STATE OF MISSOURI

BEFORE THE

MISSOURI PUBLIC SERVICE COMMISSION

IN THE MATTER OF KANSAS CITY	)	
POWER & LIGHT COMPANY'S	)	
REQUEST FOR AUTHORITY TO	)	**CASE NO. ER-2012-0174**
IMPLEMENT A GENERAL RATE	)	
INCREASE FOR ELECTRIC SERVICE	)	

SURREBUTTAL TESTIMONY OF

MATTHEW I. KAHAL

ON BEHALF OF THE

UNITED STATES DEPARTMENT OF ENERGY

OCTOBER 8, 2012

EXETER

ASSOCIATES, INC.
10480 Little Patuxent Parkway
Suite 300
Columbia, Maryland 21044

STATE OF MISSOURI

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MISSOURI PUBLIC SERVICE COMMISSION

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-2012-0174

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MATTHEW I. KAHAL

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is Matthew I. Kahal. I am employed as an independent consultant retained
3 in this matter by the firm of Exeter Associates, Inc. My business address is 10480
4 Little Patuxent Parkway, Suite 300, Columbia, Maryland 21044.

5 Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS
6 PROCEEDING?

7 A. Yes. On August 2, 2012, I submitted Direct Testimony on fair rate of return for
8 Kansas City Power & Light Company ("KCP&L" or "the Company"). I submitted
9 that testimony on behalf of the U.S. Department of Energy ("DOE"), which is a major
10 customer of KCP&L. In that testimony, I recommended a return on equity of 9.5
11 percent.

12 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

13 A. The principal purpose of my surrebuttal testimony is to respond to the Rebuttal
14 Testimony of Company witness Dr. Samuel Hadaway. I also briefly respond to

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10 customer of KCP&L. In that testimony, I recommended a return on equity of 9.5
11 percent.

12 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

13 A. The principal purpose of my surrebuttal testimony is to respond to the Rebuttal
14 Testimony of Company witness Dr. Samuel Hadaway. I also briefly respond to

certain points raised in Staff witness Murray's Rebuttal Testimony and the Rebuttal Testimony of Company witness Kevin Bryant concerning capital structure.

Q. BASED ON YOUR REVIEW OF THE REBUTTAL TESTIMONY, ARE YOU REVISING IN ANY WAY YOUR RECOMMENDED 9.5 PERCENT RETURN ON EQUITY?

A. No, I am not. Dr. Hadaway's rebuttal testimony criticisms of my analysis and recommendations are without merit, and I continue to believe that my 9.5 percent return on equity ("ROE") recommendation is both reasonable and supported by the evidence. In addition, Dr. Hadaway has submitted what he refers to as an "updated" set of cost of equity calculations, reducing his ROE recommendation slightly from 10.4 percent to 10.3 percent. I find his revised analysis (which is not a true update) to be unpersuasive and overstated.

<u>Reply to Company witness Bryant on Capital Structure</u>

Q. WHAT POSITION DOES MR. BRYANT TAKE ON CAPITAL STRUCTURE IN HIS REBUTTAL TESTIMONY?

A. At page 5, he cites to Staff's recommendation to use the actual Great Plains Energy ("GPE") consolidated capital structure, which appears to be slightly different than the Company's originally-filed capital structure estimates. In concurring with Staff he states:

> The Staff recommendation appears consistent with the Company's proposal to use the actual GPE consolidated capital structure trued-up through August 2012 for KCP&L ratemaking purposes . (Rebuttal, page 5)

In responding to my testimony on capital structure, Mr. Bryant explains why the Company proposes to remove Other Comprehensive Income ("OCI"), which is a

negative balance, from the GPE actual equity balance. (Rebuttal, pages 13-14) He states that GPE's OCI balance is primarily attributable to losses on interest rate derivatives. He further states that the use of such derivatives has been approved by the Commission, and the Company normally recovers those costs as part of the cost of debt used for ratemaking. He implies that the OCI adjustment is needed because no regulatory asset for the derivative losses has been authorized and recorded. Finally, he states that the OCI removal was approved in the Company's last case.

Q. WHAT IS YOUR RESPONSE TO MR. BRYANT?

A. I note that there is a contradiction in his testimony in that he claims to support the use of the GPE "actual" capital structure when in fact he argues for an adjustment to the actual that increases the equity balance and therefore the equity ratio. This adjustment is contrary to GAAP accounting (as Mr. Bryant acknowledges) and to my knowledge is also contrary to practices of credit rating agencies and the FERC Uniform System of Accounts. Thus, as a general matter, I do not support this adjustment and believe it is more appropriate to use the actual equity balance.

Response to Staff Witness Murray on Cost of Equity

Q. WHAT ASPECT OF WITNESS MURRAY'S REBUTTAL TESTIMONY ARE YOU ADDRESSING?

A. I agree with many aspects of Mr. Murray's rebuttal testimony, but I do need to provide one clarification. At page 22, Mr. Murray incorrectly states that I have relied "exclusively" on published analyst earnings projections to develop my Discounted Cash Flow ("DCF") growth rate range. Mr. Murray is concerned that analyst earnings growth rates are not necessarily reliable as indicating long-run investor expectations and may be overstated.

1 As a general matter, I share Mr. Murray's concern and for that reason I do **not**
2 rely on analyst earnings projections alone or "exclusively." My testimony clearly
3 states that I rely both on calculations of the "sustainable" or earnings retention growth
4 rates as well as on published analyst growth rates. For my electric utility proxy
5 group, I show the calculation of the sustainable growth rates on page 5 of Schedule
6 MIK-4. For this group, the sustainable growth rate measure averages 4.6 percent,
7 which is close to but slightly lower than my analyst earnings projections.

8 Q. DOES MR. MURRAY RAISE ANY OTHER QUESTIONS CONCERNING
9 YOUR TESTIMONY?

10 A. Mr. Murray correctly notes that my ROE recommendation is 9.5 percent even though
11 my DCF midpoint is slightly lower, i.e., 9.3 percent. The Commission may wish to
12 consider an ROE award for the Company of 9.3 percent since that figure is clearly
13 supported by the DCF evidence. The central point is that my testimony demonstrates
14 that the utility cost of capital has declined materially since the Company's last rate
15 case decided in 2011. Consequently, a significant reduction from the 10.0 percent
16 ROE awarded in that case clearly is appropriate and supported by the market
17 evidence. I consider my recommended 9.5 percent ROE to reflect a reasonable
18 reduction (i.e., a conservative 0.5 percent reduction) from the return granted by the
19 Commission in 2011 that fairly balances the interests of the Company and customers.
20

1 **Reply to Dr. Hadaway on ROE**

2 Q. WHAT ARE YOUR MAIN DISAGREEMENTS OR CONCERNS WITH
3 DR. HADAWAY'S REBUTTAL TESTIMONY?

4 A. My surrebuttal testimony discusses the following issues associated with Dr.
5 Hadaway's Rebuttal Testimony.

6 - Dr. Hadaway's Rebuttal Testimony presents what purports to be an update
7 to his original cost of equity studies, but he makes some major changes
8 that have the effect of increasing his cost of equity results compared to the
9 results he would have obtained had he done a pure update.

10 - Dr. Hadaway restates my DCF study obtaining a higher result. However,
11 he does this by selectively eliminating low growth rate and ROE figures
12 from my data set.

13 - The two-stage DCF study employed by Dr. Hadaway continues to employ
14 an overstated 5.7 percent long-term GDP growth rate which is not
15 supported by available evidence.

16 - In formulating his ROE recommendation, Dr. Hadaway argues for using
17 the high end of the range of evidence due to alleged "market volatility"
18 and the current Federal Reserve ("Fed") policy of "artificially" lowering
19 long-term interests rates.

20 - Dr. Hadaway argues that my ROE recommendation is inconsistent with
21 ROE's granted recently by other state commissions for vertically-
22 integrated electric utilities.

1 Q. WHAT IS YOUR OBJECTION TO DR. HADAWAY'S UPDATE?

2 A. As summarized on Schedule SCH-12, page 1 of 6, Dr. Hadaway presents four
3 different DCF studies. These produce cost of equity estimates ranging from 9.8 to
4 10.3 percent using the group mean and 9.8 to 10.0 percent using the group median.
5 The standard constant growth DCF study produces 9.8 percent using both measures.

6 Normally, an update presented in rebuttal testimony merely involves taking
7 the original study and plugging in more recent data. This allows a direct comparison
8 of how cost of equity conditions have changed over time, without changes in methods
9 or practice obscuring or confusing the update. However, this is not what Dr.
10 Hadaway has done. First, he substantially changed his proxy group, removing four
11 companies from his original group and adding three new companies – a total change
12 of seven companies, or one-third of his 21 company group. Second, for reasons that
13 are not clear, he introduces an entirely new DCF method, which is based on a
14 truncated four-year investor time horizon. This is an entirely new study, not an
15 update.

16 Q. WHAT IS THE EFFECT OF THE SEVEN COMPANY PROXY GROUP
17 CHANGES?

18 A. At least in the case of the constant growth study, the seven changes to the proxy
19 group significantly inflate the proxy group average ROE. It appears that most or all
20 four of the eliminated companies have below average ROE estimates, and all three of
21 the added companies have above average ROE estimates. A pure update (no change
22 to proxy group) undoubtedly would produce a return on equity much lower than his
23 reported 9.8 percent.

1 Q. IS THE NEW DCF METHODOLOGY INTRODUCED BY DR.
2 HADAWAY USEFUL?
3 A. No, it is problematic. This new model requires a rather speculative projection of the
4 2016 stock price for each proxy company, and the calculated ROE is very sensitive to
5 these price projections. Please note that this new study produces a median ROE for
6 the group of 9.8 percent.
7 Q. DO YOU HAVE ANY COMMENT ON DR. HADAWAY'S OTHER TWO
8 STUDIES?
9 A. Dr. Hadaway's long-term and two-stage DCF studies continue to rely on the
10 discredited assumption that investors expect long-term growth for the U.S. economy
11 (nominal GDP) of 5.7 percent per year. I have not been able to find any credible
12 support for that assumption from major forecast organizations. As I demonstrated in
13 my Direct Testimony, the *Blue Chip Economic Indicators* (March 2012) publishes a
14 consensus nominal GDP growth rate after 2018 of 4.7 percent, a full percentage point
15 lower. In mid September 2012, the Fed issued its new long-term growth rate forecast
16 for the U.S. economy (i.e., post 2015) which on a nominal basis is about 4.5 to 4.7
17 percent (September 13, 2013), a range slightly lower than the Blue Chip consensus.
18 If Dr. Hadaway's update had used a more realistic U.S. GDP long-term forecast, his
19 two DCF studies that use projected GDP growth as data inputs would produce ROE
20 estimates of well below 9.5 percent.
21 Q. DR. HADAWAY PRODUCED A RESTATEMENT OF YOUR DCF
22 STUDY. DO YOU AGREE WITH HIS SUGGESTED CHANGES?
23 A. No. Dr. Hadaway modified my DCF study by removing three companies – Cleco
24 Corp., Ameren and Edison International. These are the three companies in the 22
25 company proxy group that produced the lowest DCF ROEs, and with these three

1 removals, the group average cost of equity becomes 9.75 percent. Dr. Hadaway
2 removed these three companies from my study despite the fact that he selected all
3 three for his original DCF study proxy group in his Direct Testimony.
4 While I have no strong objection to the removal of observations that are
5 highly abnormal or clear aberrations, it is biased and improper to revise the study by
6 removing only the unusually low observations. A more balanced approach would
7 involve the elimination of **both** unusually low observations and the highest
8 observations, for example, removing the three highest as well as the three lowest. As
9 shown on Dr. Hadaway's Schedule SCH-10, page 1, the three highest DCF ROEs are
10 Alliant (10.4%), Great Plains (11.6%) and Hawaiian Industries (13.0%). Removing
11 these three companies, along with Dr. Hadaway's three exclusions, would produce a
12 group average DCF estimate of 9.4 percent – slightly below my ROE
13 recommendation.
14 Q. OTHER THAN DR. HADAWAY'S REMOVAL OF THREE COMPANIES
15 WITH LOW GROWTH RATES, DOES HE SET FORTH ANY OTHER
16 TECHNICAL CRITICISMS OF YOUR DCF STUDIES?
17 A. As far as I can determine, his asserted need to selectively remove the low growth rate
18 companies is his only technical criticism. For example, he does not contest either my
19 model, any data sources I used or procedures. Moreover, the three companies he
20 insists I should remove were originally selected by himself, not me.
21 Dr. Hadaway also seems concerned that I am basing my recommendation only
22 on the constant growth DCF, whereas he also employed a two-stage model. The two-
23 stage model, however, will produce a result different from the constant growth model
24 only if the long-run growth rate is different than that used in the constant growth
25 model. I have demonstrated that an appropriate long-run growth rate would be no

1 higher (and possibly lower) than 4.7 percent. Since my constant growth DCF study
2 used a 4.5 to 5.5 percent growth range, it follows that the two-stage model must
3 produce a cost of equity estimate similar to or lower than my constant growth DCF
4 midpoint.

5 Q. DR. HADAWAY ARGUES FOR AN ROE AWARD AT THE TOP END OF
6 THE RANGE IN PART DUE TO HIS BELIEF THAT TODAY'S LOW
7 INTEREST RATES AND CAPITAL COSTS ARE "ARTIFICIAL." IS THIS
8 A PERSUASIVE ARGUMENT?

9 A. No. Dr. Hadaway's point is that the Fed has been taking measures to lower interest
10 rates (both short- and long-term), and these accommodative actions have helped to
11 support share prices of utility companies. While the Fed's influence on the cost of
12 capital is a matter of some dispute, it is probably correct to argue that the Fed has
13 succeeded to some degree in lowering the utility cost of capital. Moreover, this effect
14 certainly is **not** short lived, as evidenced by the Fed's very strong policy statement of
15 September 13, 2012 that it intends to continue its low interest rate policy for the
16 forseeable future.

17 It is important to understand that the Fed's policy actions are only a part of the
18 set of forces that today has provided this sustained environment of abundant and
19 inexpensive capital. The cost of capital is very low due to very subdued inflation
20 (and inflation outlook), a relatively weak economy and the fact that U.S. financial
21 markets (including utility stocks) are viewed as a safe haven. This is not "artificial,"
22 nor is it likely to be short lived.

23 Dr. Hadaway might have a valid point if he could point to persuasive evidence
24 indicating that today's very low capital cost environment is temporary and will soon
25 disappear. He presents no such evidence. In fact, based on market behavior, there is

1 every reason to believe that low capital costs for utilities will persist for an extended
2 period. In particular, investors would not bid up prices for utility stocks and bonds as
3 they have (as Dr. Hadaway notes) if they believe the current low capital cost
4 environment will soon disappear. In setting the Company's ROE in this case, there is
5 no reason to pretend that the prevailing low cost of capital, which benefits utilities, is
6 "artificial" and is not real. It is real and should be recognized by regulators in
7 establishing ROE awards.
8 Q. DR. HADAWAY ALSO ARGUES THAT MARKET VOLATILITY
9 JUSTIFIES A HIGHER ROE. ARE FINANCIAL MARKETS
10 UNUSUALLY VOLATILE?
11 A. While financial markets do move and experience some volatility, Dr. Hadaway has
12 presented no evidence that markets in 2012 are unusually or extraordinarily volatile
13 as compared with past years. On my Schedule MIK-4, page 2, I show that electric
14 utility dividend yields so far this year have been relatively stable.
15 Dr. Hadaway's "volatility" comments also overlook an important point. The
16 accepted DCF model automatically accounts for and captures the effects of all market
17 volatility – both current and expected – as perceived by investors. For that reason,
18 market volatility need not be considered separately from the DCF model results
19 themselves. The DCF cost of equity estimates automatically embody market
20 volatility.
21 Q. DR. HADAWAY ARGUES THAT YOUR 9.5 PERCENT
22 RECOMMENDATION EXCEEDS RECENT ROE AWARDS FROM
23 OTHER STATE COMMISSIONS FOR VERTICALLY-INTEGRATED
24 ELECTRICS. WHAT IS YOUR RESPONSE?

1 A. Dr. Hadaway cites to rate case survey information on ROE awards for vertically-
2 integrated electric utilities extending through the second quarter 2012. Reasonable
3 analysts can disagree on the proper use of this information in this rate case. Neither
4 Dr. Hadaway nor any witness is arguing that ROE award survey averages from other
5 jurisdictions should be used to set the Company's ROE or should displace reliance on
6 cost of capital studies.

7 While Dr. Hadaway is correct that my 9.5 percent recommendation is below
8 the survey average ROE award, his 10.3 percent updated ROE recommendation is
9 above that average. An important insight gained from this survey information is the
10 recent trend. For example, on page 4 of Schedule SCH-7, he cites to an average ROE
11 award for 2nd Quarter 2011 of 10.26 percent for vertically-integrated electrics. As of
12 a year later (2nd Quarter 2012), this average had declined to 9.95 percent (page 5 of
13 Schedule SCH-7), a reduction of 31 basis points over one year. Similarly, my 9.5
14 percent is 50 basis points lower than the 10.0 percent ROE awarded to the Company
15 in May 2011.

16 The most reasonable conclusion is that reliance on the survey data would
17 support a material reduction to the 10.0 percent awarded in the Company's 2011 rate
18 case.

19 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

20 A. Yes, it does.

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AFFIDAVIT OF MATTHEW I. KAHAL

STATE OF MARYLAND)
) SS
COUNTY OF HOWARD)

Matthew I. Kahal, being first duly sworn, on his oath states:

1. My name is Matthew I. Kahal. I am an independent consultant having a place of business at 10480 Little Patuxent Parkway, Suite 300, Columbia, Maryland 21044.

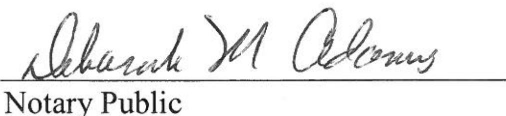
2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of the United States Department of Energy which was prepared in written form for introduction into evidence in the above-captioned docket.

3. 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.

Matthew I. Kahal

Subscribed and sworn before me this 3 day of October, 2012.

DEBORAH M ADAMS
Notary Public-Maryland
Prince George's County
My Commission Expires
2/2015



Notary Public

My commission expires: ____________________