9 utility returns on equity to the Moody's average public utility bond yield by year for the period of  
10 1980 through 2005. The authorized returns and bond yields were averaged over this period, and then  
11 the average bond yield was subtracted from the average allowed return on equity to derive an average  
12 risk premium of 3.08%. Dr. Hadaway then adjusted this risk premium by applying an "interest rate  
13 change coefficient" to the difference between the projected average utility bond yield and the  
14 Moody's average annual yield over the study period, resulting in an adjusted risk premium of 4.29%.  
15 He then added this adjusted risk premium to the projected average utility bond yield, which resulted  
16 in a risk premium cost of equity of 10.94%.

17 Dr. Hadaway also compared the results of his risk premium study to other risk premium studies on  
18 page 36 of his Rebuttal Testimony. Using the risk premium from Ibbotson Associates, Dr. Hadaway  
19 calculated a cost of equity range of 11.15%. Citing a study by Harris and Marston, and using a risk  
20 premium of 5.13%, Dr. Hadaway calculated a cost of equity of 11.78%.

21 In his risk premium studies, Dr. Hadaway employed a projected Baa yield of 6.65%.

1 Q. DO YOU AGREE WITH DR. HADAWAY'S RISK PREMIUM ANALYSES?

2 A. No. I recommend that the Commission reject the risk premium analyses.

3 Q. PLEASE EXPLAIN WHY THE COMMISSION SHOULD REJECT DR. HADAWAY'S  
4 RISK PREMIUM ANALYSES.

5 A. First, it is a risky proposition to rely on historical risk premiums from the Ibbotson Associates  
6 Yearbook. This approach naively assumes that earned returns and the resulting risk premiums over  
7 an extended historical period are reflective of current investor expectations. Such an assumption  
8 should be viewed with a good deal of skepticism. Finance literature has shown that historical risk  
9 premiums change over time. Although historical risk premiums may provide rough guides to  
10 estimating current required returns, much greater weight should be placed on DCF calculations that  
11 employ current, rather than historic data.

12 Also, as I mentioned earlier, a recent study by Ibbotson and Chen suggests that the historical risk  
13 premiums contained in the Ibbotson Associates' *Yearbook* are probably too high because of a rising  
14 P/E ratio over time. Factoring this out of historical returns reduces the historical risk premium by  
15 over 100 basis points, or 1.0%.

16 It should also be noted that the recent change in dividend taxation will reduce the expected risk  
17 premium of stocks over bonds going forward, other things being equal. As I stated earlier in my  
18 testimony, reduced taxation on dividends almost surely will lower the investor's required pretax  
19 return on equity, other things being equal. Since there was no change in the tax treatment of bond  
20 income, the required equity premium over bonds should decline going forward. Thus, historical risk  
21 premiums should overstate the current required risk premiums of utility stocks over bonds.

1 With respect to Dr. Hadaway's risk premium analysis using commission-allowed returns, this  
2 approach implies that the Commission should base its return on equity award on what commissions  
3 have done in years past in other jurisdictions. The problem here is that other commissions may  
4 include adjustments in their allowed returns on equity such as incentive mechanisms, performance  
5 rewards and/or penalties, and other items that are unique to the individual cases in other jurisdictions  
6 and may have nothing to do with a straight return on equity. Further, these equity returns may reflect  
7 utilities that were more leveraged than KCPL, that faced greater business risks than KCPL (e.g.,  
8 restructuring or deregulation), or had other circumstances that are not comparable to KCPL. Using  
9 allowed returns also implies that the Commission should rely on decisions in other jurisdictions rather  
10 than evaluate the specific evidence on return on equity in this proceeding. I recommend that the  
11 Commission reject Dr. Hadaway's risk premium approach based on commission-allowed returns.

12 **Q. BEGINNING ON PAGE 35, LINE 25, AND CONTINUING ON PAGE 36, DR.**  
13 **HADAWAY EXPLAINS WHY THE COMMISSION SHOULD ADD AN ADDITIONAL**  
14 **50 BASIS POINTS TO HIS REFERENCE GROUP COST OF EQUITY**  
15 **ESTIMATE. SHOULD THE COMMISSION ADD AN ADDITIONAL 50 BASIS**  
16 **POINTS, OR 0.50%, TO KCP&L'S COST OF EQUITY IN THIS**  
17 **PROCEEDING?**

18 **A.** No. Dr. Hadaway's upward adjustment to the Company's cost of equity is unreasonable and should  
19 be rejected by the Commission.

20  
21 **Q. PLEASE EXPLAIN WHY DR. HADAWAY'S 50 BASIS POINT ADJUSTMENT**  
22 **SHOULD BE REJECTED.**

1 A. First, Dr. Hadaway claimed that caution should be exercised in the interpretation of the risk premium  
2 and DCF results due to the "recent historically low points in the interest rate cycle." He went on to  
3 suggest on pages 35 and 36 that the interest rate risk associated with projections for higher rates over  
4 the coming year should be "considered explicitly."

5  
6 I disagree with Dr. Hadaway on this point. Given efficient securities markets, the risk of *potentially*  
7 higher interest rates has likely already been taken into consideration by investors in the prices they are  
8 willing to pay for stocks and bonds. Clearly, the interest rate projections used by Dr. Hadaway may  
9 or may not come to pass in the future. They are projections, not facts. If investors expect current  
10 interest rates to rise over the next year, then those expectations are already imbedded in *current*  
11 securities prices. No additional adder of 50 basis points is required in setting the investors' current  
12 required return on equity for KCPL.

13 Dr. Hadaway also suggested that the use of a lower DCF range would "fail to recognize the ongoing  
14 risks and uncertainties that exist in the electric utility industry, as well as the company-specific risks  
15 and uncertainties that KCP&L is facing." This statement is simply incorrect. If a comparison group  
16 of companies is properly constructed and the return on equity for that group is reasonably estimated,  
17 then the analyst should not need to adjust the results either upward or downward. For example, my  
18 comparison group is composed of electric companies that have bond ratings similar to KCPL and that  
19 derive most of their revenues from electric operations. Granted, there may be differences in specific  
20 risks that each company faces, but as a whole the bond ratings reflect all risks that each company  
21 faces. No upward adjustment to my DCF recommendation is warranted and, likewise, no upward  
22 adjustment is warranted for Dr. Hadaway's recommendation either.

1  
2 **Q. MR. BAUDINO, ARE THERE FACTORS THAT MITIGATE THE RISK PROFILE**  
3 **OF KCP&L THAT DR. HADAWAY FAILED TO CONSIDER?**

4 A. Yes. There are several factors that mitigate the risks for the Company. As I stated in my Direct  
5 Testimony, KCPL is the beneficiary of a regulatory plan that ensures that the Company meets  
6 financial parameters sufficient to support investment grade bond ratings. The plan enables the  
7 Company to request and the Commission to authorize additional amortization amounts in the rate  
8 case that enhances KCPL's cash flows. The financial support provided by the regulatory plan reduces  
9 the risk for KCPL.

10 In its Report and Order adopting the Stipulation and Experimental Regulatory Plan in Case No. EO-  
11 2005-0329, the Commission stated the following:

12 "Based upon the testimony of KCPL witnesses Giles and Cline, the Commission  
13 finds and concludes that the Stipulation should also positively affect KCPL's credit ratings  
14 (Ex.1, pp. 16-18; Ex.36, pp.2-5). Thus, KCPL should have lower debt costs that it will pass  
15 on to consumers in the form of lower future rates. The Commission also concludes, based  
16 upon the testimony of KCPL witnesses Giles and Cline, Public Counsel witness Trippensee,  
17 and Staff witness Schallenberg, that it is reasonable and appropriate to adopt regulatory  
18 policies, including the use of the additional amortization provision contained in the  
19 Stipulation, that are designed to give KCPL the opportunity to maintain its investment grade  
20 ratings during the term of the Experimental Regulatory Plan, based on the conditions set out  
21 in the Experimental Regulatory Plan regarding KCPL's necessary conduct."

22  
23 The Commission found that, based on the testimony of several witnesses, including KCPL witnesses,  
24 that the Stipulation should have positive effects on the Company's credit ratings.

1 I also stated in my Direct Testimony that, based on my reading of recent bond rating agency reports,  
2 Strategic Energy appears to be placing pressure on KCPL's bond ratings due to its weaker financial  
3 position and greater overall risk. This additional financial pressure from the unregulated operations of  
4 Strategic Energy should not be considered in estimating the return on equity for KCPL in this  
5 proceeding.

6  
7 **Q. DID DR. HADAWAY ACKNOWLEDGE ANY OF THE BENEFICIAL EFFECTS OF**  
8 **THE STIPULATION AND EXPERIMENTAL REGULATORY PLAN IN HIS**  
9 **DIRECT TESTIMONY?**

10 **A.** No, he did not. On page 26, lines 21 - 22 of his Direct Testimony, Dr. Hadaway stated that the  
11 Company's large construction program increases its risk profile, but he failed to discuss the beneficial  
12 effects of the Stipulation in mitigating those risks.

13  
14 **Q. DID DR. HADAWAY PRESENT ANY QUANTITATIVE BASIS FOR HIS 50**  
15 **BASIS POINT UPWARD ADJUSTMENT TO HIS COST OF EQUITY RESULTS?**

16 **A.** No. Dr. Hadaway's 50 basis point adjustment is based solely on his judgment. He offered no  
17 comparison of the risks between his electric utility group and KCPL that would justify his upward  
18 adjustment to the cost of equity.

19  
20 **Q. DOES THIS COMPLETE YOUR TESTIMONY?**

Rebuttal Testimony of  
Richard A. Baudino  
Case No. ER-2006-0314

9/8/2006  
9:20:23 AM

1 || A. Yes.