**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’ REPLY BRIEF**

**ON RATE OF RETURN AND CAPITAL STRUCTURE**

 Arthur Perry Bruder

 p*ro hac vice*

 Attorney for

 United States Department of Energy

 1000 Independence Ave. SW

 Washington, DC 20585

 Arthur.Bruder@hq.doe.gov

 (202) 586-3409

 Capt. Samuel T. Miller,

 *pro hac vice*

 Attorney for United States Air Force

 Utility Law Field Support Center (ULFSC)

 139 Barnes Drive, Suite 1 Tyndall Air Force Base, FL 32403 Samuel.Miller@tyndall.af.mil (850) 283-6663

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**ON RATE OF RETURN AND CAPITAL STRUCTURE**

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

**I - INTRODUCTION**

FEA witness Mr. Matthew I. Kahal, Office of Public Counsel (“OPC”) witness Mr. Michael Gorman, Staff witness Mr. David Murray, and Kansas City Power & Light Company (“KCPL”) and Greater Missouri Operations Company (“GMO”) (“the Companies”) witness Dr. Samuel Hadaway filed testimony on return on equity (“ROE”) and capital structure. They were cross-examined October 23, 2012.

FEA respectfully recommends that the Commission adopt a 9.5% ROE as per the testimonies of Mr. Kahal and Mr. Gorman, and reject the Companies’ request to increase their presently-allowed 10.0% ROE to 10.3%. FEA further recommends that the Commission seriously consider adopting a 50/50 debt/equity capital structure, and that it not include Other Comprehensive Income (“OCI”) in whatever capital structure it finally adopts.

**II - RETURN ON EQUITY**

Capital costs have fallen very significantly in the twenty months since theCommission awarded KCPL a 10.0% ROE. (Doc. No. ER-2011-0355, Final Order, p. 124; T-544; FEA initial brief, p. 2; OPC initial brief, p. 13; AARP initial brief, p. 10) OPC opines that capital costs are down by 40 to 80 basis points. (OPC brief, pp. 13-14) Midwest Energy Consumers Group (“MECG”) asserts that there has been a 110 basis point decline in “Baa” utility bond yields, which equates to an 85 basis point reduction in ROE. (MECG brief, pp. 29-30, and See OPC initial brief, p. 14)

Moreover, it appears that capital costs may likely fall lower still. (OPC brief, p. 14; AARP brief, p. 10, citing Staff Report - Revenue Requirement/Cost of Service, pp. 27-28 ) The Companies themselves have adduced only very limited indicia of some tiny and transient interruptions in the ongoing decrease in capital costs, (T-554), and no evidence at all that interest rates will be higher in the foreseeable future. (T-552) Finally, there is no indication that the Companies have become any more risky than they were at the time that a 10% ROE was awarded.

This compels that ROE must now be reduced significantly, because *ROE must follow cost of capital*. If ROE is not reduced significantly, ratepayers will pay higher costs than the Companies incur. The question is, therefore, not *whether*, but *by how* *much*, current ROE should be reduced.

Despite the undisputed substantial decrease in capital costs, the Companies demand an ROE increase to 10.3%. (Companies’ initial brief, pp. 14, 19; Hadaway Reb., pp. 2, 31) This 10.3% is very near the level that Dr. Hadaway says investors expected two years ago. (T-412) In the face of the decrease in capital cost, how do the Companies find any basis for requesting an increase in their ROE? The Companies claim that “the unprecedented intervention of the Federal Reserve Board in the nation’s money supply” makes a 10.3% ROE reasonable. (Companies’ initial brief, pp. 14-15, 20) This assertion is without merit.

Preliminarily, it should be noted that all of the ROE witnesses directly or tacitly agree that Discounted Cash Flow (“DCF”) is the only workable methodology for developing the Companies’ ROE under present circumstances. Neither the Capital Asset Price Model (“CAPM”) nor the Risk Premium Model are useful here, except to check DCF-based results. (See, *e.g.*, Companies’ initial brief, pp. 19, 25; Kahal direct, p. 26; FEA initial brief, pp 9-12; OPC initial brief, p. 20, T-549) The Companies have attempted to use each factor in the DCF methodology to artificially increase ROE.

The Companies seek to artificially increase yield. In most DCF calculations, “yield” is derived by developing a group of “comparable” companies and adopting some sort of average of their yields. Initially, Dr. Hadaway did exactly that. He proffered a group of 22 comparable companies and placed their average yield in his DCF computations. (Hadaway Reb., p. 29) Mr. Kahal and Mr. Gorman adopted Dr. Hadaway’s group, and the matter appeared to be settled.

But in rebuttal testimony months later, Dr. Hadaway removed four companies from, and added three new companies to, his original group. (Companies’ initial brief, p. 29 *et seq.*; Hadaway Reb., p. 29) This totals seven changes, nearly one-third of his 22 original companies. Four of the companies he removed have lower than average ROEs. Two of the three companies he added have higher than average ROEs. Thus, his eleventh hour changes significantly inflate the group’s average yield and, in turn, artificially inflates his recommendation. (FEA initial brief, p. 6, Kahal surrebuttal, p. 6; T-403,551)

Mr. Kahal pointed out that Dr. Hadaway did not balance his removal of four low-ROE companies by a countervailing removal of high-ROE companies. (T-550) If, for example, Dr. Hadaway removed the three companies which have the highest ROEs (Alliant (10.4%), Great Plains (11.6%) and Hawaiian Industries (13.0%)(Hadaway SCH-10, p. 1)), group average yield would be 9.4% - slightly below Mr. Kahal’s ROE recommendation. (Kahal surrebuttal, p. 8) FEA respectfully recommends that the original proxy group (with the possible exception of Ameren, which has a negative growth rate) be retained for any DCF calculation adopted herein.

The Companies have made no effort to argue that it is acceptable to make wholesale changes in proxy group members in the middle of a case. The Companies’ justification for these changes is limited to claiming, without explanation, that they are all “both necessary and reasonable,” and that they all met Dr. Hadaway’s criteria. (Companies’ initial brief, p. 20) When asked during cross-examination whether he has ever made as many as seven changes in one proxy group, Dr. Hadaway dodged. (T-415-416) He merely insisted that he made his seven self-serving changes on the basis of the same criteria that he always uses to choose companies for proxy groups.

But the criteria he claims to have used are: (1) “an investment grade bond rating” (or “at least a BBB bond rating”); (2) a 70% or greater portion of regulated revenue; (3) an equity ratio greater than 30%; (4) “stable financial reporting”; (5) “a ‘consistent’ dividend record”; (6) absence of “unusual financial circumstances”;, and (7) “no recent merger activity.” (Hadaway Dir, p. 4; Companies’ initial brief, p. 20; T-403-405, 415-416) FEA respectfully submits that thesecriteria are so numerous and open-ended that any number of “comparable” companies might be found to “fit” or not fit them. More importantly, this is a case not of one or two judicious changes which are made at an early stage, in response to a change in circumstances and perhaps in accordance with agreement among participating ROE experts. Rather, these are unilateral, wholesale, eleventh hour changes, whose transparent purpose is to artificially inflate DCF yield.

In addition, Dr. Hadaway has artificially increased the DCF formula’s long-term dividend growth rate by contriving a rate of 5.7%, which is much higher than any other party’s proffered rate and is not supported by any credible evidence. (FEA initial brief, pp. 3-7; T-544) Dr. Hadaway admitted in cross-examination that nation’s average growth for the past twenty years (1991 – 2011) and past thirty years (1981-2011) has been significantly below this 5.7% rate, and that the 5.7% rate is based in significant part on the nation’s growth rates which prevailed in the long-ago years 1971- 1980. (T-399; See T-558) (For a more complete discussion of the difficulties with Dr. Hadaway’s proffered growth rate, please see FEA’s initial brief, pp. 6-7.)

Finally, the Companies urge adoption of a strategic “adjustment” of the well-established DCF formula which it styles a “Terminal Growth Value Model” DCF methodology. Dr. Hadaway asserts that this new model is necessary to “balance” the effect of current low yields in the traditional DCF formula. (Companies’ initial brief, p. 21) The Companies’ arguments in support of this new model are unpersuasive. This model is based on incorrect assumptions, and it produces artificial increases in ROE.

Traditional DCF methodology renders ROEs on the basis of: (1) current stock prices and dividends; (2) consequent current dividend yields; (3) predicted growth rates. Currently, and for the foreseeable future: (1) stock prices are higher relative to dividends; (2) consequent dividend yields are relatively lower; and (3) predicted growth rates are low; (4) utility equity investors are accepting considerably lower yields than they have in the past. (T-387)

Current market conditions are the lifeblood of DCF methodology. DCF methodology is *supposed to be*, and *must be*, based on capital market conditions as they presently are and will likely be for the foreseeable future. This being so, any DCF calculation that is based on reasonably accurate present day stock prices, yields and growth rates produces, *must* produce, and *should* produce, relatively low ROEs, that is, recommended ROEs that are considerably lower than what the industry and those who regulate it are accustomed to. Relatively low present day ROE recommendations do not indicate that the DCF methodology/formula is “wrong,” or somehow in need of “adjustment.” They are simply accurate reflections of present day low capital costs, low forecasted growth rates, and lower investor expectations. There is no indication that there is any need to “balance” present day low capital costs, which produce present day low dividend yields, in order to calculate ROE. It is therefore entirely wrong to “adjust” DCF methodology in such fashion as to shut out, or ameliorate, or somehow “balance,” inputs which reflect these real world capital market conditions as they are and are likely to be, unless one believes that present day capital costs and dividend yields are artificially low and likely to rise soon.

Dr. Hadaway professes to believe exactly that, and he has designed his proffered strategic “adjustment” of traditional DCF methodology accordingly. His new Terminal Model adjusts the DCF formula “to balance the extremely low dividend yields in the other (DCF) models.” (T**-**384-385, 388, 446-47; See also KCPL-20, Hadaway Rebuttal, pp. 30-31) In fact, this model “balances” *real* present day low yields by the device of creating *artificial* high growth rates and injecting them into the DCF computation of ROE. It does this by the following procedure:

(a) Begin with the approximate price at which investors today purchase shares of a given electric utility’s common stock: sixteen times current earnings, a 16:1 P/E ratio;

(b) Assume that:

 (1) an investor buys a share of stock today at a price of sixteen times its current earnings;

 (2) ValueLine’s forecasts of the stock’s earnings in years 2013- 2016 are correct. (T-392);

 (3) the current 16:1 P/E ratio continues to prevail in the years 2013 through 2016;

(c) Calculate the stock’s 2016 price by multiplying its much-increased 2016 earnings by its unchanged 16:1 P/E ratio. Obviously, the resultant supposed 2016 price will be much higher than the price at which the investor purchases the stock today;

 (d) Assume that the investor sells the stock in 2016, and that the stock’s greatly increased 2016 price and earnings net the investor a high rate of return;

(e) Calculate DCF future growth rate on the basis of this very high rate of return. This resultant *artificial* growth rate “balances” *real* present day low yields, and drives up the resultant recommended ROE;

(f) Assume that this highly unlikely future ROE is the return that *investors in 2012* are demanding;

(g) Hypothesize that that highly unlikely return is the ROE which the Commission should permit the Companies to earn. (T-383 *et seq.*)

This methodology is greatly flawed.

First, it is driven by the assertion that current low dividend yields stem entirely from unusual and transient actions of the Federal Reserve. The Companies claim that, for this reason, yields are artificially low, or “distorted,” or “anomalous,” and that returns on utility stocks must therefore rise significantly in the near future. (Companies’ initial brief, pp. 21-22; T-385) But the Companies point to no evidence to support this assertion, and the evidence in fact demonstrates the opposite. Mr. Kahal has pointed out that the Fed’s actions, and their effect on interest rates and dividend yields, reflect only the Fed’s proper and ongoing conduct of monetary policy, and resultant low dividend yields are not properly deemed “artificial,” “distorted,” or “anomalous.” (T-547) More importantly, and as Mr. Kahal has also noted, the Fed is only one influence among many on interest rates. Indeed, the Fed is a significant contributing factor regarding short term rates and much less a factor regarding long term rates. Other highly influential factors which have pushed interest rates down include present and likely ongoing extremely low inflation rates, the “flight to quality” phenomenon, and the sluggish economy. (T-555; Kahal Dir., pp. 8-9) To accept Dr. Hadaway’s view, one must believe not only that all of the forecasters are wrong, but that present day investor behavior cannot be trusted and that present day markets themselves are wrong. Present day low interest rates reflect capital market conditions as they presently are and, by all indications, as they will continue to be for the foreseeable future to be. Any proper DCF calculation should reflect this.

Moreover, the Companies say that conservative investors are nowadays willing to purchase utility stocks at prices (and concomitant P/E ratios like 16:1) that are higher than they have been in the past because, such investors cannot presently attain sufficiently high returns from debt instruments. (T-387) If interest rates rise as Dr. Hadaway says they will, those investors will likely return to buying debt instruments. This will cause demand for utility stocks, and utility stock prices, to decrease. When that happens, the 16/1 P/E ratio will no longer prevail. When the 16:1 P/E ratio no longer prevails, the Terminal Model ceases to be valid. (Dr. Hadaway has acknowledged that if interest rates rise, as he says that they will, the P/E ratio will fall. (T-406))

Furthermore, the Terminal Model flies in the face Dr. Hadaway recent statement that “equity market turmoil” presently prevails. (Hadaway Dir., p. 5) If “equity market turmoil” presently prevails, it is extraordinarily unlikely that the current 16:1 P/E ratio will prevail in 2016, or that Valueline’s current 2016 earnings predictions will come to pass. Indeed, acceptance of the Terminal Model requires not only acceptance of the view that a 16:1 P/E ratio will exist in 2016 and that Valueline’s predicted 2016 stock prices will prevail. It requires acceptance of the notion that *present day investors believe* that that 16:1 ratio and those 2016 stock price forecasts will prevail. There is no basis for believing that that is what present day investors believe. Finally, the Terminal Model as Dr. Hadaway proffers it is quite new and untested. Mr. Kahal said flatly that he has never seen it used before, (T-557) and Dr. Hadaway admitted that he did not use it “routinely” until last summer. (T-388) All traditional DCF methodologies measure long term expectations, but this new model measures just four years. Dr. Hadaway said that the only reason for this four year limit is that ValueLine offers only four years of dividend forecasts. (T-391) FEA respectfully submits that that explanation is altogether inadequate. Dr. Hadaway also attempted to claim that Mr. Gorman and Mr. Murray have used this “terminal” model, but admitted in cross- examination that they have gone “much father out” than four years when they did so. (T-390)

To summarize, let us look at the DCF formula:

ROE = current dividend x (1+long-term dividend growth rate) + long term dividend growth rate

 stock price 2

Dr. Hadaway has created a 10.3% ROE recommendation by artificially manipulating each and every factor in this DCF formula, and by artificially manipulating the DCF formula itself. He has artificially manipulated *stock price* by substituting dubious predictions of what 2016 stock prices will be. He has artificially manipulated yield (*current dividend/stock price)* by no fewer than seven late changes in his proxy group. And he has doubly manipulated *long term dividend growth rate*, first by adopting an altogether inapposite 5.7% growth rate, and then by abandoning “*long term* dividend growth” for a dividend growth term of just four years.

Mr. Kahal’s and Mr. Gorman’s DCF presentations Mr. Kahal’s and Mr. Gorman’s DCF-based calculations both produce 9.5% ROE recommendations. (Kahal Dir., p. 24,Kahal Surreb. 1,2,4; FEA initial brief, pp. 2-5; Gorman Dir., p. 39) The only criticism the Companies have made of Mr. Kahal’s and Mr. Gorman’s DCF presentations is that they apply DCF without “adjustment” or “explicit consideration” of “current abnormal market anomalies.” (Companies’ initial brief, pp. 22-25, 35; Hadaway rebuttal, p. 25, T-413*et seq*.) The Companies initial brief gives no specific explanation or suggestion as to what specific “adjustments” or “explicit consideration” Mr. Kahal and Mr. Gorman should have introduced or exercised. (Companies' initial brief, pp. 22-26) When asked in cross-examination what specific “adjustments” or “explicit consideration” Mr. Kahal and Mr. Gorman should have introduced, Dr. Hadaway suggested only that Mr. Kahal “could have” adopted the top of his equity range, or looked at dividend yields for a longer time period. (T-412-414) With regard to the first suggestion, there is simply no basis for adopting the top end of Mr. Kahal’s range, because the top end of an equity range is almost by definition not a "best estimate," and would inevitably bias the ratemaking process against consumers. Indeed, Mr. Kahal showed great restraint by recommending a conservatively high 9.5% ROE, when a great deal of evidence suggests that ROE ought to be significantly lower than that. With regard to the second suggestion, Dr. Hadaway proffered no explanation of why Mr. Kahal should have looked at dividend yields over a longer time period.

Here,the Companies are insisting that Mr. Kahal and Mr. Gorman should have made the very same assumptions as those which underlie Dr. Hadaway’s above-discussed unacceptable Terminal Model:

(1) that current low interest rates are “anomalies” or “distortions”; and,

(2) that traditional and accepted DCF methodologies must be “adjusted” for these “anomalies” or “distortions, lest resultant ROE recommendations be concomitantly anomalous or distorted.

Again, this does not bear scrutiny. As discussed above, current low capital costs are not “anomalous” or “distorted,” and are likely to prevail for the foreseeable future. It is therefore incorrect to “adjust” DCF methodology to “balance” them.

By way of analogy, let us imagine a medical caregiver whose job it is to take patients’ temperatures. Day after day, this person observes one patient after another with a normal body temperature of 98.6º. Then, one day, he is confronted with a patient who is suffering from hypothermia and whose temperature is 95.0º. If the caregiver is true to the thermometer’s reading and to its message, he will accept the low temperature reading and treat the patient accordingly. But suppose that, like Dr. Hadaway, the caregiver chooses instead to treat the low reading as a “distortion” or an “anomaly.” Further suppose that the caregiver responds to this by “adjusting” the thermometer’s shape, size, or thickness, or its markings, or the quantity or quality of the mercury which it contains. Certainly, if one experimented with numerous such “adjustments,” one could “adjust” the thermometer in such fashion as to cause it to indicate that the hypothermic patient’s temperature is at a normal level.

Hopefully, anyone who engages in such an endeavor will quickly realize that the thermometer is doing exactly what it always does and is designed to do, and that the temperature reading, although it falls outside the caregiver’s comfort zone, is accurate, and must be addressed as such. A caregiver who does otherwise will harm patients. Similarly, a regulator which seeks to “adjust” the DCF in such fashion as to cause it to render a reading which falls within its comfort zone, rather than accept what the DCF is saying and act accordingly, will harm ratepayers.

Conclusion on rate of return The Commission should reject the Companies’ 10.3% ROE recommendation. It would require the Commission in effect to determine that the Companies’ capital costs have *increased*, when all signs show that they have decreased very significantly. It is based on unrealistic growth rates, critical proxy group changes, and an enormously flawed DCF model.

FEA respectfully recommends that the Commission retain the original proxy group (with the possible exception of Ameren, which has a negative growth rate) for any DCF calculation adopted herein, and that it adopt the very conservative DCF**-**based 9.5% ROE that, for the reasons set forth in FEA’s initial brief and herein, both FEA and OPC recommend.

**III - CAPITAL STRUCTURE**

The Companies ask the Commission to adopt Great Plains Energy’s projected consolidated capital structure (Companies’ initial brief, pp. 38-40; Hadaway Dir., p. 5), which includes a sizeable increase in common equity ratio from 45.51% at March 31, 2012 (MECG initial brief, p. 35) to 52.475%. (Kahal Dir., p. 5) This is discussed in FEA’s initial brief at pages 13-14. The 52.475% equity portion is very high compared to Dr. Hadaway’s “comparable” proxy group companies' equity ratios. (MECG brief, p. 35) Furthermore, the higher equity ratio increases the purported revenue deficiency, and benefits no one except the Companies**.** OPC recommends that the Commission adopt a hypothetical 50/50 debt/equity capital structure. (OPC brief, p. 19 *et seq.*) FEA respectfully recommends that the Commission seriously consider that option.

The Companies also ask that they be permitted to remove Other Comprehensive Income (“OCI”) from capital structure. FEA respectfully points out that the proposed 52.475% equity portion is higher than it might be at least in part because the Companies have removed OCI from capital structure. The Companies’ witness Mr. Kevin Bryant explains that the Companies did this because the parent company’s OCI balance is primarily attributable to losses on interest rate derivatives, and that the OCI adjustment is needed to enable the Companies to recover these debt costs. (Bryant Reb., pp13-14) In his surrebuttal testimony, Mr. Kahal pointed out that Mr. Bryant has contradicted himself in that, while he claims to support the “actual” capital structure, the OCI adjustment increases the “actual” capital structure’s equity ratio. Mr. Kahal added that this is contrary to GAAP accounting, credit rating agencies’ practices, and the FERC Uniform System of Accounts. (Kahal Surreb., p. 12-13) For this reason, FEA believes the Companies should not be permitted to remove OCI from whatever capital structure is adopted.

 Respectfully submitted,

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 Arthur Perry Bruder *pro hac vice*

 Attorney for U. S. Department of Energy

 1000 Independence Ave. SW

 Washington, DC 20585

 (202) 586-3409

 Arthur.Bruder@hq.doe.gov

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 Capt. Samuel T. Miller

 *pro hac vice*

 Attorney for United States Air Force

 Utility Law Field Support Center

 139 Barnes Drive, Suite 1

 Tyndall Air Force Base, FL 32403

 Samuel.Miller@tyndall.af.mil

 (850) 283-6348

Dated: December 11, 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