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Witness:	Samuel C. Hadaway
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Case No.:	ER-2006-0314
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MISSOURI PUBLIC SERVICE COMMISSION
CASE NO.: ER-2006-0314

SURREBUTTAL TESTIMONY

OF

SAMUEL C. HADAWAY

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
October 2006

SURREBUTTAL TESTIMONY

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Case No. ER-2006-0314

I. Introduction

Q. Please state your name and affiliation.

A. My name is Samuel C. Hadaway. I previously filed Direct and Rebuttal Testimony on behalf of Kansas City Power & Light Company ("KCPL" or the "Company") in this proceeding.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony filed on September 8, 2006 by Missouri Public Service Commission Staff ("Staff") witness Matthew J. Barnes and the Office of the Public Utility Counsel ("OPC") witness Richard A. Baudino.

II. Staff Witness Matthew J. Barnes

Q. Please summarize your comments on Mr. Barnes' rebuttal testimony.

A. With the updated capital structure data that Mr. Barnes provided in his rebuttal testimony, our principal differences are narrowed to the return on equity.

Mr. Barnes' updated capital structure is based on the same June 30, 2006 data I discussed in my Rebuttal Testimony. He now recommends 53.24 percent equity, 45.22 percent long-term debt, and 1.54 percent preferred stock. These capital structure ratios and the associated cost rates for debt and preferred stock are similar to those requested by the Company.

I continue to disagree strongly with Mr. Barnes' ROE recommendation. In his rebuttal testimony, his proposed ROE is unchanged at 9.37 percent. He continues to rely solely on only one version of the DCF model while ignoring other valid approaches that provide valuable perspective to the ROE estimation process. He refuses to acknowledge the role of long-term economic growth and the trend toward higher interest rates and, as a result, his recommendation remains far too low. In the remainder of this surrebuttal testimony, I will discuss these issues in more detail and briefly respond to Mr. Barnes' criticism of my recommendations.

Q. What were the particular issues that Mr. Barnes had with your ROE analysis?

A. Mr. Barnes criticizes my GDP growth rate calculation and my 50 basis point ROE risk adjustment. He disagrees with my use of a multi-stage DCF model and ultimately concludes that the "single stage constant growth DCF model is the appropriate model to use for a mature utility company when determining a reasonable return on equity" (Barnes rebuttal, page 10, lines 2-3).

Q. How do you respond to Mr. Barnes' criticism of your GDP growth rate calculation?

A. In my Direct Testimony, I estimated the long-term DCF growth rate as a weighted average of nominal GDP growth for overlapping periods between 1947 and 2004. I gave significantly greater weight to the more recent, lower growth periods. On page 5 at line 13, Mr. Barnes claims that my GDP growth rate is "skewed upward" because it includes periods that were "anomalous or unusually high." He cites the late 1970s to mid 1980s as examples of such periods. Mr. Barnes' criticisms are accounted for in the weights I apply to the various sub-periods. In my approach, I give greater weight to more recent years and less weight to the earlier periods. In fact, the period that Mr. Barnes mentions (late 1970s to mid 1980s) receives only 16 percent weighting in the final average as shown in the following table.

GDP Growth Weights by Decade

Decade	Weight
1995-2004	41.0%
1985-1995	24.3%
1975-1984	**16.0%**
1965-1974	10.4%
1955-1964	6.3%
1947-1954	2.0%
Total	100.0%

Mr. Barnes also says that I should have used the "median" of the GDP growth rate data rather than the "mean" because this "would have minimized the anomalous years that are included in his mean" (Barnes rebuttal, page 5, lines 18-19). As I discussed above, I did minimize the so-called "anomalous years" through the use of my weighting scheme. Furthermore, as Mr. Barnes shows, the GDP growth rate using the median is 6.3 percent, as compared to 6.6 percent using the mean. This is a difference of only 30 basis points. The real point is that some measure of long-term growth should be represented in the DCF model. Whether that measure is the mean or the median growth rate is not the key issue.

Q. Please respond to Mr. Barnes' rejection of your 50 basis point risk adjustment.

A. Mr. Barnes implies that by virtue of the Regulatory Plan Stipulation and Agreement signed by KCPL and approved by the Commission in Case No. EO-2005-0329, the Company's construction risk is reduced and no risk adder is necessary. I disagree with this viewpoint. As I stated in my Rebuttal Testimony of Mr. Woolridge:

> While the Company and many of the other parties were indeed signatories to the Stipulation, it did not limit any party's ability in this case or any future rate case to challenge the prudence of KCPL's expenditures or to disagree with KCPL's assessment of its rate base or cost of service. I understand that nothing in the Stipulation limits the rights of a non-signatory party to take any position on an issue. Similarly, I understand that nothing in the Stipulation restricts the ability of the Commission to make a finding of fact or conclusion of law on any issue. <u>Therefore, neither the Stipulation nor the process that led to its negotiation and approval has eliminated the financing, construction, and ultimate regulatory risks that the Company faces.</u> Capital market participants recognize these ongoing risks and require adequate compensation for these risks. For Professor Woolridge at page 52, lines 1-9 to use the Stipulation and the process that preceded it as justification for rejecting the Company's requested risk adjustment is inappropriate. (emphasis added)

These same comments apply to Mr. Barnes. In summary, the Stipulation, in and of itself, has not eliminated the construction risks facing the Company and these risks increase the Company's required rate of return.

Q. At page 8, lines 26-27, Mr. Barnes says that "nowhere does Dr. Hadaway explain the rationale for this upward adjustment" (referring to the 50 basis point adder). Is this correct?

A. No. Beginning at page 4 of my Direct Testimony, I explain in detail the need for the 50 basis point risk adjustment. In particular, I refer to my Schedule SCH-1, page 1, which shows that KCPL's construction program is almost double that of the companies in my comparable group. KCPL's larger construction program increases its financing and regulatory risks and, therefore, should be reflected in a higher allowed rate of return.

Q. Please comment on Mr. Barnes' assertion that the single-stage constant growth DCF model is the best and only method for fairly evaluating the Company's required return on equity.

A. This position is too narrow and biased towards low ROEs. This is especially true since Mr. Barnes only considers short-term analysts' growth rate forecasts and ignores long-term growth trends. Mr. Barnes should have reviewed multi-stage growth versions of the model or alternative estimates of the model's required growth rate. In addition, he should not have rejected his own capital asset pricing model ("CAPM") or other risk premium approaches. All of these alternative techniques serve as useful checks of reasonableness on the constant growth DCF results. As I demonstrated in my rebuttal testimony, had Mr. Barnes more reasonably considered alternative approaches and alternative growth rates, his DCF estimates would have been considerably higher. As I also showed, had Mr. Barnes not rejected his CAPM and included higher projected interest rates in his analysis, those results would have been even higher, further showing that his DCF-based ROE recommendation is too low.

III. <u>OPC Witness Richard A. Baudino</u>

Q. On page 2 at line 10, Mr. Baudino recommends that your "unsubstantiated assertion on pages 5 and 6 be rejected." What is the basis for his criticism and is it appropriate?

A. Mr. Baudino's criticism is inappropriate because he misstates my Direct Testimony. His claim that I found analysts' growth rate forecasts to be too low "because of missing information on interest rate forecasts" (at 2, line 9) is incorrect and his claim that I based my concerns about using analysts' forecast in the DCF model on this thesis is simply wrong. In my Direct Testimony at page 31 and in Schedule SCH-5, I explained and demonstrated that analysts' utility growth rate forecasts five years ago, in 2001, were 6.8 percent and that recently such forecasts were only 4.3 percent. On its face, there is nothing "unsubstantiated" about this fact, and I did not testify that the drop in earnings growth projections was due to analysts' missing any other information.

The traditional constant growth DCF model, upon which Mr. Baudino and other parties solely rely, requires an estimate of investors' very long-run growth rate expectations. As I demonstrated in my Direct Testimony, analysts' current 3-to-5 year forecasts are not consistent with long-term economic growth as measured by nominal GDP. Five years ago, analysts' forecasts for utilities were entirely consistent with long-term economic growth and, as such, were appropriate as proxies for long-term investor expectations. Such growth rates today are not consistent with long-term economic growth and, therefore, are not appropriate as the sole basis for estimating long-term expectations as required in the traditional DCF model.

Q. **On page 3 at line 9, Mr. Baudino suggests that the GDP growth rate is an "outlier" relative to current utility dividend and earnings growth projections and, therefore, the GDP growth rate should be rejected. Is the GDP growth rate an outlier?**

A. No. The anomalous result is Mr. Baudino's and the other parties' low ROE estimates from their incorrect applications of the traditional DCF model. Although convenient for producing low ROEs, it is simply incorrect to rely solely on currently low, near-term analysts' growth estimates as if they were for the very long-term. I demonstrated in my Direct Testimony that analysts' growth projections fluctuate significantly from period to period. As such, they are not historically reliable estimates of the very long-term growth rate expectations required in the DCF model.

Q. **On page 5, Mr. Baudino notes that the studies you cited in your Direct Testimony, which link long-term growth expectations to long-term growth in GDP, are not specific to electric utilities. Does this mean that their findings do not apply to electric utilities?**

A. No. The cited materials explain and demonstrate that long-term earnings and dividend growth are logically and statistically tied to long-term economic growth. The Brigham, Gapenski, and Ehrhardt discussion indicates that an overall growth rate of 6 percent to 8 percent, as measured by nominal GDP, is the likely average for investors' expectations. In the analysis shown in my Schedule SCH-6, I gave greater weight to more recent, lower nominal economic growth and estimated the long-term utility growth rate at 6.6 percent. In addition to being consistent with prior analysts' growth rates, my estimate is below the middle of the range estimated by Brigham et al. While it is certainly true that utilities are not viewed as supernormal growth companies, they are a fundamental part of the overall economic infrastructure and, therefore, are expected to grow like the overall economy in the long run.

Q. On pages 8 and 9, Mr. Baudino criticizes your risk premium study and says that your approach "implies that the Commission should rely on decisions in other jurisdictions rather than the specific evidence on return on equity in this proceeding." Are you making such a recommendation?

A. No. The purpose of a reasonableness check is to see whether a given recommendation is "in the ballpark." My risk premium study shows that under present market conditions a base ROE of 10.94 percent would be consistent with other regulators' decisions. This result is not intended to replace my primary DCF analysis, which supports a base ROE of 11.0 percent. The risk premium result provides a comfort level that my DCF estimate is reasonable, and that the other parties' ROE recommendations are too low.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City) Power & Light Company to Modify Its Tariff to) Begin the Implementation of Its Regulatory Plan)	Case No. ER-2006-0314

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 am 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, 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 Kansas City Power & Light Company consisting of 8 ~~(XX)~~ pages, all of which 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 2nd day of October 2006.

Notary Public

My commission expires: 3/3/08

SHIRLEY FRASHER
My Commission Expires
March 3, 2008