Exhibit No.:	
Issue:	Revenue Requirement
Witness:	Michael P. Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Midwest Energy Consumers' Group
Case No.:	ER-2016-0285
Date Testimony Prepared:	January 27, 2017

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Kansas City Power & Light Company's Request for Authority to Implement A General Rate Increase for Electric Service	))))))	**Case No. ER-2016-0285**

Surrebuttal Testimony of

Michael P. Gorman

On behalf of

Midwest Energy Consumers' Group

January 27, 2017

BRUBAKER & ASSOCIATES, INC.

Project 10290

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Kansas City Power & Light Company's Request for Authority to Implement A General Rate Increase for Electric Service	))))))	**Case No. ER-2016-0285**

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 Midwest Energy Consumers' Group 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-2016-0285.

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

Michael P. Gorman

Subscribed and sworn to before me this 27th day of January, 2017.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2017
Commission # 13706793

Notary Public

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Surrebuttal Testimony of Michael P. Gorman

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

A Yes. On November 30, 2016 and December 30, 2016, I filed revenue requirement direct testimony and rebuttal testimony, respectively, on behalf of the Midwest Energy Consumers' Group ("MECG") regarding Kansas City Power & Light Company's ("KCPL" or "Company") rate increase request.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I will respond to the rebuttal testimony of KCPL witness Robert Hevert.

Q PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS OUTLINED IN YOUR SURREBUTTAL TESTIMONY.

A I respond to KCPL witness Hevert's rebuttal testimony. I describe why his claims that utility risks require a higher return on equity than what I propose in this case is without merit. I also respond to his assessment of market data and again explain why a balanced and fair interpretation of market data supports a return on equity for KCPL in the range of 8.9% to 9.5%, and that Mr. Hevert's recommended return on equity of 9.75% to 10.50% is excessive and should be rejected.

Q DOES MR. HEVERT OFFER SOME CAPITAL MARKET OUTLOOKS THAT HE CLAIMS SUPPORT HIS BELIEF THAT KCPL'S MARKET COST OF EQUITY IS HIGHER THAN YOU HAVE RECOMMENDED IN THIS PROCEEDING?

A Yes. Mr. Hevert points to five analyses to support this outlook:

1. Mr. Hevert compares the yield spreads for A-rated utility bonds compared to 30-year Treasury bonds, and observes that for the period January 2006 through November 2016, the yield spread for A-rated utility bonds is near its highest level since 2006 (pages 3 and 4 and Chart 1). He concludes that this is evidence the market perceives utilities as risky investments. (Hevert Rebuttal Testimony at 3-4).

2. He also observes that because of the historical volatility and spreads between A-rated corporate bonds and utility bonds, there is no reason to conclude that the spreads are any different now than in the past. He believes that over time there has been a nearly one-to-one relationship between the credit spreads on A-rated corporate and utility bonds. He further concludes that a regression analysis of yield spreads of A-rated corporates and A-rated utility bonds, shows a slope of approximately 1, and finds that the intercept term is statistically insignificant. From this he concludes that there is no material difference between A-rated corporate bond yield spreads, and those for utilities. (*Id*. at 5 and 6).

3. He believes that the market sees an increase in interest rates based on an outlook of expected changes to the Federal Fund rate in December 2016 and out over approximately the next year. (*Id*. at 6 to 7).

4. He also looks to long-term interest rate projections suggesting that the market expects an increase in interest rates, which will put downward pressure on utility stock prices. (*Id.* at 7 to 8).

5. Finally, he comments on changes in Treasury yields since the Company's last case where the Commission awarded it a return on equity of 9.5%. (*Id.* at 9 to 10).

Q PLEASE COMMENT ON MR. HEVERT'S OBSERVATION CONCERNING YIELD SPREADS ON A-RATED UTILITY BONDS RELATIVE TO TREASURIES IN ASSESSING UTILITY INVESTMENT RISK.

A I agree with Mr. Hevert that observing utility bond yields relative to Treasury bond yields is a measure of gauging the market's risk premiums relative to different investment risk characteristics of the industry. Indeed, this measure is a more accurate gauge of an appropriate equity risk premium in the current marketplace than simply relying on nominal interest rates as Mr. Hevert has proposed in this case. What this analysis does not support, however, is Mr. Hevert's belief that a wide spread for utilities to Treasuries indicates increased risk for utility securities.

To the contrary, the market is requiring higher than average premiums for investments of greater risk. However, the general assessment of the utility investment risk requires a comparison of spreads between utilities to Treasuries and those of corporates to Treasuries. This comparison shows that utility spreads to Treasuries are higher than they have been historically, but corporate to utility spreads for issuers with the same bond rating favor utilities due to the low-risk character of utility investments. This favorable pricing and low yields for utilities relative to corporates indicate the market's acceptance of utilities as safe-haven, lower risk investments. In any event, the yield spreads while above average, still indicate very low capital market costs for both utilities and corporate securities in today's marketplace. Therefore, these yield spreads do not support Mr. Hevert's proposal for an overstated return on equity for KCPL in this proceeding.

Q DID YOU RECOGNIZE CURRENT YIELD SPREADS FOR A-RATED UTILITY BONDS RELATIVE TO TREASURY BONDS IN MEASURING KCPL'S RETURN ON COMMON EQUITY IN THIS PROCEEDING?

A Yes. I did observe in my analysis abnormally high spreads between utility bond yields and those of Treasuries (Gorman Direct at 44-46). I also observed that utility bond yield spreads relative to corporate bond yield spreads support the conclusion that the market is paying a premium for lower risk investments like Treasury bonds and utility securities. The current wide spreads for corporate and utilities to Treasuries, and utilities to corporates, support the finding that the market is paying a premium for lower risk investment options, and that utility securities are included in low-risk options based on observable market valuations. All of this market data supports the notion that the market is paying a premium for low-risk securities, and utility securities' yield spreads indicate that the market regards utilities as low-risk investment options.

Q PLEASE COMMENT ON MR. HEVERT'S OBSERVATIONS CONCERNING THE YIELD SPREAD BETWEEN A-RATED CORPORATES AND A-RATED UTILITY BONDS.

A Mr. Hevert's analysis suggests that there is no discernible difference in current yield spreads of A-rated corporate bonds and A-rated utility bonds in the last 10 years or so. He concludes that the yield spread differential is not meaningful and not statistically significant.

Q PLEASE RESPOND TO MR. HEVERT'S ANALYSIS OF THE YIELD DIFFERENCE BETWEEN A-RATED UTILITIES AND A-RATED CORPORATES.

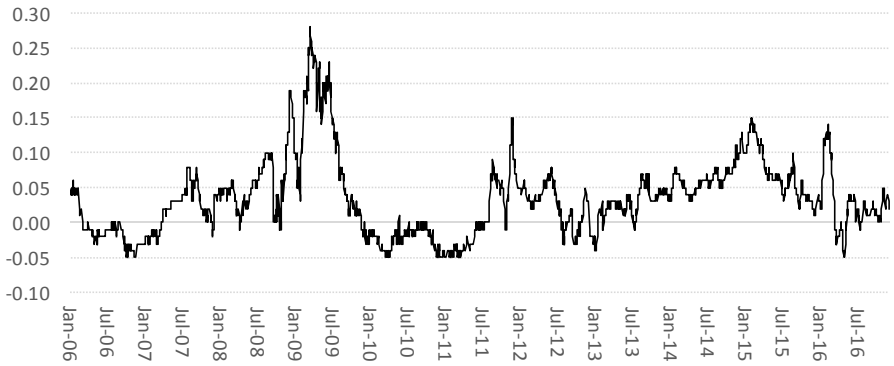
A Mr. Hevert's regression analysis (page 6) is set up in a manner that tends to use corporate credit spreads as a method to "explain" utility yield spreads. He does this in his regression analysis by using corporate spreads as the independent variable, and the utility credit spreads as the dependent variable. However, this regression analysis simply is not useful in observing whether current market valuations suggest that utility costs of capital are lower than non-regulated or corporate bond issuances.

The question is not whether the yield spreads of corporate and utility bond yield can be predicted. Rather, the question is simply whether or not there is an observable difference in the current yields of A-rated utility bonds relative to those of A-rated corporate bonds.

By observing changes in the yield spread from corporate to utility bond yields, the data shows that corporate bond yields are more expensive than utility bond yields in the current market. This yield spread is a clear indication that utilities' cost of capital is currently lower than the cost to a corporate issuer. The data for this observation is based on the yields in Mr. Hevert's own data, which is shown below in Figure 1.

Figure 1

'A' Rated Bond Yield Spread
(Corporate vs. Utility)



Source: Mr. Hevert's Credit Spread Workpaper.

As shown in Figure 1 above, for almost all periods since 2009, I show that the spread between corporate yields and utility yields has been above zero. This indicates that corporate yields are higher than those of utility yields. While the relationship varies over time, predominantly, utility yields have been lower than those of corporate issuers over the last two to four years.

Q DO YOU BELIEVE THAT THE OUTLOOK FOR AN INCREASE IN FEDERAL FUNDS RATES SUPPORTS MR. HEVERT'S BELIEF THAT THE RETURN ON EQUITY WILL INCREASE OVER TIME?

A No. The outlook for an increase in the Federal Funds rate has been available to market participants for many years now. Despite such an outlook, it was only recently that the Federal Funds rate did increase interest rates, in December 2016 by 25 basis points. That change, along with the change in Administration, did have an impact on

utilities' security valuations. However, since that change was made on December 14, those valuations were reflected in my updated analysis and recommended return on equity range of 8.9% to 9.5% as outlined in my rebuttal testimony.

Q DO YOU HAVE ANY COMMENTS CONCERNING MR. HEVERT'S ASSESSMENT OF OUTLOOKS FOR CHANGES IN LONG-TERM INTEREST RATES?

A Yes. I think there are several important observations about outlooks for changes in long-term interest rates. All of these observations, however, support a finding that KCPL's return on equity is reasonably within the range of 8.9% to 9.5%.

In Table 1 below, I show the quoted quarterly actual bond yield, along with the projected Treasury bond yields two years out, and five and ten years out as reported by *Blue Chip Financial Forecasts ("BCFF")*. As shown in Table 1 below, the average of the quarterly recorded actual Treasury bond yields in the *BCFF* was around 3.3% to 3.8% in 2014. At that time, the consensus analysts were projecting increases in interest rates up to the 4.3% to 4.5% area over the next two years, and projected further increases in Treasury bond yields up to 4.9% to 5.6% five to ten years out. In 2015, current observable utility bond yields dropped to a range of 2.6% to 3.0%, and two-year projected Treasury bond yields also decreased relative to 2014. The projected yields in 2015 range from 3.7% to 4.0% over two years, and from 4.5% to 5.0% in five to ten years out. Continuing in this trend, Treasury bond yields in 2016 declined down to 2.3% to 3.0%, and were projected to range from 3.1% to 3.8% two years out, and projected five years to ten years out down to 4.2% to 4.6%.

TABLE 1

30-Year Treasury Bond Yield Actual vs. Projection

Description	Quarterly Average (1)	2-Year Projected (2)	5- to 10-Year Projected (3)
2014			
Q1	3.8	4.4	
Q2	3.7	4.5	5.3% - 5.6%
Q3	3.4	4.4	
Q4	3.3	4.3	4.9% - 5.1%
2015			
Q1	3.0	4.0	
Q2	2.6	3.7	4.8% - 5.0%
Q3	2.8	4.0	
Q4	2.8	3.9	4.5% - 4.8%
2016			
Q1	3.0	3.8	
Q2	2.7	3.6	4.3% - 4.6%
Q3	2.6	3.4	
Q4	2.3	3.1	4.2% - 4.5%

Source: *Blue Chip Financial Forecasts* , 2014-2016. The 5- and 10-Year Projections are made in June and December.

This information shown in Table 1 makes clear that consensus economists' outlooks are expecting much lower interest rates out over the five to ten-year horizon in 2016 than they were expecting in 2014 and in 2015. This is clear evidence that consensus market participants are more accepting of the sustainability of today's low capital market costs.

Q AT PAGES 49-53 OF HIS REBUTTAL TESTIMONY, MR. HEVERT STATES CONCERN ABOUT YOUR CONSTANT GROWTH DCF ANALYSIS. PLEASE DESCRIBE MR. HEVERT'S CONCERN.

A Mr. Hevert describes a DCF model as a combination of an inverse relationship between expected growth and the dividend yield. He states that under increases in growth the price would increase and the dividend would decrease. The converse would also be true. This concern with my constant growth DCF analysis relates to the current price-to-earnings ("P/E") ratio. He observes that the P/E ratios for utility stocks are high by historical standards but the growth rates are relatively low. (*Id*. at 50). He states that the existence of a high P/E ratio with relatively low growth results in components of the DCF model which are largely not compatible.

Q ARE MR. HEVERT'S COMMENTS CONCERNING YOUR DCF ANALYSES REASONABLE?

A No. Indeed, Mr. Hevert's observations simply are not accurate. P/E ratios are higher than average, but that corresponds to growth rates over the next three to five years that are higher than long-term sustainable growth rates. The long-term sustainable growth rate is based on forward-looking projections made by independent economists of growth in the U.S. economy compared to short-term utility earnings growth projections. Mr. Hevert's assessment that three- to five-year growth rates are low in comparison to history is not based on any market participant's outlook. Rather, it is largely based on his assessment of actual historical growth in the U.S. stock market as reported in my testimony by Duff & Phelps (*Id*. at 50), and his GDP projection that is not reflective of the market consensus.

Contrary to Mr. Hevert's assertions, the results of the DCF analysis provide a very robust and reliable high-end estimate of a fair return on equity based on observable stock valuation principles. More specifically, P/E ratios likely are high because prices are driven up due to the expected abnormally high levels of short-term growth in relationship to growth in the overall U.S. GDP. Utilities' growth outlooks over the next three to five years largely reflect very large capital programs which are growing rate base, and earnings and dividends outlooks. These growth rates are expected to slow over time as utility capital programs return to more normal levels and as those capital programs are added to larger embedded capital programs which slow utility growth naturally.[1] For these reasons, Mr. Hevert's criticisms of my DCF return simply are inaccurate.

The robust outlook for growth over the next three to five years is evident by a critique of the sustainable growth rate study I performed on the proxy group in my rebuttal testimony. As shown on my Schedule MPG-R-8, page 1, the sustainable growth methodology suggests the proxy group will grow 4.3%. That growth rate is based on internal growth of 3.91%, and additional growth of almost 40 basis points that is attributable to selling stock in the market at prices above book value. Selling stock in the market is an indication that utilities' internal cash is not adequate to meet their capital investment and other cash requirements. By selling stock to the market during this abnormally high investment period, utilities are increasing their growth rate by almost 40 basis points relative to the growth that would be realized if the utilities did not need to sell stock to the market. Clearly, P/E ratios are as high as they are right now at least in large part due to the expectation of very high growth rates over the next three- to five-year period.

[1]Indeed, the expected decrease in growth rates is reflected in the various growth rates in my multi-stage DCF analysis.

Q DO YOU HAVE ANY COMMENTS CONCERNING MR. HEVERT'S DISCUSSION OF YOUR CAPM STUDIES (PAGES 53-55)?

A Yes. Mr. Hevert takes criticism largely with my market risk premium estimate including my CAPM return estimate. He observes at page 53 of his testimony that my CAPM return estimate is based on expected returns on the market of around 9.1% to 11.2%. At page 54 of his rebuttal testimony he asserts that the 9.1% market return estimate is too low. While I do not agree with the facts underlying Mr. Hevert's assertion, I would note that I provided less weight to my market risk premium based on expected return on market of 9.1%.

My primary weight was given to 11.2% estimated return on the market. Mr. Hevert, however, also believes that that return estimate is too low. He states at page 54 of his rebuttal testimony that a market return of 11.2% is lower than the 50-year average return on the market of 12%, and asserts this return falls at the lower end of actual market returns historically.

Q PLEASE RESPOND TO MR. HEVERT'S CONCERN OF YOUR MARKET RISK PREMIUM ESTIMATE.

A Mr. Hevert's assessment of a current expected return on the market is largely based on historical data. What is missing from Mr. Hevert's assessment of historical data is that historical inflation has been approximately 3.0%, where future-looking inflation is expected to be around 2%. While the return on the market has been 12% over the last 50 years, that aligned with inflation outlooks of around 3%. Prospectively, inflation is expected to be around 2%. As such, an expected return on the market of around 11% in the face of a 1 percentage point reduction in inflation, corresponds

with the same real market return that was experienced over the last 50 years, when inflation was much higher.

The same is true for Mr. Hevert's comparison of my market return estimate relative to the rolling average of market returns historically. The historical market returns reflect historical inflation, whereas my market return reflects forward-looking inflation. When the historical and forward-looking returns are adjusted for inflation, it shows that my market return estimate is fully consistent with historical returns, and reasonably consistent with market analysts' projections of future returns adjusted for reduced level of expected future inflation.

Q DID MR. HEVERT TAKE ISSUE WITH YOUR RISK PREMIUM ANALYSES?

A Yes. At page 57, he states he has three concerns with my risk premium study. Those include:

1. I understated the required risk premium in the current market because I ignored important relationships evident in my own data.
2. The low-end of my risk premium results is far lower than any return on equity authorized since at least 1996.
3. A market-to-book ratio is not a relevant benchmark for assessing authorized returns.

Q PLEASE RESPOND TO MR. HEVERT'S CRITICISM OF YOUR RISK PREMIUM ANALYSES.

A Mr. Hevert is critical of my risk premium studies stating that I should have embraced a simple inverse relationship of nominal interest rates and equity risk premiums. He believes that the only factor that should be considered in gauging an appropriate risk premium in the current marketplace, is the current level of nominal interest rates relative to history. That belief is simply not supported by academic literature. As I

stated in my rebuttal testimony, changes in nominal interest rate is one factor that helps to gauge an appropriate equity risk premium but is not the only factor. Rather, gauging an appropriate equity risk premium in the market today depends on the market's perceived level of "investment risk" differentials between equity and bond investments, and not only nominal interest rates.

To the extent equity investments increase or decrease relative to bonds, the equity risk premium in investing in equity versus debt securities will increase or decrease.

It is this latter, more complete gauge of equity risk premium which I relied upon. Specifically, I gauged whether or not the market is demanding risk premiums that are above or below historic averages using observable market evidence. I did conclude based on that finding that equity risk premiums are above average currently relative to the past because the market is placing higher valuation on lower risk stable investments. While one factor in describing those risk/required return relationships is nominal interest rates, it is not based on only one factor – interest rates. Therefore, Mr. Hevert's belief that I did not consider market evidence in gauging an appropriate risk premium is simply without merit.

Q DO YOU HAVE ANY COMMENTS CONCERNING MR. HEVERT'S CRITICISMS OF THE LOW-END RISK PREMIUM ESTIMATES INCLUDED IN YOUR STUDY?

A Yes. Mr. Hevert's belief that the low-end of my risk premium analysis is far too low to support a reasonable return on equity is simply a red herring. The equity risk premiums used in my database, as well as those used in his database, include equity risk premiums that would produce return on equity estimates that are unreasonably low. Conversely, the same database contains data that produces returns on equity

which are unreasonably high. In arriving at my recommended return based on my risk premium I did not allow these outliers to skew my estimate of a fair return on equity in this proceeding. Therefore, variations in the database did not detract from the reasonableness and reliability of my market risk premium estimate.

Q PLEASE COMMENT ON MR. HEVERT'S MARKET-TO-BOOK RATIO ARGUMENT CHALLENGING THE RELIABILITY OF YOUR RISK PREMIUM STUDY.

A Mr. Hevert's belief that relying on a market-to-book ratio in judging an appropriate time period to construct a market risk premium estimate is again a red herring. The only aspect of a market-to-book ratio that was used in my study was to determine that my study time period of 1986-2016 included a period where utility stock prices traded at a premium to book value. This was used as observable evidence to show that the authorized returns on equity supported stock prices that allow utilities to sell additional shares to the market without diluting existing shares. This is an indication that the authorized returns on equity were perceived as fair compensation by the market based on observable valuations of utility stocks. Conversely, during periods where market-to-book ratios are below 1, a utility could not sell stock to the market without diluting the value of existing shareholders. Under those circumstances, utilities likely would not choose to sell stock to the market.

Q PLEASE COMMENT ON MR. HEVERT'S CRITICISMS OF YOUR FINANCIAL INTEGRITY STUDY.

A Mr. Hevert is critical of my financial integrity study because he believes that even at very low authorized returns on equity, the analysis would support investment grade

credit metrics. He states this analysis does not provide meaningful information. (Hevert Rebuttal at 63-65).

Q PLEASE COMMENT.

A The United States Supreme Court has set forth standards for determining whether a return on equity is fair and reasonable. Included in those standards are the following two determinations. First, the determination that the return on equity represents fair compensation for the level of risk assumed. Second, the fair return standard requires a return that supports the utility's financial integrity and ability to attract capital. My financial integrity study comes after my determination of a fair return on equity, and is used to show that my recommended return on equity will support the utility's financial integrity and access to capital. The necessary implication is that, if my return on equity recommendation will fulfill the requirement that it supports the utility's financial integrity and ability to attract capital, then Mr. Hevert's recommended return must be inflated.

Importantly, Mr. Hevert does not provide evidence that my recommended return on equity will not support investment grade credit metrics, or not support KCPL's investment grade bond rating. While he is critical of my study, he has provided no alternative methodology or rebuttal to my conclusion that my return on equity recommendation represents fair compensation to KCPL, and will preserve its financial integrity and provide it access to capital. For all these reasons, Mr. Hevert's arguments concerning my financial integrity studies should be disregarded.

Q DO YOU DISPUTE MR. HEVERT'S ARGUMENTS THAT A CREDIT RATING ANALYSIS CONSIDERS MORE THAN JUST CREDIT METRICS AS YOU PERFORMED IN YOUR FINANCIAL INTEGRITY STUDY?

A No. I agree with Mr. Hevert that a credit rating depends on both quantitative and qualitative valuations. The credit metrics are simply one factor. However, the return on equity within the ratemaking calculus primarily impacts the utility credit metrics. The other factors which support a qualitative finding of a fair return on equity are addressed by reviewing the current marketplace capital costs, and risk variability. As outlined in my testimony, I provided evidence that authorized returns on equity in the range of 8.9% to 9.5% will provide fair compensation, and I have also shown that utility companies have been able to access capital and maintain strong credit ratings as their authorized returns on equity have dropped from over 10% down to the mid 9.0% area more currently. This downward trend in authorized returns on equity should continue until capital market data changes.

Q MR. HEVERT ALSO EXPLAINED AT PAGE 48 OF HIS REBUTTAL WHY HE INCLUDED OTTER TAIL POWER IN HIS ANALYSIS RELATIVE TO YOUR REASONING FOR EXCLUDING IT. PLEASE RESPOND.

A. I excluded Otter Tail Power from the proxy group because it was not followed by my source of security analyst growth rate publications. Mr. Hevert states that it was followed by the analysts from his growth rate sources. Including or excluding Otter Tail Power does not have a measurable impact on either of our analyses or recommended returns. So I do not consider this issue to be a factor that explains the difference between Mr. Hevert's and my return on common equity recommendations.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes.

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