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Witness:	Samuel C. Hadaway
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Case No.:	ER-2009-0090
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2009-0090

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

ON BEHALF OF

KCP&L GREATER MISSOURI OPERATIONS COMPANY

Kansas City, Missouri
April 2009

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SAMUEL C. HADAWAY

Case No. ER-2009-0090

I. Introduction

Q. Are you the same Samuel C. Hadaway who submitted Direct and Rebuttal Testimony on behalf of KCP&L Greater Missouri Operations Company ("GMO" or the "Company") in this proceeding?

A. Yes, I am.

Q. Please state the purpose of your Surebuttal Testimony and summarize your response to the other parties' Rebuttal Testimony.

A. The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimony filed on March 13, 2009 by Missouri Public Service Commission Staff witness David Murray and the Office of the Public Counsel ("OPC") witness Michael Gorman.

As I stated in my Rebuttal Testimony, I strongly disagree with the other parties' positions on GMO's allowed rate of return. I have reviewed their continuing recommendations for a low authorized return on equity ("ROE") and I have considered their criticisms of my rate of return methodologies. Their recommendations are not consistent with current capital market conditions and their criticisms of my testimony are misplaced. I will limit my current responses to those areas that I have not previously covered in my Rebuttal Testimony.

II. Response to Staff Witness David Murray

Q. What is Mr. Murray's principal criticism of your analysis?

A. Mr. Murray's only substantive criticism is that he believes the growth rates in my DCF analysis are too high. He criticizes analysts' growth rates, which until recently were the growth rates used by Staff in its DCF calculations. See Murray Rebuttal Testimony at 8-9. He also criticizes long-term economic growth as measured by gross domestic product ("GDP"), even though he cites textbooks that recommend using GDP growth in multi-stage DCF models like his. See Murray Rebuttal Testimony at 9-10. As I explained previously, his preferred 3.1 percent growth rate, based on growth in electricity consumption (0.9%) and currently low inflation projections (2.2%), is too low for the DCF model because it leaves out many other factors that investors include in their long-term growth rate expectations. See Hadaway Rebuttal Testimony at 12. Mr. Murray's criticisms and his low growth rate recommendation are also entirely inconsistent with the Commission's recent finding of a 6 percent growth rate based on projected GDP growth in the recent AmerenUE Report and Order in Case No. ER-2008-0318 at 21 (Jan. 27, 2009). His criticisms are, therefore, inconsistent with prior Staff practice, inconsistent with textbook presentations of the DCF model, and inconsistent with the Commission's recent findings. His Rebuttal Testimony should be considered accordingly.

Q. On pages 10 and 11, Mr. Murray cites equity cost rates of 6.90 percent to 8.75 percent and growth rates of 1 percent to 3.6 percent from the Company's response to Staff Data Request No. 0121. Should these numbers be used to set the allowed rate of return?

A. No. In stock valuation analysis, low equity cost rates are sometimes used to test stock price determinations. This is done because the DCF model and other financial models may not directly assess all the factors that go into a stock valuation analysis. These intangibles are, in effect, proxied by applying a below market discount rate.

Q. On page 12, Mr. Murray cites GDP growth forecasts from several government entities. Are these 4.2 percent to 4.7 percent projected growth rates consistent with long-term experience in the U.S. economy?

A. No. The actual GDP growth rates for the U.S. economy are those I presented in my Rebuttal Testimony Schedule SCH-10. From those data, I projected a long-term nominal GDP growth rate of 6.2 percent. My forecast is entirely consistent with the Commission's GDP growth rate finding cited above in Case No. ER-2008-0318. The lower current GDP growth forecasts from the government entities are caused by the low inflation rates contained in those forecasts. While such low inflation rates are consistent with the low actual rates that have occurred in recent years, they are not consistent with tight energy supplies or more robust growth that will inevitably occur, or the long-run historical inflation rates that have actually occurred.

Q. On pages 13 and 14, Mr. Murray discusses the spread between long-term U.S. Treasury bond yields and yields on Treasury Inflation Protected Securities ("TIPS") as a measure of expected long-term inflation. How do you respond to his calculation of a 1 percent to 1.52 percent projected inflation rate?

A. While the expected inflation rate implied recently by the Treasury-TIPS relationship has been low, as I explained previously in my rebuttal of Mr. Gorman, the low implied inflation rate is more likely a reflection of current anomalies in the Treasury bond market than a measure of expected long-term inflation. See Hadaway Rebuttal Testimony at 13, n. 1. "Flight to safety" issues and government monetary policy appear to have affected the nominal Treasury bond and TIPS markets differently and, therefore, have disrupted the implied inflation rate relationship. There is also a high likelihood that the government's current expansionary monetary policies will eventually lead to significantly higher inflation. These factors indicate that Mr. Murray's 1 percent to 1.52 percent projected inflation rates are not reasonable estimates of long-term expectations.

Q. On pages 17 and 18, Mr. Murray notes that in your rate of return testimony when you were a staff witness for the Texas Public Utility Commission ("TPUC"), you did not use a GDP growth rate. How do you respond to his comments?

A. I provided that testimony in the 1980 to 1982 timeframe. The specific case he discusses (TPUC Docket No. 3473) was in 1980. Apparently, Mr. Murray believes that the 15 percent to 16 percent ROEs I recommended in those TPUC cases were low, but several factors support the approach that I used at the time. First, to my knowledge, in 1980 no one had suggested that GDP growth should be used in the DCF model. The growth rate issue, in fact, generally focused on the work of Professor Myron Gordon (who first developed the DCF model for use in utility rate cases). In his original growth rate methodology, he used the "sustainable" growth or "b times r" retention growth estimation method. See Myron J. Gordon, "Dividends, Earnings and Stock Prices,". Review of Economics and Statistics, 1959, pp. 99–105. Data from Value Line and from some individual security analysts were the other growth rate sources that were sometimes used.

As shown in the table in my updated risk premium analysis, in 1980 Moody's Average Utility Bond yield was 13.15 percent and the average allowed ROE was 14.23

percent. <u>See</u> Hadaway Rebuttal Testimony Schedule SCH-13. In this context, my analysis using the growth rates that I used at that time produced a higher, not lower, ROE than the national average. In his criticisms based on my TPUC testimony, Mr. Murray effectively ignores the 25 years of economic history and data that have occurred since 1980-82, including higher growth rates and other factors that I, and others, have used in the DCF analysis and that this and other public utility commissions have accepted. Mr. Murray's criticism of my current recommendation based on my prior testimony is, therefore, without merit.

Q. On page 20, Mr. Murray criticizes the allowed rates of return you use in your risk premium analysis, saying that "…commissions and some ROR witnesses hesitated to recognize the lower costs of common equity that utility companies realized…." How do you respond to this comment?

A. His comment about allowed rates of return is a direct reflection of his personal bias. He criticizes my risk premium analysis by essentially saying that he is right and that other rate of return witness and the public utility commission that accepted their testimony are wrong. He provides no other basis to criticize my use of commission allowed rates of return in my risk premium analysis.

Q. Also on pages 20, Mr. Murray says that your review of the Ibbotson/Morningstar broader market risk premium data "should be dismissed." How do you respond to this comment?

A. First, in my Direct Testimony I offered the following qualification about my review of the Ibbotson data: "Although I do not use the Ibbotson data in my final ROE estimates, I do review the data for their perspective on the overall market cost of equity capital." <u>See</u>

Hadaway Direct Testimony at 35. Therefore, his characterization of my review as my "other risk premium analysis" is incorrect. Second, in my updated Rebuttal Testimony, which supports my current ROE recommendation of 11.55 percent, I did not use the Ibbotson data at all.

Q. On page 21, Mr. Murray also says that your risk premium analysis based on projected bond yields is "inappropriate." How do you respond to this comment?

A. Again, Mr. Murray is mistaken. Many commissions rely on both current and projected interest rates in their ROE deliberations. However, in my Rebuttal Testimony update, I have provided the same risk premium analysis based on both projected and recent actual interest rates. <u>See</u> Hadaway Rebuttal Testimony Schedules SCH-12 and SCH-13. The analysis based on actual interest rates produces a higher estimate of ROE.

III. Response to OPC Witness Michael Gorman

Q. Please summarize your comments on Mr. Gorman's Rebuttal Testimony.

A. Like Mr. Murray, Mr. Gorman continues to recommend a low ROE that does not adequately reflect current market conditions. His criticisms of my ROE recommendation are also similar to Mr. Murray's. While he makes no comment about the analysts' growth rate projections I used in my first version of the constant growth DCF model, he attempts to average down these DCF results (11.2%) by applying various inappropriate "adjustments" to the other portions of my analysis. He also criticizes my forecast of GDP growth and offers a lower GDP growth forecast based on recent extremely low projected inflation rates. Finally, he disagrees with my risk premium analysis and mischaracterizes my review of the broader market Ibbotson/Morningstar data. Since I have already responded in my Rebuttal Testimony to most of our differences of opinion on these issues, I will respond briefly to his criticism with references to my Rebuttal Testimony.

Q. On pages 4 and 5, Mr. Gorman criticizes your GDP growth rate forecast and recommends using the five to ten year forecasts published previously in Blue Chip Economic Indicators (October 10, 2008). Is this a better growth rate source for the long-term expected growth rate in the DCF model?

A. No. Similar to the government forecasts offered by Mr. Murray, the Blue Chip forecasts cited by Mr. Gorman are based on an extremely low inflation rate (2.1%) and a currently depressed forecast for real economic growth (2.2%). In his own later discussion of the Morningstar GDP growth rate forecast, he cites the historical actual growth rate in real GDP at 3.4 percent. See Gorman Rebuttal Testimony at 5. He also acknowledges that the actual long-term inflation rate shown in my GDP growth forecast is over 3 percent. These factors demonstrate why his Blue Chip forecast is not consistent with the long-run actual results for the U.S. Economy and why such data understate the long-term expected growth rate required for the DCF model.

Q. At page 6, Mr. Gorman compares your GDP growth forecast to his recalculation of the Morningstar forecast with the inflation rate (1.10%) based on the recent Treasury bond-TIPS relationship. What is your response to this calculation?

A. As discussed above in my response to Mr. Murray and in my Rebuttal Testimony in response to this same calculation by Mr. Gorman, because of current market anomalies, the current Treasury-TIPS relation does not provide a reasonable estimate of long-term inflation. See Hadaway Direct Testimony at 13, n. 1. Therefore, Mr. Gorman's recalculation of the Morningstar GDP growth forecast produces an unreasonably low result.

Q. At page 7, Mr. Gorman again explains that he does not believe that a quarterly compounding adjustment in the DCF model should be used. Did you apply a quarterly compounding adjustment anywhere in your ROE analysis or testimony?

A. No. I did not apply any such adjustment in my analysis or mention such adjustment in my testimony. However, it is worth noting that in making this comment, Mr. Gorman appears to fail to recognize that companies do, in fact, pay dividends quarterly and investors do set stock prices slightly higher because of this feature, thus producing a slightly understated dividend yield in the unadjusted DCF model.

Q. On pages 8 through 10, Mr. Gorman criticizes your risk premium analysis and offers a discussion of academic articles that he says support his position. How do you respond to his discussion?

A. It is difficult to understand why Mr. Gorman would say that the Harris & Marston and the Brigham, Shome, and Vinson articles cited in his Rebuttal Testimony at n. 3 would not support the inverse relation between interest rates and risk premiums that I used in my risk premium analysis. While it is true that there have been many explanations of factors that affect risk premiums, the basic inverse relationship that I used in my analysis is the same one that Harris & Marston originally proposed. See Robert S. Harris and Felicia C. Marston, "Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts," Financial Management, Summer 1992. As I demonstrated in my Rebuttal Testimony, Mr. Gorman's approach and his "adjustments" to my risk premium analysis are incorrect. See Hadaway Rebuttal Testimony at 18 and 19. In fact, Mr. Gorman's own unadjusted corporate bond yield plus risk premium analysis supported an ROE of 11.47 percent. See Gorman Direct Testimony Schedule MPG-17.

Q. At page 11, Mr. Gorman says that the Ibbotson data do not support "a return on common equity for KCPL of 11.49% as estimated by Dr. Hadaway" (emphasis added). Did you claim that the Ibbotson data supported any ROE for GMO?

A. No. As I discussed in my response to Mr. Murray, I reviewed the Morningstar/Ibbotson data to provide perspective for the overall market cost of equity. See Hadaway Direct Testimony at 35.

Q. Does that conclude your testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of KCP&L Greater Missouri Operations Company to Modify Its Electric Tariffs to Effectuate a Rate Increase	)))	Case No. ER-2009-0090

AFFIDAVIT OF SAMUEL C. HADAWAY

STATE OF TEXAS)
) **ss**
COUNTY OF TRAVIS)

Samuel C. Hadaway, being first duly sworn on his oath, states:

1. My name is Samuel C. Hadaway. I employed by FINANCO, Inc. in Austin, Texas. I have been retained by Great Plains Energy, Inc., the parent company of Kansas City Power & Light Company, to serve as an expert witness to provide cost of capital testimony on behalf of Kansas City Power & Light Company.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of KCP&L Greater Missouri Operations Company consisting of nine (9) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Samuel C. Hadaway
Samuel C. Hadaway

Subscribed and sworn before me this 2 day of April 2009.

Notary Public

My Commission expires: 10/01/11

EDWIGE J. PAYLIM
Notary Public
STATE OF TEXAS
My Comm. Exp. 10-01-2011