Exhibit No.:
Witness: Michael Gorman
Type of Exhibit: Surrebuttal Testimony
Issue: Revenue Requirement
Sponsoring Party: The Office of Public Counsel
Case No.: ER-2009-0089

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power and Light Company for Approval to Make Certain Changes in its Charges for Electric Service To Continue the Implementation of Its Regulatory Plan.	)	**Case No. ER-2009-0089**

Surrebuttal Testimony and Schedule of

Michael Gorman

On behalf of

The Office of Public Counsel

Project 9073
April 7, 2009

BRUBAKER & ASSOCIATES, INC.
CHESTERFIELD, MO 63017

BEFORE THE PUBLIC SERVICE
COMMISSION OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power and Light Company for Approval to Make Certain Changes in its Charges for Electric Service To Continue the Implementation of Its Regulatory Plan.	)	Case No. ER-2009-0089

STATE OF MISSOURI)
) SS
COUNTY OF ST. LOUIS)

Affidavit of Michael Gorman

Michael Gorman, of lawful age and being first duly sworn, deposes and states:

1. My name is Michael 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 Office of Public Counsel in this proceeding on its behalf.

2. Attached hereto and made a part hereof for all purposes are my surrebuttal testimony and schedule.

3. I hereby swear and affirm that my statements contained in the attached testimony and schedule are true and correct to the best of my knowledge and belief.

Michael Gorman
Consultant

Subscribed and sworn to before me this 6th day of April, 2009.

MARIA E. DECKER
Notary Public, State of Missouri
St. Louis City
Commission # 05706793
My Commission Expires May 05, 2009

Maria E. Decker
Notary Public

My commission expires May 5, 2009.

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

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Surrebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael Gorman and my business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017.

Q ARE YOU THE SAME MICHAEL GORMAN WHO FILED TESTIMONY PREVIOUSLY IN THIS PROCEEDING?

A Yes, I am.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?

A I will respond to Kansas City Power & Light Company's ("KCPL" or "Company") cost of capital witness Dr. Samuel Hadaway and his revised return on equity recommendation of 11.55%.

Response to Dr. Samuel C. Hadaway

Q IS DR. HADAWAY RECOMMENDING THAT HIS REVISED RETURN ON EQUITY OF 11.55% BE ADOPTED IN LIEU OF HIS ORIGINAL RECOMMENDED RETURN ON EQUITY OF 10.75%?

A It is not entirely clear from his rebuttal testimony. At page 2 of his rebuttal testimony, Dr. Hadaway states that 11.55% is his revised return on equity recommendation. However, at page 21, he states that his updated analysis confirms his original recommendation of 10.75% to be extremely conservative. Again, at page 22, he summarizes what appears to be the Company's revised capital structure and overall rate of return. It appears that KCPL is now requesting a return on equity of 11.55%.

Q HAVE UTILITIES IN GENERAL ATTEMPTED TO INCREASE THEIR AUTHORIZED RETURN ON EQUITY TO REFLECT THE ABNORMAL MARKET CONDITIONS AND TEMPORARILY INFLATED CAPITAL MARKET COSTS?

A No. As an example, in AmerenUE's last rate case, its witness estimated that cost of capital had increased by at least 25 basis points.[1] However, AmerenUE in that case, in an effort to mitigate the rate impact on its customers, chose to honor its original estimated return on equity.

KCPL's proposal to set rates based on abnormal market conditions and cost will unreasonably inflate utility profits, and rates. This is clearly evident from the fact that current authorized returns on equity still indicate that authorized returns on equity are around 10.5%. Dr. Hadaway's recommendation, and KCPL's apparent proposal for a significant increase in its authorized return on equity, are out of line with industry

[1] Case No. ER-2008-0318, Surrebuttal Testimony of Roger A. Morin, at 3.

practice, and inconsistent with Dr. Hadaway's own evidence that market costs are being driven by anomalous market conditions. Therefore, adopting a return on equity as high as 11.55% is egregious, and indeed, Dr. Hadaway's estimated return on equity of 10.75% is still inflated for the reasons set forth below.

Q WHY DOES DR. HADAWAY BELIEVE THAT CORPORATE CAPITAL COSTS HAVE INCREASED?

A Dr. Hadaway believes that the current Treasury and utility yields are moving in opposite directions. The Treasury yields are artificially low and the utility yields have increased significantly, which has resulted in widened utility-Treasury spreads over the last three months, as shown in Table 1 of Dr. Hadaway's rebuttal testimony. Further, he argues that the volatile stock market, which has declined approximately 50% since November 2007,[2] has also contributed to the increased borrowing costs.

Q DO YOU AGREE WITH DR. HADAWAY THAT CORPORATE CAPITAL COSTS HAVE INCREASED?

A Yes. While Dr. Hadaway correctly observes that the spreads between utility and government bond yields have increased, he fails to consider the bigger picture and long-term implications. These widened spreads are not going to continue indefinitely. The U.S. economy is currently in a recessionary stage, which directly or indirectly affects almost all industry sectors. However, when the economy stops contracting and recovers from the effects of the current market turmoil, the abnormal market conditions will disappear and the utility costs will converge to the normalized level we

[2] Hadaway Rebuttal at 4-6.

have experienced in the past. Therefore, when setting utility rates, as I mentioned in my direct testimony, we need to reflect capital costs on a normalized basis.

Q DO YOU BELIEVE THAT THE CURRENT MARKET CONDITIONS REPRESENT A MARKET ANOMALY?

A Yes. The lower Treasury yields and the increased utility yields, which lead to abnormally wide spreads, clearly represent a market anomaly that will be corrected as the economy starts improving. This could be seen in the table below.

TABLE 1

Utility Bond Yields

Line	Year	"A" Yield (1)	"Baa" Yield (2)
1	2004	6.16%	6.40%
2	2005	5.65%	5.93%
3	2006	6.07%	6.32%
4	2007	6.07%	6.33%
5	2008	6.51%	7.21%
6	**Average**	**6.09%**	**6.44%**

Sources: *Mergent Public Utility Manual* 2003, and Moody's Daily News.

As shown in Table 1 above, over the last five years the "A" rated utility yields have ranged from 5.65% to 6.51%. Similarly, the "Baa" rated utility yields ranged from 5.93% to 7.21%. The upper end of these ranges reflects the abnormal market conditions observed in 2008. Importantly, over the last five years, the average "A" and "Baa" rated utility yields were 6.09% and 6.44%, respectively. These yields are significantly lower than the yields observed in the current market environment.

However, once the credit and financial markets stabilize, the Treasury and

public utility yields will converge to the normalized level experienced in the past.

Q DOES DR. HADAWAY AGREE THAT THE ABNORMAL UTILITY SPREADS AND LOW INFLATIONARY PRESSURE REPRESENT A MARKET ANOMALY?

A Yes. Specifically, he states the following in regards to the low inflation level:

> This indication is caused by current "flight to safety" anomalies in the Treasury bond market and the differing impact that those anomalies have had on nominal Treasury yields versus yields on the Treasury Inflation Protected Securities (TIPS) used in that analysis.[3]

What Dr. Hadaway has apparently not recognized, however, is this flight to Treasury securities, thereby bidding up the prices and reducing Treasury yields, has had the exact opposite effect on corporate bonds, including utilities. Specifically, the movement from corporate securities to Treasury securities, has produced a temporary deflation in utility bond prices, and an increase in utility bond yields. Once these abnormal market conditions correct, Treasury yields will likely increase, and utility bond yields will likely decrease.

Q HAVE OTHER UTILITY COMPANIES RECOGNIZED THE FACT THAT THE HIGHER UTILITY YIELDS ARE A MARKET ANOMALY?

A Yes, they have. Recently, Northern Indiana Public Service Company (NIPSCO) purchased the Sugar Creek base load plant, and it had plans to finance the plant by issuing long-term debt at a rate of 7.5%.[4] However, in its December 5, 2008 Motion for Extension, NIPSCO recognized that the higher interest rates are a market anomaly caused by the credit markets and the rates will stabilize in the future.

[3] Hadaway Rebuttal, at 13, footnote no. 4.

[4] Indiana Utility Regulatory Commission Cause No. 43563, Rebuttal Testimony of Vincent Rea, at 3 and 4.

Q IS THERE EVIDENCE THAT THE BORROWING COSTS FOR UTILITIES WILL DECLINE AND THE INTEREST RATES WILL STABILIZE?

A Yes. In December 2008, Consolidated Edison, an "A" rated utility, issued a 10-year note at 7.125%. Three months later, on March 23, the company issued another 10-year note at 6.65% and a 5-year note at 5.55%. Clearly, the borrowing costs for this utility declined by 50 basis points over the three-month period. The table below summarizes the additional new debt issuances over the last month.

TABLE 2

Public Utility Debt Issuances

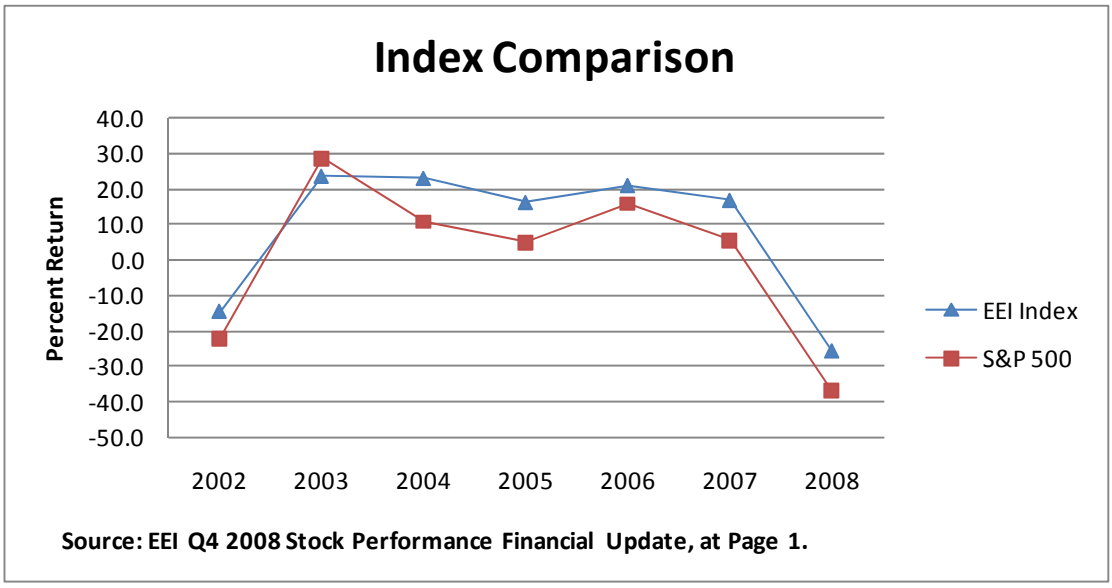
Date	Issuer	Rating	Maturity	Type	Rate
3/25/09	Idaho Power	BBB	20	Secured	6.15%
3/23/09	Consolidated Edison	BBB	10	Unsecured	6.65%
	Consolidated Edison	BBB	5	Unsecured	5.55%
3/20/09	Empire District	BBB	15	Secured	7.00%
3/19/09	Kansas City Power & Light	BBB	20	Secured	7.15%
3/16/09	Progress Energy	BBB	10	Unsecured	7.05%
	Progress Energy	BBB	5	Unsecured	6.05%

Source: SNL Financial.

As shown in the table above, the utility companies have been able to access the credit markets and issue additional debt at costs much lower than what Dr. Hadaway has shown in his Table 1. Therefore, the utility yields are on their way to recovery and they are converging to the normalized level experienced in the past.

Q HAVE YOU CHANGED YOUR OPINION ABOUT THE UTILITY STOCK PERFORMANCE AS SUGGESTED BY DR. HADAWAY?

A No. Dr. Hadaway falsely asserts that my outdated utility stock performance analysis based on the data published by the Edison Electric Institute (EEI), as discussed on pages 6-8 of my direct testimony, is "not consistent with the market conditions that utilities face." I have updated this analysis and my conclusions have not changed. As shown on the graph below, the Electric Utility Stock Index has outperformed the market in every year over the last five years.



Source: EEI Q4 2008 Stock Performance Financial Update, at Page 1.

Again, this strong stock performance indicates commission-authorized returns on equity over the last several years have been positively received by the market.

Q DO YOU CONTINUE TO SUPPORT YOUR CONCLUSION THAT UTILITY STOCKS ARE PERCEIVED AS "SAFE HEAVENS?"

A Yes. While clearly the market performance for all securities has been dismal throughout 2008, the only positive signal from the market performance is the fact that

electric utility stocks and bonds have continued to be perceived by the market as "safe" investments. Indeed, during times of market turbulence, the market generally exhibits a "flight to quality" and lower-risk securities generally perform better than the overall market and higher-risk securities. This has happened through 2008. For example, EEI noted the following concerning electric utility stock performance in 2008:

> **Flight to Safety**
>
> The relatively stronger performance of utility stocks in both the quarter and the year offers a classic illustration of their traditional role as a defensive investment in times of market stress. In a weakening economy, investors are drawn to the relative stability offered by utilities' dividend yields and more predictable earnings (in comparison with other sectors of the economy), made possible by the essential role that electricity plays in the lives of Americans at work and at home compared to other, more optional products and services.
>
> Indeed, the comparative category returns shown in Charts II and VIII highlight the theme that dividend stability and earnings predictability – generally most associated with the regulated utility business model – translated into better stock market performance in 2008. The Regulated group's -5.9% return in the fourth quarter was about 8 percentage points better than the Mostly Regulated group's -14.0% return, which in turn was slightly better than the Diversified group's -17.0% return. The Regulated group, with a -15.6% return for the year as a whole, also outperformed the Mostly Regulated group's -27.0% return and the Diversified group's -33.9% return for the year.
>
> The stronger performance of Regulated company stocks is also evident in Table XIV, as nine of the top-ten performing stocks in the EEI Index in 2008 were those in the Regulated category. In fact, the EEI Index's quarterly and full-year 2008 returns were largely supported by the performance of the Regulated group. However, to place this performance in a broader context, the Mostly Regulated and Diversified groups outperformed the Regulated group in 2003, 2004, 2005 and 2007. Each group offers investors a somewhat different risk and return profile, and their changing performance patterns illustrate changing investor preferences in relation to the broader trends taking place in the industry's structure and organization as well as trends in global financial and commodity markets.[5]

[5] "Stock Performance," EEI *Q4 2008 Financial Update*, emphasis added.

This stock price performance again supports the notion that regulated electric utilities are perceived by the market as safe haven investments, which will help support their access to capital during difficult financial times. This is clearly evident through a review of their stable credit outlook and stable stock prices, relative to the securities of non-regulated companies.

Q DR. HADAWAY ARGUES THAT SIMPLY REMOVING YOUR CAPM RETURN ESTIMATE WILL INCREASE YOUR RETURN ON EQUITY TO 10.74% FROM 10.3%. PLEASE RESPOND.

A Dr. Hadaway erroneously reaches this conclusion by simply removing the low end of my return on equity range. A more balanced approach would be, at a minimum, to remove both the low-end return on equity estimate of 8.94%, and also the high-end return estimate of 12.02%. Removing high and low return estimates would produce a return on equity of 10.5%, which is very similar to my recommended return on equity of 10.3%.

Q DO YOU HAVE ANY COMMENTS CONCERNING DR. HADAWAY'S CRITICISM OF YOUR DCF METHODOLOGY?

A Yes. The primary disagreements between Dr. Hadaway and me are the reliability of the constant growth model and the determination of a reasonable GDP growth rate.

As I discussed in my direct and rebuttal testimonies, the current return on equity estimates produced by the constant growth DCF model are substantially higher because they are driven by abnormally high growth rates that are not sustainable in the long run. Even though I disagree with the return estimates produced by the

constant growth DCF model, I have included the result in my return on equity recommendation because the preferred methodology of the Commission is to average all DCF results.

Q PLEASE DESCRIBE YOUR DISAGREEMENT WITH DR. HADAWAY ON THE DETERMINATION OF A REASONABLE GDP GROWTH RATE?

A In Dr. Hadaway's direct and rebuttal testimonies, he derived his own long-term GDP growth rate of 6.5% and 6.2%, respectively. In significant contrast, in my non-constant growth DCF models, I used a published economists' consensus GDP growth rate over the next five and ten years of 4.9%. I also, considered Morningstar's methodology since this is the Commission preferred estimate for long-term sustainable growth rate. In fact, in the 2009 Valuation Edition, which became available to me after I filed my rebuttal testimony, Morningstar estimates a long-term growth rate of 3.9%.[6]

Dr. Hadaway argues that my long-term sustainable GDP growth rate projection is relatively short-term and it is based on inflation estimates that are significantly lower than the long-term historical averages. Again, the GDP growth rate projection I used in my non-constant DCF models is based on consensus economists' estimates published by the *Blue Chip Economic Indicators* and it is a superior estimate than the GDP growth rate projection provided by a single analyst such as Dr. Hadaway or myself.

Dr. Hadaway's GDP growth forecasts are significantly higher than independent consensus market economists' projections and do not reflect market

[6]2009 Ibbotson SBBI® Valuation® Yearbook at 53; Inflation of 0.6% and Real GDP of 3.3%.

consensus expectations. Further, as a result of Dr. Hadaway's use of an excessive growth rate forecast, his DCF estimates are inflated and not reliable.

Q PLEASE DESCRIBE DR. HADAWAY'S CRITICISMS OF YOUR RISK PREMIUM ANALYSIS.

A Dr. Hadaway acknowledged that my risk premium analysis is similar to his, excluding his explicit adjustment to reflect an inverse relationship between interest rates and equity risk premiums.

Q ARE DR. HADAWAY'S RISK PREMIUM ARGUMENTS ACCURATE?

A No. The clear finding in academic research on equity risk premiums is that the relationship between interest rates and risk premiums changes over time based on a multitude of factors. Second, academic research concludes that the relationship between equity risk premiums and interest rates changes based on the perception of the risk difference between equity investments and fixed income investments, and not simply interest rates.

This relationship is not based on a simple inverse relationship between risk premiums and interest rates, but rather is tied to perceived risk differentials between the two competing investments, as described in my rebuttal testimony.

Q PLEASE DESCRIBE THE ACADEMIC RESEARCH ON THE RELATIONSHIP BETWEEN EQUITY RISK PREMIUMS AND INTEREST RATES.

A The academic literature on the inverse relationship between interest rates and equity risk premiums has observed that there has been a transient inverse relationship that

was not tied to changes in nominal interest rates. It was caused by changes to perceived risk differentials between debt and equity investments. Further, the relationship between interest rates and equity risk premiums is not constant, but rather can change materially over time.

Most of the academic literature addressing this issue that I am familiar with is based on market data from the 1980s and very early 1990s. During the 1980s and very early 1990s, an inverse relationship did exist. However, that relationship did not exist prior to 1980, and it has not been shown to be the case since the early 1990s. For example, the abstract for a paper written by Eugene Brigham, Dilip K. Shome and Steve R. Vinson, entitled "The Risk Premium Approach to Measuring a Utility's Cost of Equity," published by the Public Utility Research Center, August 1984, states:

> (4) Before 1980, equity risk premiums for utilities increased as interest rates rose, but after that date an increase in interest rates was associated with lower risk premiums. As a result, in recent years a 100 basis point increase in long-term interest rates has led to an increase of about 37 basis points in the cost of equity. (5) Risk premiums are not stable; they change substantially over relatively short periods of time, and this volatility has implications for anyone who seeks to measure equity capital costs on the basis of a debt yield plus a risk premium, including advocates of the CAPM approach. [Emphasis added.]

These academics found that there was a positive relationship between interest rates and equity risk premiums before 1980, and an inverse relationship from 1980-1984. This study does not establish a consistent relationship between interest rates and equity risk premiums over the entire period.

In the more recent, yet still outdated, study by Robert S. Harris and Felicia C. Marston published in the *Journal of Applied Finance* – 2001, "The Market Risk Premium: Expectational Estimates Using Analysts Forecasts," the authors expanded an earlier study of risk premiums to cover the period of 1982-1998. In this study, the

authors did note a historical inverse relationship between equity risk premiums and interest rates. However, the authors went into detail to explain why that historical relationship was likely affected more by relative investment risk changes, and not simply changes to nominal interest rates as Dr. Hadaway implies in his testimony. The authors state as follows:

> The market risk premium changes over time and appears inversely related to government interest rates but is positively related to the bond yield spread, which proxies for the incremental risk of investing in equities as opposed to government bonds.

Importantly, the authors in that same study concluded as follows:

> As a result, our evidence does not resolve the equity premium puzzle; rather, the results suggest investors still expect to receive large spreads to invest in equity versus debt instruments.
>
> There is strong evidence, however, that the market risk premium changes over time. Moreover, these changes appear linked to the level of interest rates as well as ex ante proxies for risk drawn from interest rate spreads in the bond market.

Clearly, the academic literature does not support a simplistic inverse relationship between interest rates and equity risk premiums. Rather, the authors of these studies recognize that equity risk premiums change with perceived changes in investment risk. Dr. Hadaway's simplistic analysis takes no account of changes to perceived risk, and inappropriately increases equity risk premiums for no other reason than a reduction in nominal interest rates.

Q ARE REDUCTIONS IN NOMINAL INTEREST RATES AN ADEQUATE REASON FOR INCREASES TO EQUITY RISK PREMIUMS?

A No, they are not. Reductions to nominal interest rates are simply not an adequate reason for increases to equity risk premiums. Indeed, decreases to interest rates

over the last ten years have been likely caused by reduced inflation expectations, which would decrease both bond interest rates and common equity required returns. Reduced inflation expectations alone should not change relative debt to equity investment risk, and thus would not cause equity risk premiums to increase. Consequently, Dr. Hadaway's proposal to reflect an inverse relationship between equity risk premiums and bond interest rates is flawed and unreliable, and it should be rejected.

Q DR. HADAWAY ARGUES THAT YOU ARE INCONSISTENT IN THIS CASE COMPARED TO PRIOR CASES WHERE YOU ACCEPTED THE NEGATIVE RELATIONSHIP BETWEEN RISK PREMIUMS AND INTEREST RATES. PLEASE RESPOND.

A Dr. Hadaway argues that in prior cases I have adopted his belief that there is an inverse relationship between interest rates and equity risk premiums. This is an incorrect assertion.

In prior cases, just as in this case, I have recognized that the relationship between interest rates and equity risk premiums is tied to changing market perceptions of investment risk outlooks for these two competing investments. In prior cases, I attempted to measure the changing equity risk premiums based on changing risk for bond investments. Bond investment risk was measured based on the "real" return embedded in utility bond yields plus an inflation component. I found that the changing real return component of bond yields corresponded to greater or lower bond investment risk. Again, this was an attempt to measure equity risk premiums in relation to the market's assessment of bond and equity risk.

However, in the current case, and more recently I have been relying on yield spread of utility bonds and Treasury bonds to gauge the level of equity risk premium. As noted in the Harris article discussed above, the authors found that a good proxy for gauging the investment risk of industry equity and debt investments was to review corporate bond spreads to Treasury investments. The authors found that when the yield spread increased, the equity risk premiums increased.

Furthermore, there is no inconsistency of any kind in my position concerning Dr. Hadaway's use of a simplistic inverse relationship between equity risk premiums and nominal interest rates. The relationship is not that simple. Because Dr. Hadaway assumes the existence of such a simplistic relationship, his risk premium model is flawed.

Q PLEASE DESCRIBE DR. HADAWAY'S CRITICISMS OF YOUR CAPM ANALYSIS.

A Dr. Hadaway argues that the current market conditions understate the CAPM return on equity simply because its inputs, the risk-free rate and the market risk premium, are understated (Hadaway Rebuttal at 9-10). Therefore, he concludes that the CAPM should not be used to estimate KCPL's fair return on equity.

Q DO YOU AGREE WITH DR. HADAWAY THAT THE CAPM SHOULD BE DISREGARDED BECAUSE OF THE LOW TREASURY BOND YIELDS?

A No. Dr. Hadaway seems to embrace the abnormally high utility bond yields based on today's exceptional market conditions which drive up his return on equity estimates, but he ignores the abnormally low yields on Treasury bonds also attributable to the extraordinary economic conditions which decrease the return on equity estimates.

Predictably, Dr. Hadaway only relies on data which causes the return on equity estimate to increase, while ignoring other information which could cause an offsetting decrease to the return on equity estimate. Utility bond yields have been driven up because the market has largely moved out of corporate securities and into safe haven, low-risk Treasury securities. This shift in the capital market has caused utility bond prices to decrease and yields to increase, and Treasury bond prices to increase and yields to decline. All of the movement in the yields on Treasuries and utility bonds is attributable to the anomalies taking place in the capital markets. Neither utility bond yields nor the Treasury bond yields are reasonable estimates of long-term valuations for these securities, after the markets return to more normal conditions, and the economy recovers from the current recession. As such, it is inappropriate and self-serving for Dr. Hadaway to rely on inflated utility bond yields despite these economic circumstances, but propose to reject abnormally low Treasury bond yields which are the result of the same extraordinary economic circumstances. I suggest that either both are given fair consideration, or both should be rejected in an effort to reach a more normalized sustainable return on equity estimate.

Q DO YOU HAVE ANY OTHER COMMENTS CONCERNING YOUR RETURN ON EQUITY ESTIMATES?

A Yes. The current market conditions produce relatively high DCF and low CAPM estimates. Therefore, it is important for any rate of return witness to create a balanced return on equity recommendation, which will compensate KCPL shareholders and will not create a burden on the KCPL ratepayers. By relying on both the high and low estimates of my return on equity analyses, I have captured the

current abnormally high utility yields and growth rates and the abnormally low government bond yields. Hence, my return on equity recommendation fairly compensates KCPL's ratepayers and investors.

Dr. Hadaway's Updated Analysis

Q PLEASE DESCRIBE DR. HADAWAY'S UPDATED RETURN ON EQUITY ESTIMATES.

A Dr. Hadaway's return on equity estimates are shown in the table below under column (1). Under column (2), I have summarized Dr. Hadaway's adjusted results after more reasonable estimates are applied.

TABLE 3

Summary of Dr. Hadaway's ROE Estimate

Description	Hadaway Results (1)	Adjusted Hadaway Results (2)
DCF Analysis		
Constant Growth (Analysts' Growth)	11.6% - 11.9%	11.6% - 11.9%
Constant Growth (GDP Growth)	11.4%	10.3%
Multi-Stage Growth Model	11.2%	10.3%
DCF Return	**11.55%**	**10.30%**
Risk Premium Analysis		
Risk Premium (Projected Yields)	11.14%	10.29%
Risk Premium (Current Yields)	11.56%	11.01%
Risk Premium Return	**11.35%**	**10.65%**

Source: Hadaway Rebuttal at 21.

Q DOES DR. HADAWAY'S UPDATED RETURN ON EQUITY ANALYSIS CONTAIN THE SAME FLAWS AS THE ANALYSIS IN HIS DIRECT TESTIMONY?

A Yes. Dr. Hadaway's updated return on equity estimates contain the same flaws as those in his direct testimony. Specifically, his DCF model is based on a GDP growth rate of 6.2%, which significantly exceeds the consensus economists' GDP growth rate projections of 5.1% (the average of the 5-year GDP growth projection of 5.2% and the 10-year GDP growth projection of 4.9%)[7]. He continues to rely on the inverse relationship between risk premium estimates and interest rates in his equity risk premium analysis. Therefore, Dr. Hadaway's analyses produce an inflated return on equity recommendation and should be adjusted to reflect the current market expectations.

Q DO YOU HAVE ANY OTHER COMMENTS CONCERNING THE APPLICATION OF THE CONSTANT GROWTH DCF MODEL IN THE CURRENT MARKET?

A Yes. The constant growth DCF model parameters are particularly illogical and irrational, and produce results that simply should not be relied upon. Specifically, Dr. Hadaway's constant growth DCF model still contains growth rates that are far too high to be sustainable in the long term. While that in and of itself is an irrational outlook, use of those growth rates with today's yields compounds the irrational outlook that this model is currently conveying. Specifically, this model contains a very robust growth outlook despite the fact that utility sales growth is negatively impacted by the economy, capital costs are at least temporarily out of line with normalized costs, and many utility capital budgets have been reduced as utilities attempt to

[7] *Blue Chip Economic Indicators*, March 10, 2009 at 15.

conserve cash. All of these actions have been observed by the stock market and have resulted in declines to utility stock prices.

It is simply irrational to expect, as Dr. Hadaway does, that the market expects a robust growth outlook for utility stocks during a period when utility stock prices have dropped due to reduce sales outlooks, lower capital expenditures and abnormal capital market and service area economy conditions.

As such, Dr. Hadaway's constant growth DCF model should be rejected initially for use of growth rates which are too high to be reasonable estimates of long-term sustainable growth, but particularly in this instance should be disregarded because the outlook for robust growth is completely contradicted by the decline in stock price given the uncertainty of future earnings and growth outlook for utility companies. Dr. Hadaway's constant growth DCF model should simply be given no weight in this case.

Importantly, it is unreasonable to expect DCF returns in the range of 11.6% to 11.9%, as Dr. Hadaway suggests. Therefore, Dr. Hadaway's constant DCF return estimates should be rejected.

Q HOW WOULD DR. HADAWAY'S UPDATED DCF MODELS CHANGE IF THE CONSENSUS ANALYSTS' GDP GROWTH RATE IS USED IN HIS STUDY?

A On Surrebuttal Schedule MPG-1, I updated Dr. Hadaway's DCF analysis using the consensus economists' projected GDP growth rate of 5.1%. The results of this update are shown in Table 3 above. As shown in the table, Dr. Hadaway's updated DCF return estimates would decline from 11.55% to 10.30%, excluding Dr. Hadaway's constant growth DCF return estimates.

Q HOW WOULD DR. HADAWAY'S RISK PREMIUM STUDY CHANGE WITHOUT APPLYING THE INVERSE RELATIONSHIP BETWEEN RISK PREMIUMS AND INTEREST RATES?

A As shown in the table above, applying Dr. Hadaway's indicated risk premium of 3.19% to his projected "BBB" utility bond yield of 7.10% and his current "BBB" utility bond yield of 7.82% will result in a risk premium return on equity range of 10.29% to 11.01%, with a midpoint of 10.65%.

Q PLEASE SUMMARIZE YOUR ASSESSMENT OF DR. HADAWAY'S UPDATED RETURN ON EQUITY STUDY.

A Corrections to Dr. Hadaway's updated cost of equity estimates show that a fair return on equity for KCPL supports a return on equity in the range of 10.30% to 10.65%. Therefore, my recommended return on equity of 10.3% for KCPL is still reasonable and fairly compensates investors.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes.

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Kansas City Power and Light Company

Summary of Adjusted Hadaway DCF

Line	Description	Hadaway[1] (1)	Hadaway Adjusted[2/3] (2)
	Constant Growth DCF		
1	Average	11.9%	11.9%
2	Median	11.6%	11.6%
	Long-Term Constant Growth DCF		
3	Average	11.4%	10.3%
4	Median	11.4%	10.3%
	Multi-Stage Growth DCF		
5	Average	11.2%	10.3%
6	Median	11.2%	10.3%

Sources & Notes:

[1] Schedule SCH-11, Page 1 of 5.

[2] Surrebuttal Schedule MPG-1, Pages 2 to 4.

[3] The adjustment reflects changing the GDP Growth Rate to 5.10%.

Kansas City Power and Light Company

Adjusted Hadaway Constant Growth DCF Model
Analysts' Growth Rates

Line	Company	Recent Stock Price (1)	Next Year's Dividend (2)	Dividend Yield (3)	Analysts' Growth Rates			Average Growth Rate (7)	Constant Growth DCF (8)
					Value Line (4)	Zacks (5)	Thomson (6)		
1	ALLETE	$32.15	$1.76	5.47%	N/A	6.50%	6.50%	6.50%	12.0%
2	Alliant Energy	$29.17	$1.50	5.14%	6.00%	5.00%	6.10%	5.70%	10.8%
3	Ameren	$32.85	$2.54	7.73%	4.50%	5.50%	4.00%	4.67%	12.4%
4	American Elec. Power	$31.20	$1.66	5.32%	5.00%	5.50%	4.84%	5.11%	10.4%
5	Avista Corp.	$18.54	$0.78	4.21%	9.00%	8.70%	4.67%	7.46%	11.7%
6	Central Vermont P.S.	$20.78	$0.92	4.43%	7.50%	N/A	8.90%	8.20%	12.6%
7	Cleco Corp.	$21.95	$0.95	4.33%	10.50%	15.00%	13.63%	13.04%	17.4%
8	Consol. Edison	$39.95	$2.36	5.91%	1.00%	3.30%	2.61%	2.30%	8.2%
9	DTE Energy	$35.22	$2.18	6.19%	5.00%	6.00%	3.50%	4.83%	11.0%
10	Edison Int'l	$31.97	$1.25	3.91%	6.00%	7.00%	6.83%	6.61%	10.5%
11	Empire District	$17.34	$1.28	7.38%	10.00%	N/A	6.00%	8.00%	15.4%
12	Entergy Corp.	$80.78	$3.00	3.71%	7.50%	8.50%	9.42%	8.47%	12.2%
13	FPL Group	$47.87	$1.88	3.93%	9.50%	9.20%	9.62%	9.44%	13.4%
14	FirstEnergy	$51.87	$2.45	4.72%	10.00%	7.70%	9.00%	8.90%	13.6%
15	Hawaiian Electric	$23.99	$1.24	5.17%	5.00%	4.50%	4.50%	4.67%	9.8%
16	IDACORP Inc.	$28.83	$1.20	4.16%	5.00%	6.00%	5.00%	5.33%	9.5%
17	Northeast Utilities	$23.03	$0.88	3.82%	12.00%	9.80%	8.32%	10.04%	13.9%
18	NSTAR	$34.13	$1.53	4.48%	7.50%	7.20%	6.00%	6.90%	11.4%
19	PG&E Corp.	$36.95	$1.68	4.55%	7.00%	7.10%	7.00%	7.03%	11.6%
20	Pinnacle West	$31.08	$2.10	6.76%	1.00%	5.50%	4.33%	3.61%	10.4%
21	Portland General	$18.30	$1.01	5.52%	7.00%	6.30%	5.92%	6.41%	11.9%
22	Progress Energy	$38.62	$2.48	6.42%	5.00%	4.90%	5.65%	5.18%	11.6%
23	Southern Co.	$35.40	$1.73	4.89%	5.50%	5.00%	5.59%	5.36%	10.3%
24	Teco Energy, Inc.	$11.90	$0.82	6.89%	7.50%	10.40%	7.44%	8.45%	15.3%
25	UIL Holdings	$29.09	$1.73	5.95%	4.00%	6.40%	4.80%	5.07%	11.0%
26	Vectren Corp.	$25.82	$1.35	5.23%	5.00%	6.40%	5.67%	5.69%	10.9%
27	Westar Energy	$19.47	$1.24	6.37%	2.00%	6.00%	4.45%	4.15%	10.5%
28	Wisconsin Energy	$42.06	$1.35	3.21%	8.00%	9.00%	9.49%	8.83%	12.0%
29	Xcel Energy Inc.	$18.06	$0.97	5.37%	7.50%	6.50%	6.90%	6.97%	12.3%
30	**Average**	**$31.32**	**$1.58**	**5.21%**	**6.45%**	**7.00%**	**6.44%**	**6.65%**	**11.9%**
31	**Median**			**5.17%**				**6.50%**	**11.6%**

Source:
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Kansas City Power and Light Company

Adjusted Hadaway Constant Growth DCF Model
Long-Term GDP Growth

Line	Company	Recent Stock Price (1)	Next Year's Dividend (2)	Dividend Yield (3)	GDP Growth* (4)	Long-Term Constant Growth DCF (5)
1	ALLETE	$32.15	$1.76	5.47%	5.10%	10.6%
2	Alliant Energy	$29.17	$1.50	5.14%	5.10%	10.2%
3	Ameren	$32.85	$2.54	7.73%	5.10%	12.8%
4	American Elec. Power	$31.20	$1.66	5.32%	5.10%	10.4%
5	Avista Corp.	$18.54	$0.78	4.21%	5.10%	9.3%
6	Central Vermont P.S.	$20.78	$0.92	4.43%	5.10%	9.5%
7	Cleco Corp.	$21.95	$0.95	4.33%	5.10%	9.4%
8	Consol. Edison	$39.95	$2.36	5.91%	5.10%	11.0%
9	DTE Energy	$35.22	$2.18	6.19%	5.10%	11.3%
10	Edison Int'l	$31.97	$1.25	3.91%	5.10%	9.0%
11	Empire District	$17.34	$1.28	7.38%	5.10%	12.5%
12	Entergy Corp.	$80.78	$3.00	3.71%	5.10%	8.8%
13	FPL Group	$47.87	$1.88	3.93%	5.10%	9.0%
14	FirstEnergy	$51.87	$2.45	4.72%	5.10%	9.8%
15	Hawaiian Electric	$23.99	$1.24	5.17%	5.10%	10.3%
16	IDACORP Inc.	$28.83	$1.20	4.16%	5.10%	9.3%
17	Northeast Utilities	$23.03	$0.88	3.82%	5.10%	8.9%
18	NSTAR	$34.13	$1.53	4.48%	5.10%	9.6%
19	PG&E Corp.	$36.95	$1.68	4.55%	5.10%	9.6%
20	Pinnacle West	$31.08	$2.10	6.76%	5.10%	11.9%
21	Portland General	$18.30	$1.01	5.52%	5.10%	10.6%
22	Progress Energy	$38.62	$2.48	6.42%	5.10%	11.5%
23	Southern Co.	$35.40	$1.73	4.89%	5.10%	10.0%
24	Teco Energy, Inc.	$11.90	$0.82	6.89%	5.10%	12.0%
25	UIL Holdings	$29.09	$1.73	5.95%	5.10%	11.0%
26	Vectren Corp.	$25.82	$1.35	5.23%	5.10%	10.3%
27	Westar Energy	$19.47	$1.24	6.37%	5.10%	11.5%
28	Wisconsin Energy	$42.06	$1.35	3.21%	5.10%	8.3%
29	Xcel Energy Inc.	$18.06	$0.97	5.37%	5.10%	10.5%
30	**Average**	**$31.32**	**$1.58**	**5.21%**	**5.10%**	**10.3%**
31	**Median**					**10.3%**

Sources:
Schedule SCH-11, Page 3 of 5.
** Blue Chip Economic Indicators,* March 10, 2009.

Kansas City Power and Light Company

Adjusted Hadaway Low Near-Term Growth
Two-Stage Growth DCF Model

Line	Company	Recent Stock Price (1)	2009 Forecasted Dividend (2)	2012 Forecasted Dividend (3)	Annual Change to 2012 (4)	Cash Flows 2009 Dividend (5)	2010 Dividend (6)	2011 Dividend (7)	2012 Dividend (8)	2013 Dividend (9)	GDP Growth* (10)	Two-Stage Growth DCF (11)
1	ALLETE	$32.15	$1.76	$2.00	$0.08	$1.76	$1.84	$1.92	$2.00	$2.10	5.10%	10.5%
2	Alliant Energy	$29.17	$1.50	$1.92	$0.14	$1.50	$1.64	$1.78	$1.92	$2.02	5.10%	10.7%
3	Ameren	$32.85	$2.54	$2.54	$0.00	$2.54	$2.54	$2.54	$2.54	$2.71	5.10%	11.9%
4	American Elec. Power	$31.20	$1.66	$2.40	$0.25	$1.66	$2.00	$2.20	$2.40	$2.56	5.10%	11.6%
5	Avista Corp.	$18.54	$0.78	$1.15	$0.12	$0.78	$0.90	$1.03	$1.15	$1.22	5.10%	10.3%
6	Central Vermont P.S.	$20.78	$0.92	$0.92	$0.00	$0.92	$0.92	$0.92	$0.92	$0.98	5.10%	8.9%
7	Cleco Corp.	$21.95	$0.95	$1.50	$0.18	$0.95	$1.13	$1.32	$1.50	$1.60	5.10%	10.8%
8	Consol. Edison	$39.95	$2.36	$2.42	$0.02	$2.36	$2.38	$2.40	$2.42	$2.54	5.10%	10.4%
9	DTE Energy	$35.22	$2.18	$2.30	$0.04	$2.18	$2.22	$2.26	$2.30	$2.42	5.10%	10.8%
10	Edison Int'l	$31.97	$1.25	$1.64	$0.13	$1.25	$1.38	$1.51	$1.64	$1.72	5.10%	9.5%
11	Empire District	$17.34	$1.28	$1.40	$0.04	$1.28	$1.32	$1.36	$1.40	$1.49	5.10%	12.1%
12	Entergy Corp.	$80.78	$3.00	$4.80	$0.60	$3.00	$3.60	$4.20	$4.80	$5.04	5.10%	10.1%
13	FPL Group	$47.87	$1.88	$2.34	$0.15	$1.88	$2.03	$2.19	$2.34	$2.46	5.10%	9.3%
14	FirstEnergy	$51.87	$2.45	$3.05	$0.20	$2.45	$2.65	$2.85	$3.05	$3.25	5.10%	10.1%
15	Hawaiian Electric	$23.99	$1.24	$1.30	$0.02	$1.24	$1.26	$1.28	$1.30	$1.38	5.10%	9.8%
16	IDACORP Inc.	$28.83	$1.20	$1.20	$0.00	$1.20	$1.20	$1.20	$1.20	$1.26	5.10%	8.7%
17	Northeast Utilities	$23.03	$0.88	$1.03	$0.05	$0.88	$0.93	$0.98	$1.03	$1.10	5.10%	8.9%
18	NSTAR	$34.13	$1.53	$1.85	$0.11	$1.53	$1.64	$1.74	$1.85	$1.97	5.10%	9.7%
19	PG&E Corp.	$36.95	$1.68	$2.04	$0.12	$1.68	$1.80	$1.92	$2.04	$2.14	5.10%	9.8%
20	Pinnacle West	$31.08	$2.10	$2.30	$0.07	$2.10	$2.18	$2.24	$2.30	$2.45	5.10%	11.5%
21	Portland General	$18.30	$1.01	$1.20	$0.06	$1.01	$1.07	$1.14	$1.20	$1.28	5.10%	10.7%
22	Progress Energy	$38.62	$2.48	$2.55	$0.02	$2.48	$2.50	$2.53	$2.55	$2.68	5.10%	10.9%
23	Southern Co.	$35.40	$1.73	$2.00	$0.09	$1.73	$1.82	$1.91	$2.00	$2.10	5.10%	10.0%
24	Teco Energy, Inc.	$11.90	$0.82	$0.90	$0.03	$0.82	$0.85	$0.87	$0.90	$0.96	5.10%	11.7%
25	UIL Holdings	$29.09	$1.73	$1.73	$0.00	$1.73	$1.73	$1.73	$1.73	$1.84	5.10%	10.3%
26	Vectren Corp.	$25.82	$1.35	$1.47	$0.04	$1.35	$1.39	$1.43	$1.47	$1.54	5.10%	10.0%
27	Westar Energy	$19.47	$1.24	$1.32	$0.03	$1.24	$1.24	$1.28	$1.32	$1.41	5.10%	11.0%
28	Wisconsin Energy	$42.06	$1.35	$1.60	$0.08	$1.35	$1.43	$1.52	$1.60	$1.68	5.10%	8.3%
29	Xcel Energy Inc.	$18.06	$0.97	$1.06	$0.03	$0.97	$1.00	$1.03	$1.06	$1.11	5.10%	10.2%
30	**Average**	**$31.32**	**$1.58**	**$1.86**	**$0.09**	**$1.58**	**$1.68**	**$1.77**	**$1.86**	**$1.97**	**5.10%**	**10.3%**
31	**Median**											**10.3%**

Sources:

Schedule SCH-11, Page 4 of 5.

* *Blue Chip Economic Indicators,* March 10, 2009.