EXHIBIT

OPC 230

Exhibit No.:	
Issue:	Revenue Requirement
Witness:	Michael P. Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Public Counsel
Case No.:	ER-2016-0156
Date Testimony Prepared:	September 2, 2016

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement a General Rate Increase for Electric Service	**Case No. ER-2016-0156**

FILED
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Missouri Public Service Commission

Surrebuttal Testimony of

Michael P. Gorman

On behalf of

The Office of Public Counsel

September 2, 2016

BAI
BRUBAKER & ASSOCIATES, INC.

Project 10265

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OF THE STATE OF MISSOURI

In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement A General Rate Increase for Electric Service	)	Case No. ER-2016-0156

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

Affidavit of Michael P. Gorman

Michael P. Gorman, being first duly sworn, on his oath states:

1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. 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 is my surrebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. ER-2016-0156.

3. I hereby swear and affirm that the testimony is true and correct and that it show the matters and things that it purports to show.

Michael P. Gorman

Subscribed and sworn to before me this 2nd day of September, 2016.

TAMMY S. KLOSSNER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Charles County
My Commission Expires: Mar. 18, 2019
Commission # 15024862

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
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In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement A General Rate Increase for Electric Service	Case No. ER-2016-0156

Surrebuttal Testimony of Michael P. Gorman

INTRODUCTION AND SUMMARY

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation and a Managing Principal of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A Yes. On July 15, 2016, I filed direct testimony on behalf of the Office of Public Counsel ("Public Counsel").

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to KCP&L Greater Missouri Operations Company ("GMO" or the "Company") witness Robert B. Hevert's rebuttal testimony.

Q **IN HIS REBUTTAL TESTIMONY, DID GMO WITNESS HEVERT SUMMARIZE THE RECOMMENDATIONS OF THE OTHER RATE OF RETURN WITNESSES?**

A Yes. At pages 7 and 8 of Mr. Hevert's rebuttal testimony, he states that the opposing return on equity witnesses (which include Staff witness David Murray and me) offer recommendations that individually and as a group are far below the returns that investors would expect for a vertically integrated electric utility company. Mr. Hevert asserts the low return on equity recommendations by the opposing witnesses are the result of the opposing witnesses giving too much weight to the DCF methodology.

Q **PLEASE RESPOND TO MR. HEVERT'S COMMENTS REGARDING THE RECOMMENDED RETURNS ON EQUITY OFFERED BY OPPOSING RETURN ON EQUITY WITNESSES.**

A Mr. Hevert's general assessment of current market costs is simply off base and unreliable. As clearly observable in utility bond yields, utilities have access to significant amounts of capital at reasonably low prices. Based on valuations of utility stocks, it is clear that utilities also have access to significant amounts of equity capital at very low prices. All this observable market evidence confirms my findings and refute Mr. Hevert's findings, that utility companies' cost of capital is very low in the current market. For all these reasons, I recommend the Commission disregard Mr. Hevert's comments concerning a fair return on equity and adopt a return on equity in line with what I have found to be reasonable in this proceeding.

Q **AT PAGES 3-5 OF MR. HEVERT'S REBUTTAL TESTIMONY, HE OBSERVES CURRENT "A"-RATED UTILITY BOND SPREADS OVER TREASURY YIELDS. HE CONCLUDES THAT "A"-RATED UTILITY CREDIT SPREADS ARE AT HISTORICALLY ELEVATED LEVELS AND THAT THE YIELD SPREADS ARE STRONGLY RELATED TO EQUITY MARKET VOLATILITY. PLEASE RESPOND.**

A Mr. Hevert's conclusion that "A"-rated utility credit spreads relative to Treasury yields are at historically high levels is erroneous. This argument should be disregarded.

Mr. Hevert largely supports this argument based on a review of "A"-rated utility bond yield spreads, and market volatility over the period January 2006 through June 2016. This 10-year period largely encompasses a period of significant market volatility during the 2007-2009 time period, a period of significant financial distress, and periods following the market distress which exhibited a strong preference by the market for low-risk stable investments, including utility investments. By limiting his "A"-rated utility bond yield spread study period to a relatively narrow period of time, Mr. Hevert failed to observe what normal utility bond yield spreads are and therefore he has not accurately identified that current utility spreads are relatively low by historical standards.

Q **DID YOU OFFER TESTIMONY THAT CONSIDERED NORMAL "A"-RATED UTILITY BOND YIELD SPREADS?**

A Yes. A review of "A"-rated utility bond yield spreads to Treasuries over an approximate four decade period clearly shows that recent "A"-rated utility bond yield spreads to Treasury yields are below the four-decade average. Further, "A"-rated utility bond yields are trading at a relatively narrow spread to Aaa corporate bond yields. Both of these observable narrow "A"-rated utility yield spreads are evidence of

the market's robust pricing of "A"-rated utility bonds and thus, prove that utilities' cost of capital is currently low relative to the four-decade historical period.

Q **PLEASE EXPLAIN.**

A In my direct testimony on my Schedule MPG-15, the 36-plus year average "A"-rated utility yield spread over Treasuries is 1.52%. As shown on page 1 of my Schedule MPG-16, the 13-week average "A"-rated utility yield spread was 1.36%, 16 basis points below the long-term average. The current 13-week average "A"-rated utility spread is practically unchanged since I filed my direct testimony. For the 13-week period ending August 26, 2016, the average "A"-rated yield spread is 1.34%, or 2 basis points lower than at the time of filing my direct testimony and 18 basis points lower than the 37-year historical average.

Further, as shown on my Schedule MPG-15 to my direct testimony, under Column 4, I show the "A"-rated utility bond yield spread relative to Treasury bonds. As shown in this column, the yield spreads since 2010 to the most recent yield have all been below the 37-year historical average yield spread shown on this schedule. This is an indication that "A"-rated utility bond yields have traded at a lower premium to Treasury bonds over this more recent time period, compared to the last four decades. Further, since the 2010 more recent time period, "A"-rated utility bond yields relative to Aaa-rated corporate bond yields have traded at a lower than average yield spread. Again, this indicates "A"-rated utility bonds have exhibited strong valuations and strong demand by the investment community during this time period.

Q **DO YOU HAVE ANY COMMENTS CONCERNING MR. HEVERT'S COMPARISON OF MARKET VOLATILITY TO UTILITY BOND YIELD SPREADS?**

A Yes. At page 4, lines 6-8 of his rebuttal testimony, Mr. Hevert concludes that "Treasury yields explain virtually none of the change in credit spreads," and "market volatility (as measured by the VIX), on the other hand, explains 69.00 percent of the change in credit spreads." I do not dispute this finding.

In reviewing yield spreads, my analysis and Mr. Hevert's analysis are largely directed at trying to identify equity risk premiums for utility stocks relative to observable Treasury and utility bond yields. This spread is impacted by market risk generally, but more specifically by the difference in investment risk of a utility equity security versus a utility bond security. Mr. Hevert's contention that Treasury yields do not explain investment risk changes supports my testimony. Further, this evidence proves that equity risk premiums cannot be explained by only changes in nominal bond yields.

However, I caution the use of the market volatility index in estimating an appropriate equity risk premium for a utility security. Market volatility generally reflects the change in valuation of market securities. This volatility helps describe the uncertainty that investors will earn their expected return. Relative to utility risks, market volatility is far more significant because expected returns on market stocks have a relatively minor dividend yield component. In contrast, expected returns on utility investments are mitigated because dividend yields represent approximately 50% of the total investor-expected return. Because dividend payments are far more certain than changes in stock price, the expected return on a utility stock is far less volatile than the expected return on a market security.

Q AT PAGE 5 OF HIS REBUTTAL TESTIMONY, MR. HEVERT ASSERTS THAT UTILITIES' PRICE TO EARNINGS ("P/E") RATIOS ARE AT ELEVATED LEVELS, AND THERE IS NO REASON TO BELIEVE THAT THESE ELEVATED P/E RATIOS WILL BE SUSTAINABLE. HE CONCLUDES THAT THESE ELEVATED P/E RATIOS DOWNWARDLY BIAS THE RESULTS OF THE DCF STUDIES. PLEASE RESPOND.

A Mr. Hevert's analyses are simply incomplete and not based on relevant data. He measures P/E ratios by comparing current prices relative to historical earnings per share. Based on this relationship, he is measuring elevated P/E ratios. However, many electric utility companies, including GMO, have stronger near-term earnings outlooks, relative to what they have had in the past.

For example, as shown on my Schedule MPG-7 filed with my direct testimony, my proxy group's earnings per share is expected to increase from $2.75 in 2015 to $3.52 over the three- to five-year projected period, an increase of approximately 28.0% in earnings over a three- to five-year period. This strong improvement in expected earnings is causing stock prices to adjust to stronger future earnings outlooks. Mr. Hevert's P/E ratio is tied to historical earnings and ignores the expected earnings. Reflecting the proxy group's forward-looking earnings, the P/E ratio of the proxy group's prevailing stock price is actually below the historical normal.

The 13-week average current observable proxy group stock price of $53.04, and a projected earnings per share three to five years out for the proxy group of $3.52, produce a P/E ratio of 15.07x.[1] A P/E ratio of 15.07x is below the historical P/E ratios for the electric utility industry of 15.9x as shown on my Schedule MPG-3. Therefore, Mr. Hevert's claim that current P/E ratios are elevated and throw into

[1]See Schedule MPG-6 and Schedule MPG-7 filed with my direct testimony.

question the reliability of the DCF results is based on a faulty analysis and inappropriate data inputs.

Q DO YOU HAVE ANY OTHER COMMENTS CONCERNING MR. HEVERT'S OBSERVATION ON P/E RATIOS AND THE IMPLICATIONS THAT HIGH P/E RATIOS SUGGEST THAT DCF RETURN ESTIMATES ARE NOT RELIABLE CURRENTLY?

A Yes. High P/E ratios also correspond to very low dividend yields, which are an indication of reductions to utilities' cost of capital. As noted above, dividend yields for utility companies have decreased to well below 4% more recently where in the last case they were above 4%, which at that time was relatively low. All of this is an indication that current utility capital costs are very low relative to the past. While Mr. Hevert and others may have opinions that capital market costs will increase sometime in the future, increasing capital costs and the timing of when the increase will occur are highly uncertain and not easily reconciled for measuring the current market cost of capital for utility companies. Because customers are burdened by increasing fuel costs, and increasing costs associated with capital investments, they should not be denied the benefits of declines in cost of service related to reductions in utilities' cost of capital. For all these reasons, Mr. Hevert's incomplete and erroneous data suggesting the current DCF return estimates are unreliable should be rejected and the Commission should consider all viable and accurate measures of the current market cost of equity in setting a fair return on equity in this proceeding.

Q **AT PAGES 50-51, MR. HEVERT ARGUES THAT YOU OBSERVED EXPANDING AND CONTRACTING P/E RATIOS IN MEASURING THE MARKET RISK PREMIUM. DOES THIS SUPPORT HIS BELIEF THAT CURRENT VALUATION OF UTILITY STOCKS IS NOT RELIABLE?**

A No. Mr. Hevert is referring to my observation from the Duff & Phelps manual used to estimate market risk premiums based on historical actual achieved rates of return. In that publication, Duff & Phelps measures the market risk premium under various market conditions to provide the information needed to make an informed assessment of the market risk premium. In one of Duff & Phelps' analyses, it did reflect expanding and contracting market P/E ratios in measuring the impact on the market risk premium. However, that methodology simply does not support Mr. Hevert's contention that a high P/E ratio in the current market limits the reliability of the DCF model to accurately measure a utility's cost of capital.

While P/E ratios may change in the future, the relative market valuation of securities now, both debt and equity, represents the utility's cost of capital. If a utility issues a bond now at 3% to 4%, that does not mean the utility's cost of capital should be stated at something higher because the interest rate at some point in the future might be higher. Similarly, if a utility can sell a stock now based on an above average P/E ratio, that means it sells less shares to get the equity it needs to fund utility plant and equipment. Selling less shares means the utility has a lower cost of capital in funding its plant investment now compared to changes in the capital market in the future.

Utility P/E ratios may change over time, but that does not impact the clear observable evidence in the current marketplace, that supports my conclusion that

utilities' cost of capital in the market today, and during the market likely to prevail when rates in this proceeding are in effect, is at a low cost relative to past markets.

Q DOES MR. HEVERT MAKE CERTAIN CRITICISMS OF YOUR APPLICATION OF A CONSTANT GROWTH DCF ANALYSIS?

A Yes. His comments include the following:

1. A concern about the reliability of the constant growth DCF model based on current P/E ratios. As I responded to this argument above, Mr. Hevert's concerns are based on faulty analyses, incomplete data, and a flawed assessment of market prices and relative valuation.

2. A concern that my proxy group's average projected earnings growth rate of 5.38% is relatively low when compared to the historical levels of nominal GDP growth and capital appreciation in the S&P 500. He then uses this argument to further support his notion that current P/E levels cannot be sustained. I explained in great detail in my direct testimony why the consensus analyst growth rates for my proxy group were too high to be sustainable in the long-run. I have also addressed Mr. Hevert's faulty notion of currently elevated P/E ratios and will not address them further.

Q DID MR. HEVERT COMMENT ON YOUR CAPITAL ASSET PRICING MODEL ("CAPM")?

A Yes. Mr. Hevert took issue with my development of the market risk premium component of my CAPM. He states that the market risk premium estimate was too low based on several measures including frequency distributions of market returns, and earnings retention ratios. Mr. Hevert seems to primarily take issue with the development of my 6.0% market risk premium, while acknowledging that I adopted the CAPM return estimate of my 7.8% market risk premium. He states that the expected market return of 11.2% that I assumed in developing my market risk premium is more reasonable, but that market return still falls in the bottom 24th percentile of annual market returns as reported by Morningstar. He states that

the 50-year average market return ending 2015 was 12.0%, which is only 10 basis points below the long-term average of 12.1%.

Q ARE MR. HEVERT'S COMMENTS CONCERNING AN APPROPRIATE MARKET RISK PREMIUM WITHIN A CAPM REASONABLE?

A No. While Mr. Hevert will quickly point out that the historical market return of 12.1% is higher than my expected market return in the current market, he fails to mention that the historical rate of inflation was approximately 3.0%, but current inflation is closer to 2.0%. The difference in historical and expected inflation of about 1.0% fully explains the difference in the historical market return of 12.1% and my projected market return of 11.2%.

Considering the projected level of inflation relative to historical inflation, my projected return on the market of 11.2%, and resulting market risk premium of 7.8% reasonably reflect current market costs, and result in a reliable CAPM estimate.

Q DID MR. HEVERT COMMENT ON YOUR RISK PREMIUM STUDY?

A Yes. He makes three comments:

1. He says that the methodology ignores an inverse relationship between equity risk premiums and interest rates.
2. He states that the low end of my estimated range is far lower than the return on equity authorized since at least 1986 and as such has no relevance in estimating the Company's cost of equity.
3. He takes issue with my suggestion that a Market/Book ratio of 1.00 is a relevant benchmark for assessing authorized returns on equity.

Additionally, Mr. Hevert expresses concern that I retained risk premium results that were more than 100 basis points below DCF results on which I chose to not rely.

Q **PLEASE RESPOND TO MR. HEVERT'S COMMENTS CONCERNING YOUR RISK PREMIUM STUDY.**

A Mr. Hevert's criticisms are without merit for the following reasons.

First, Mr. Hevert's belief that there is an inverse relationship between interest rates and equity risk premiums is simplistic and without merit. While interest rates and equity risk premiums are interrelated, changes in interest rates are not the sole factor, which explains changes in equity risk premiums. Rather, academic literature states that equity risk premiums change based on perceived changes in investment risk between equity investments and debt investments. It is simply not accurate nor consistent with academic literature to assume an inverse relationship between equity risk premiums and interest rates over all market periods. Academic literature is clear. This relationship changes over time, and is driven by changes in relative investment risk between equity and debt securities, not just interest rates.

Second, Mr. Hevert's observation concerning my lowest derived risk premium is again based on his arbitrary adjustment to market models to produce an imbalanced estimate of the current market cost of equity. Mr. Hevert's practice is to exclude numbers which he does not like in an effort to try to drive up the indicated return on equity for a specific model. Instead, the model should be performed in an unbiased manner in order to produce a valid and reliable estimate from the market-based model.

If there are reasons to dismiss, give minimal weight, or give significant weight to the model result, then such considerations should be taken into account when interpreting the results of the models. Mr. Hevert's practice is to bias the results of the model, which diminishes the validity and value of the returns produced from the

model and limits the amount of useful information to make an informed decision of the current market cost of equity.

Finally, Mr. Hevert's concern with my mention of Market/Book ratios exceeding 1.00 is misguided. I merely make an observation that investors were willing to pay a premium relative to book value for utility securities at their given level of authorized returns on equity and regulatory environment throughout that time period.

Q DID MR. HEVERT OFFER COMMENTS CONCERNING YOUR FINANCIAL INTEGRITY ANALYSIS?

A Yes. He states that: (1) simply maintaining an "investment grade" rating is an inappropriate standard; and (2) a return on equity of 3.25%, which is well below GMO's embedded cost of debt, would be sufficient enough to achieve the same financial benchmarks as my recommended 9.25% return on equity. He concludes that, in his view, because my 9.25% return on equity produces *pro forma* ratios that fall within S&P's intermediate range does not lead to the conclusion that my recommendation would support GMO's financial integrity. He also mentions that rating agencies consider a number of factors beyond *pro forma* coverage ratios.

Q PLEASE RESPOND TO MR. HEVERT'S CONCERNS WITH YOUR FINANCIAL INTEGRITY ANALYSIS.

A Mr. Hevert's criticisms of the financial integrity assessment of my recommended return on equity lack any meaningful critique of the accuracy or reliability of the methodology. I do not dispute that a lower return on equity may support credit metrics that will be indicative of a strong investment grade bond rating. However, a

fair return on equity needs to meet two standards. First, it needs to be a reasonable estimate of fair compensation to GMO's investors, and second, there must be a demonstration that the rate of return is adequate to support GMO's financial integrity.

I offer this methodology in support of these two standard methodologies. Clearly, a return on equity of 3.25% is well below what I believe to be a reasonable and fair return on equity for GMO's investors. Nevertheless, Mr. Hevert does not appear to dispute my finding that a return on equity of 9.25% will support GMO's financial integrity.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes.

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