**MISSOURI PUBLIC SERVICE COMMISSION**

**In the Matter of Kansas City )**

**Power & Light Company’s Request )**

**for Authority to Implement a ) Case No. ER-2012-0174**

**General Rate Increase for Electric Service )**

**)**

**In the Matter of KCP&L Greater )**

**Missouri Operations Company Request )**

**for Authority to Implement a ) Case No. ER-2012-0175**

**General Rate Increase for Electric Service )**

**THE FEDERAL EXECUTIVE AGENCIES’ INITIAL POST-HEARING BRIEF**

**ON RATE OF RETURN AND CAPITAL STRUCTURE**

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**THE FEDERAL EXECUTIVE AGENCIES’**

**INITIAL POST-HEARING BRIEF ON RATE OF RETURN**

COME NOW the United States Department of Energy and the United States Nuclear Security Administration (“DOE/NNSA” or “DOE” or “the Department”), the United States Air Force (“USAF”), and other affected Federal entities (collectively “FEA”) , by and through counsel, and for their initial post-hearing brief in the above-captioned proceedings state as follows:

**I - INTRODUCTION**

NNSA’s Kansas CitySite Office and Kansas City Plant (“KCP”) are located within the Bannister Federal Complex in Kansas City. They consume approximately 160,000 MWhs of electric power annually, at a cost of approximately $6 million. KCP is a high tech research production facility that specializes in science-based manufacturing. NNSA is in the process of moving the KCP to a new 1.5 million square foot campus at the corner of Missouri Highway 150 and Botts Road in Kansas City, seven miles south of the current facility and in KCP&L Greater Missouri Operations Company (“GMO”) service territory. The new campus is expected to be fully occupied by 2014. Whiteman Air Force Base, also located in GMO’s service territory, consumes approximately 91,000 MWhs of electricity annually at a cost of approximately $6 million. For these reasons, FEA’s interests differ materially from those of the general public and will be significantly impacted by the electric rate increases which Kansas City Power & Light Company (“KCP&L”) and GMO (collectively “the Companies”) seek in these proceedings.

This brief addresses return on equity (“ROE”) and capital structur**e**. In line with principles established by the United States Supreme Court in *Federal Power Comm’n. v. Hope Natural Gas Co.,* 320 U.S. 591 (1944) *and Bluefield Water Works & Improvements Co. v. P.S.C.*, 262 U.S. 679 (1923), this Commission has explained that its duty in setting ROE is to consider investors’ expectations at the time they choose to invest their money in the subject utility rather than in some other investment opportunity. (*Ameren, ER-2011-0028,* Report and Order, 7-7-11, p. 64)

**II - COST OF CAPITAL**

The Commission must determine the approximate ROE that KCPL/GMO stockholders are seeking *at this time* to incent them to invest in or retain the Companies’ common stock. Because it is impossible to determine an ROE in any direct manner, standardized methodologies for estimating cost of equity have gained currency. Three such methodologies, Discounted Cash Flow (“DCF”), Risk Premium Analysis, and the Capital Asset Price Model (“CAPM”), have been presented by one or more witnesses in this proceeding and are discussed here.

FEA has presented direct and surrebuttal testimony of Mr. Matthew I. Kahal, (DOE Exs. 500, 501) a nationally-known expert on utility ROE and related matters. (Kahal Direct, Appendix A)Mr. Kahal explained and demonstrated that capital costs from 2001 through mid- 2012 have generally declined, as indicated by inflation rates, ten-year Treasury yields, 3-month Treasury bill yields, and Moody’s Single A yields on long-term utility bonds. Early in the period, utility bond yields averaged about 8% and 10-year Treasury yields about 5%. By 2011, those bond and Treasury yields had declined to 5.1% and 2.8%, respectively. In the past six months, yields have declined even further, to near or below the lowest levels in decades. (Kahal Dir., pp. 5, 9 *et seq.*)

Staff and Office of Public Counsel (“OPC”) expert witnesses confirm that capital costs have declined significantly and are at very low levels. (Staff Report - Revenue Requirement/Cost of Service, p. 26; Direct Testimony of OPC witness Mr. Michael Gorman,, p. 5)

Capital costs have declined since 2011 and low rates are expected to continue. Relatively low demand for capital and minimal inflation are expected to continue. Mr. Kahal stated that Blue Chip Economic Indicators’ recently published consensus forecasts call for real GDP growth of 2.1% in 2012 and 2.3% in 2013. He added that the consensus ten-year inflation forecast of 2.1% to 2.2% per year constitutes almost no change from the near term outlook. (Kahal Dir., p. 10)

Thus, near-term and long-term outlooks are for sluggish economic growth, very low inflation, and consequent low capital costs. Although utility equity cost and cost of debt do not necessarily move together either in lock step or in the short run, low long-term interest rates nonetheless imply low utility equity cost. Economic forces that are causing and will very likely continue to cause historically low interest rates also tend to exert downward pressure on utility equity cost. Utility stocks and long-term bonds are generally viewed as alternative investment vehicles for portfolio allocation and are in that sense closely related by market forces. (Kahal Dir., p. 10)

**III - DCF-BASED ANALYSES AND RECOMMENDATIONS**  (A) The methodology The standard DCF model posits that a stock’s price equals the cumulative present value of the dividends per share that the stock will pay out for the indefinite future. The discount rate used in calculation of the present value is investors’ cost of equity for that stock and is the competitive market return that investors find acceptable to hold or purchase that stock. The discount rate can be calculated as the stock’s current dividend yield (as directly and precisely observed) plus the long term dividend growth rate (which must be estimated). Normally, this growth rate is assumed for simplicity to be constant, but in some applications it is assumed to change over time (e.g., the two-stage DCF).

DCF computation depends upon the rate of long-run dividend growth, which cannot be directly observed and must be inferred. Because long-run earnings are the ultimate source of dividends, analysts often use historical or projected earnings growth as a proxy for expected long-run *future* dividendgrowth. Thus, the higher the growth rate, the higher the sum of the future returns, and the higher the resultant equity cost. Because of this, the growth rate(s) that underlie any DCF analysis are in great measure determinative of what the resultant recommended ROE shall be. For this reason, the manner in which growth rate is determined is crucial.

(B) Mr. Kahal’s DCF analysis and recommendation For his DCF analysis, Mr. Kahal adopted the 22-company proxy group which Company ROE witness Dr. Samuel Hadaway originally selected. Mr. Kahal listed the 22 proxy group companies on SCH. MIK-3, together with certain financial or risk indicators. Mr. Kahal explained that this group was appropriate because it was selected by use of the Value Line electric utility data base, with reasonable criteria which exclude companies that do not have investment grade credit ratings, have recently reduced dividends, have more than 30% non-utility revenue, or have been involved in mergers. (Kahal direct, p. 18) Mr. Kahal pointed out that his acceptance of Dr. Hadaway’s group has the advantage of eliminating potential controversies over sample company selection, and allows more direct comparison of the two witnesses’ respective DCF studies. (Kahal direct, 18)

To apply the DCF to the proxy group, Mr. Kahal elected a six-month period to measure the DCF formula’s dividend yield component. Using Standard & Poor’s *Stock Guide*, he compiled dividend yields for the six months ending June, 2012, the most recent data then available. During first quarter 2012, the market showed significant gains but was nonetheless fairly stable. In recent months, the broader stock market declined somewhat from its earlier highs, but electric utility stocks were reasonably stable. Mr. Kahal sets out each proxy company’s dividend yield for each month for, January through June 2012, at SCH. MIK-4, page 2. Over this period the group’s average dividend yields were relatively stable, ranging from a low of 4.04% in June to a high of 4.30% in February, and averaging 4.19% for the six months. On this basis, Mr. Kahal adopted a 4.19% group dividend yield. With the standard “half year” growth rate adjustment technique, forward-looking DCF adjusted yield is 4.3%, very similar to Dr. Hadaway’s 4.39%. (Exhibit SCH-5, p. 2 of 5)

Analysts have frequently used historic earnings growth as a proxy for expected long-run *future* dividends growth. Mr. Kahal stated, however, that historic measures have in recent years been too volatile to be reliable measures of future growth, and that he therefore chooses to rely on available published projections.

Mr. Kahal presents five widely-available sources of projected long-run earnings growth rates published in June and July, 2012. (Valueline Investment Survey, YahooFinance.com, MSNMoney.com, CNNfin.com, Reuters.com) (Kahal Dir., SCH. MIK-4, p. 3) Although individual companies’ growth rates vary somewhat, the sources’ average growth rates are very similar. They range from 4.4% to 5.25%, with an average of 4.8%, or 5.1% if one company’s (Ameren) negative growth rate is removed. From this, Mr. Kahal adopted a 4.5% to 5.5% growth range. He said that this should be viewed as conservatively high, because the sources’ average is actually 4.8%, or 5.1% if Ameren is removed. (Kahal Dir., SCH. MIK-4, p. 3)

Mr. Kahal stated that there are a number of reasons why investor expectations of long-run growth may differ from securities analysts’ five-year earnings projections. Consequently, while securities analysts’ growth rate estimates should be given significant weight, they must also be subject to a reasonableness test and to corroboration. In line with this, Mr. Kahal compiled three related growth rates: (1) dividends; (2) book value per share; (3) long-run retained earnings. He demonstrated that these are similar to analyst earnings growth projections. (SCH. MIK-4, p. 4 )

Finally, Mr. Kahal stated that sustainable growth rate should include an “adder” to reflect potential future earnings growth contribution from issuance of new common stock at prices above book value. He pointed out that this is extremely speculative and difficult to estimate because stock issuances over the long-term are an unknown. Nonetheless, he estimated this “external growth” factor using Value Line growth rate projections (through 2015-2017) in shares outstanding, along with recent stock price premium over book value. He said that external growth rate thus calculated averages about 0.6%. The sum of “internal” or earnings retention growth factor (4.0%) and “external” growth rate factor (0.6 %) is 4.6 %. He stated that, given this 4.6% estimate for sustainable growth rate and 4.8% for analyst earnings projections (or 5.1% if Ameren is excluded), a reasonable and conservatively high DCF growth rate range to reflect uncertainty is 4.5% to 5.5%. (Kahal Dir., p. 22)

Mr. Kahal summarized his DCF-based conclusion at SCH. MIK-4, p.1. Adjusted dividend yield for the six months ending June 2012 is 4.3%. Mr. Kahal added this adjusted yield to his 4.5% to 5.5% growth rate range of is appropriate, for a total return of 8.8% to 9.8%, with a 9.3% midpoint. Mr. Kahal’s final ROE recommendation is 9.5%, well within his 8.8 to 9.8% range and slightly above its midpoint. (Kahal Dir., p. 24; Kahal Reb., pp.1, 2, 4) This is a reasonable and balanced reduction from the currently-authorized 10.0%, consistent with the well-documented decline in capital costs since early 2011.

(C) Mr. Gorman’s DCF analysis and recommendation OPC witness Mr. Michael Gorman explained that a simple DCF, based on the percentage of earnings that is retained and reinvested rather than paid out in dividends, renders a 9.15% ROE. He said, however, that this simple model cannot reflect the reasonable expectation that a period of high/low short-term growth will be followed by a rate more reflective of long-term sustainable growth. For this reason, Mr. Gorman did a multi-stage analysis to reflect an “outlook of changing growth expectations.” This reflects three periods: (1) short term - 3-5 years; (2) transition period - 6-10 years; (3) long-term **-** year 11 through perpetuity. This produces a 4.9% projected GDP growth rate, a 9.30% ROE, and average and median DCF returns of 9.30% and 9.47%, respectively. Mr. Gorman finally recommends a 9.5% DCF-based ROE. (Gorman Dir., p. 39)

(D) Dr. Hadaway’s DCF analysis and recommendation Dr. Hadaway’s DCF methodology is not significantly different from Mr. Kahal’s, and Dr. Hadaway’s calculated dividends yields differ from Mr. Kahal’s by only about 0.1 to 0.2%. (Kahal direct p. 29) Yet Dr. Hadaway recommends a 10.3% ROE, fully 80 basis points more than Mr. Kahal’s 9.5% recommendation. (Hadaway Rebuttal, pp. 2, 31) These are several causes for this very large difference.

First, Dr. Hadaway removed four companies from his above-described original proxy group. Three of those companies have below average ROEs. (Hadaway rebuttal, 29; SCH-12) Dr. Hadaway also added three new companies, all with above average ROEs. Obviously, these changes inflate Dr. Hadaway’s ROE estimate. (Kahal Surrebuttal, 6)

Second, there is a very striking difference between Dr. Hadaway’s and Mr. Kahal’s growth rates.

In his original testimony, Dr. Hadaway presented three DCF studies which appear to use 4th quarter 2011 market data. Two use the standard constant growth DCF model, while the third is a two-stage growth model. The three produce 10.0 to 10.4% ROE range, with an average of about 10.1%. (Hadaway Dir., pp. 2, 42, SCH-5, p.1) The studies differ among themselves primarily because they are based on different growth rates. The first adopts a growth rate calculated from a combination of securities analyst projections which average 5.63%. (Hadaway Dir., SCH. 5, p.2) The second adopts a 5.8% growth rate (later reduced to 5.7%) based on Dr. Hadaway’s own calculation of the Nation’s annual *historic* GDPgrowth rate. (Hadaway Dir., 36) and later reduced to 5.7%. The third adopts a growth rate based on Value Line dividend growth projections for the next five years together with the aforementioned 5.7 % *historic* growth rate for all years thereafter.

Thus, Dr. Hadaway *estimates* a national 5.7% *historic* GDP growth rate, adopts his 5.7% estimated *historic* growth rate as the U.S. economy’s *future* growth rate, and then plugs that historic 5.7% growth rate into his DCF computations. Mr. Kahal pointed out that Dr. Hadaway’s 5.7% future growth rate reflects *only* historic trends and gives no weight whatsoever to the future. In fact, the great majority of professional forecasters, as documented in the Blue Chip survey, today agree that no such *future* growth rate will prevail. (Kahal direct, p. 5-6, 9)

Mr. Kahal further noted that Dr. Hadaway’s adoption of this 5.7% growth rate is premised on the assumption that investors *today* expect the U.S. economy’s long-term *future* growth be 5.7%. (Kahal Reb., p. 7) Mr. Kahal stated that he is unable to find any credible support for that assumption from major forecast organizations. (Kahal Dir., p.6; Kahal Reb., p. 7)

As a check on Dr. Hadaway’s 5.7% growth rate, Mr. Kahal consulted *Blue Chip Economic Indicators* (March and July, 2012 editions) which surveyed 40 major forecasting organizations and developed the following average or “consensus” GDP growth rate forecast:

2012 - 3.9%

2013 - 4.1%

2014 – 2018 5.1% (range: 4.3 to 5.9%)

2019 – 2023 4.7% (range: 4.1 to 5.4%)

Thus, the Blue Chip consensus forecast growth rate is nearly a full percentage point lower that Dr. Hadaway’s recommended 5.7%, but is fully consistent with Mr. Kahal’s 4.5% to 5.5% range.

Moreover, it must be recalled that the Commission here seeks to determine the approximate ROE that KCPL/GMO stockholders are seeking *at this present time* to incent them to invest in or retain the Companies’ common stock. Any acceptable ROE calculation must therefore be based in large measure on a utility earnings growth rate that reasonable present day investors actually expect. It is extremely unlikely that present day investors expect a 5.7% utility earnings growth rate. For one thing, and as shown above, virtually all expert projections of the *national* growth rate are substantially below 5.7%. Moreover, it is reasonable to assume that present day investors know that electric utilities are characteristically slower-growing than U.S. industry as a whole. (Kahal Dir., p. 31) Thus, even if present day investors really did expect the national economy to grow at 5.7%, it is extremely unlikely that they would also expect utility earnings to grow at that ate. For all of these reasons, Dr. Hadaway’s 5.7% growth rate is extremely unrealistic. And, if Dr. Hadaway’s DCF studies are adopted *verbatim*, except for substitution of a more reasonable growth rate, resultant ROE estimates are well below Dr. Hadaway’s recommendations. (Kahal surrebuttal, p. 7; T-397)

Mr. Kahal also pointed out that Dr. Hadaway’s rebuttal testimony had introduced a DCF method that is so different from those he introduced in his initial testimony as to be entirely new.

This new DCF model is based on a series of speculative and entirely unsubstantiated projections of what the price of each of the individual proxy companies’ stock will be *in 2016.* (T-384) These highly questionable four year projections greatly affect the ROE level which this DCF model produces. Thus, the model’s ROE recommendation is only as valid as these long term predictions of stock prices. Dr. Hadaway has declared that “equity market turmoil” presently prevails (Hadaway Dir., p. 5). FEA respectfully submits that, in light this, it is most unlikely that Dr. Hadaway’s new DCF model can deliver any accurate prediction of what the prices of specific corporate entities’ common stock will be in 2016. Because the validity of this DCF model depends largely upon its being able to do just that, the Commission should reject this DCF model and the ROE recommendation which it underlies.

In sum:

(1) Dr. Hadaway’s new DCF methodology, together with his exaggerated 5.7% growth rate and eleventh hour alterations in his proxy group are prime bases for the Companies’ 10.3% ROE recommendation;

(2) Two of Dr. Hadaway’s new DCF studies continue to rely on the above-discussed assumption that investors *currently* expect a 5.7% economic growth rate ;

(3) That assumed 5.7% growth rate exceeds the Nation’s likely future economic growth rate by perhaps by as much as one hundred basis points;,

(4) even if the Nation’s growth rate proves to be at or near 5.7% , it is highly unlikely that reasonable present day investors currently expect dividends and earnings of electric utilities generally, or of the proxy companies specifically, to grow at or near that rate;

(5) because DCF-based recommended ROEs are based in largest measure on what reasonable investors *believe* growth rates will be, and because there is no credible reason for any such investor to believe that a 5.7% growth rate or anything near it is to be expected, it would be inapposite to calculate and award ROE one the basis of a 5.7% growth rate, or anything near it.

Dr. Hadaway’s final recommended ROE is 10.30%. (Hadaway Reb., pp. 2, 31) Thus, despite capital costs that have decreased since the Commission permitted a 10% ROE, the Companies are asking this Commission to *increase* ROE.

**IV - RISK PREMIUN-BASED ANALYSES AND RECOMMENDATIONS**

(A) The methodology Risk premium methods are based on the assumption that investors expect higher returns on equity securities than on debt. Proceeding from this, the analyst calculates equity return and cost of debt, subtracts the latter from the former, and determines a “risk premium” that investors demand for purchasing equity rather than debt. Mr. Kahal did not rely upon an equity risk premium model because present conditions make it difficult to assess risk premiums with any accuracy. (Kahal Dir., 6-7, 26)

(B) Mr. Gorman’s risk premium analysis and recommendation Mr. Gorman bases his Risk Premium model on estimated differences between 1986-2011 commission-allowed utility equity returns and: (a) Treasury bonds (average risk premium: 5.23%; range: 4.41%-6.13%); (b) Moody’s “A” utility bond yields. (average risk premium: 3.81%; range: 3.03%- 4.62%) He begins with a projected 3.60% 30 year bond yield, which he adds to a 4.41%-6.13% Treasury bond risk premium, to produce an 8.01% **-** 9.73% ROE range. Giving the high end two thirds weight, he recommends a 9.16% ROE, which he rounds to 9.20%. He adds his 4.95% equity risk premium to his 3.03 to 4.62% risk premium range to produce a range of 7.98% to 9.57%. To recognize the unusually wide Treasury-to-utility-bond spreads, he recommends a risk premium of 9.04% rounded to 9.00%. His risk premium-based recommendation is 9.00%-9.20%, with a of 9.10% midpoint.

(C) Dr. Hadaway’s risk premium analysis and recommendation Dr. Hadaway developed what Mr. Kahal described as an econometric model, a simple regression from a time series of data extending from 1980 to 2011. (Kahal Dir., p. 32) This model is based on the assumption that equity risk premium is entirely driven by, and influenced by nothing except, the level of contemporaneous interest rates. Thus, Dr, Hadaway’s simple model finds an inverse relationship: *The lower the interest rate* at any given point in time, the higher the risk premium, and *vice versa*. Here, Dr. Hadaway’s contrived and highly questionable message is: At today’s rock bottom interest rates, there must be very steep equity risk premiums.

The key to Dr. Hadaway’s analysis is his definition of risk premium. He calculates an historic risk premium data series as the average of state regulatory commissions’ allowed ROEs in a given year minus the prevailing yield on Moody’s utility bonds in that year. He proceeds to select 5.08 and 5.34% triple B utility bond yields, and calculate a risk premium-based 9.97% to 10.12% cost of equity (Hadaway direct, p. 42) In other words, his risk premium model is based on *historical* regulatory decisions and only partially on market data. Mr. Kahal observed that commission-allowed returns cannot necessarily be equated to market cost of equity. He added that, to equate the one with the other is not very different from recommending that the Commission simply calculate the average ROEs which other commissions have allowed, adjust that average for some change in interest rates, and adopt the resultant ROE. (Kahal direct, p. 32)

There is no support, within the record or without, for Dr. Hadaway’s risk premium model. Moreover, although that model produces an ROE estimate of only about 10.0%, Dr. Hadaway simply disregarded that result and recommended a10.3% ROE. (Hadaway Reb., pp. 2, 7)

**V - CAPM-BASED ANALYSES AND RECOMMENDATIONS**

(A) The methodology The CAPM methodology is premised on the theory that the market does not compensate the investor for assuming “business” or “non-systemic” risks that the investor could avoid by owning a diversified investment portfolio. Rather, the market compensates the investor only for “non-diversifiable” risks that the investor cannot thus avoid. To develop an ROE, the CAPM methodology seeks to determine, for the subject individual company, a risk premium that represents only its stock’s non-diversifiable risks.

To do this, the CAPM first requires identification/derivation of three variables. The first of these variables is a *risk free yield*. (For example, a Treasury security yield) The second variable is the subject stock’s *specific risk factor*, which is called a *“beta.”* Beta is computed by comparing movements in a stock’s price (or market return) to contemporaneous movements in the broadly-defined stock market . The third variable is an *expected overall stock market rate of return*.

The first of the three variables, risk-free rate is directly observable. The second, the beta, is also “observable.” Value Line publishes estimated betas for all of the companies it covers, and Value Line betas are widely used by rate of return witnesses, including, in past cases, Dr. Hadaway. The third variable, expected stock market return, is the most difficult to measure because it cannot be observed.

CAPM computes a subject stock’s equity riskpremium by subtracting the risk free rate from the overall market return. Finally, CAPM estimates an ROE by multiplying the equity risk premium by the beta, and adding the product to the risk free rate. Thus, the CAPM formula is: ROE = risk *free rate + (beta x equity risk premium)* (Hadaway Dir., p. 34; Gorman Dir., p. 34 *et seq.*; Staff Report – Revenue Requirement/Cost of Service, p. 57 *et seq.*) Differences in betas and market returns greatly impact CAPM-based ROE recommendations. (Kahal Dir., p. 25)

(B) Mr. Kahal’s CAPM analysis and recommendation Mr. Kahal did not rely on the CAPM in formulating his ROE recommendation. He said that CAPM much less useful than DCF, because Treasury bond markets’ unusual behavior together with recent stock market turmoil have made it difficult to assess equity risk premiums. (Kahal direct, p. 26) Thus, he conducted his CAPM merely to check the validity of his above-discussed DCF recommendation. (Kahal Dir., p. 15)

For his CAPM analysis, Mr. Kahal used long-term (30 year) Treasury yield as the risk-free return and average beta for the proxy group. (See SCH. MIK-3, page 1, for individual company betas.) He said that 30 year Treasury yields have averaged approximately 3.0% in past six months, and that the proxy group’s currently-published Value Line betas averaged 0.73. Finally, he used a 5% to 8% overall stock market equity risk premium range.

Mr. Kahal’s CAPM-based results are shown at SCH MIK-5, page 1. His 6.7% low-end cost of equity estimate uses a 3.0% risk-free rate, a 0.73 proxy group beta, and a 5% equity risk premium. (ROE = 3.0% + 0.73 (5.0%) = 6.7%) His 8.8% upper end uses a 3.0 % risk**-**free rate, a 0.73 proxy group beta, and an 8.0% equity risk premium. (ROE = 3.0% + 0.73 (8.0%) = 8.8%) This yields a 6.7% to 8.8% ROE range, with a 7.7% midpoint. This is significantly lower than his DCF-based range. (Kahal Dir., p. 26)

CAPM should not be directly used in this case to set ROE. But it is of some value in demonstrating that Mr. Kahal’s DCF**-**based 9.5% recommendation is conservative, and does not understate the Companies’ cost of equity.

(C) Dr. Hadaway’s CAPM analysis and recommendation Dr. Hadaway did not present a CAPM analysis. He asserts that current capital market conditions render CAPM unreliable. (Hadaway direct, p. 34) He has used CAPM in the past. A PacifiCorp Utah 2007 electric utility study which he presented in 2007 used a 5.75% to 7.60% stock market risk premium range, consistent with Mr. Kahal’s recommended 5.0% to 8.0% range. Mr. Kahal notes that Value Line electric utility betas at that time averaged 0.87 , compared to 0.73 today, as shown in SCH MIK-3. (Kahal Dir., p. 28) Obviously, this indicates that electric utilities’ risk profile, as compared to the broader, overall stock market, has declined significantly since 2007. (Kahal direct, p. 28)

(D) Mr. Gorman’s CAPM analysis and recommendation Mr. Gorman’s CAPM produces an ROE of just 8.35%, which he rounds to 8.4%. This is much lower than both his DCF-based 9.5% recommendation and risk premium**-**based 9.2% recommendation. (Gorman Direct, 39)

**VI - STAFF’S ROE ANALYSES AND RECOMMENDATIONS**

Staff has conducted traditional ROE analyses. It rejects projected long term growth as a measure of growth rate because it believes that actual long term growth will be much lower than available projections. It calculates a 7.92%**-**8.52% ROE range (at 3% risk premium) and 8.52%**-**9.52% (at 4% risk premium). Commission Staff witness Mr. David Murray testifies that ROEs in the 8% or even the 7% range are realistic in the current capital and macroeconomic environment. (Murray rebuttal, 19) Staff’s final ROE recommendation is a 9.00%. It explains that, “(a)lthough this is well above what Staff believes…cost of equity to be…(it)…would balance the concern about the impact a lower allowed ROE would have on investors’ view of Missouri’s regulatory environment, while passing along the benefit of lower capital costs to ratepayers.” (Staff Report - Revenue Requirement/Cost of Service, p. 66)

**VII - CONCLUSION ON RATE OF RETURN**

The Companies’ presently**-**allowed 10.0% ROE was set in 2011. All reliable sources show that capital costs have since decreased significantly, and will likely remain low for the foreseeable future. This strongly suggests that the Companies’ capital costs, too, have decreased. It follows that the Commission must now the Companies’ ROE at significantly lower than 10.0%.

The Companies’ 10.3% ROE recommendation is unacceptable. It reflects an unsupported increase in cost of capital in that it:

(1) is based on altogether unrealistic growth rates and critical late­ changes in the proxy group;

(2) would reflect an unsupported increase in capital cost, and require the Commission in effect to render a determination that the Companies’ cost of capital has *increased*, when all signs indicate the opposite.

FEA respectfully recommends that the Commission adopt the very conservative DCF**-**based 9.5% ROE that both FEA and OPC recommend.

**VIII - CAPITAL STRUCTURE**

Dr. Hadaway recommends that the Commission adopt Great Plains Energy’s projected consolidated capital structure, which he asserts is consistent with the approach that was taken in the Companies’ prior rate cases. (Hadaway Dir., p. 5) This constitutes a sizeable increase in common equity ratio from 45.51% to 52.475%. (Kahal Dir., p. 5)

Mr. Kahal observed that this proposed capital structure is somewhat more equity laden, and therefore more expensive, than the industry average. He said that such an increase in equity ratio is unnecessary because of the Companies’ stable credit standing and adequate cash flows. He further pointed out that the Companies’ relatively strong ratemaking capital structure should be taken into account in deriving ROE. (Kahal direct, pp. 6-7)

Mr. Kahal further noted that the recommended capital structure excludes Other Comprehensive Income (“OCI”) from the actual common equity component. He pointed out that, because OCI is a negative item, this exclusion increases and overstates the actual common equity ratio and therefore the authorized overall rate of return. He further pointed out that Dr. Hadaway provided no explanation for, and did not quantify the dollar amount of, this adjustment. Mr. Kahal recommended that the Commission reject this OCI adjustment unless the Companies provide a persuasive explanation for it. (Kahal direct, p. 6)

The capital structure which Dr. Hadaway recommends is updated to August 31, 2012. (Hadaway Dir., p. 6) The Companies will at a later date provide the Commission with a final version of this consolidated capital structure. FEA neither supports nor opposes the Companies’ proposed capital structure. FEA does recommend that , unless the Companies provide an acceptable explanation for the OCI adjustment, the Commission remove that adjustment from whatever final capital structure it adopts in this proceeding. (Kahal Dir., p. 6) This will prevent the Companies’ common equity ratio and, therefore, its overall return, from being overstated.

Respectfully submitted,

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Dated: November 28, 2012

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this 28th day of November, 2012, filed the foregoing Federal Executive Agencies’ Initial Post-Hearing Brief on Rate of Return and Capital Structure on the website of the Missouri Public Service Commission in accordance with all applicable procedures, and emailed a copy of the same to all of the parties by their attorneys of record.

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Arthur Perry Bruder