

*Exhibit No.:*

*Issue: Capital Structure and Cost  
of Debt*

*Witness: David Murray*

*Sponsoring Party: MoPSC Staff*

*Type of Exhibit: Surrebuttal Testimony*

*Case No.: ER-2016-0285*

*Date Testimony Prepared: January 27, 2017*

**MISSOURI PUBLIC SERVICE COMMISSION**

**COMMISSION STAFF DIVISION**

**FINANCIAL ANALYSIS**

**SURREBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

**KANSAS CITY POWER & LIGHT COMPANY**

**CASE NO. ER-2016-0285**

*Jefferson City, Missouri*

*January 2017*

**\*\* Denotes Highly Confidential Information \*\***

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**DAVID MURRAY**  
**KANSAS CITY POWER & LIGHT COMPANY**  
**CASE NO. ER-2016-0285**

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1 the future, Mr. Bryant claims this now supports using subsidiary capital structures because  
2 this indicates separate financial management. However, if this is Mr. Bryant's standard for  
3 using subsidiary capital structures, then KCPL should have recommended the use of its  
4 capital structure in past rate cases. It did not. Staff will explain several issues, other than a  
5 utility just issuing its own debt, which must be considered in determining whether GPE has  
6 managed its utility finances separately. GPE has been very active both in performing  
7 construction for its KCPL operations and acquiring and managing financing issues related to  
8 the GMO operations. In competitive markets, past incurred capital costs are not relevant to  
9 the rates charged to customers, but not in utility ratemaking. Consequently, past financing  
10 activities are relevant to fair and reasonable rates going forward. Therefore, a good  
11 understanding of GPE's capital market activity since it acquired Aquila is important for  
12 setting fair and reasonable rates now. Staff will explain the issues it believes the  
13 Commission needs to consider in determining whether to use GPE's consolidated capital  
14 structure and capital costs to set KCPL's rates or KCPL's capital structure and capital costs  
15 to set rates.

16 **STAFF'S RESPONSE TO KEVIN E. BRYANT'S REBUTTAL TESTIMONY ON**  
17 **CAPITAL STRUCTURE AND COST OF DEBT**

18 Q. On page 2, lines 7-8 of his rebuttal testimony, Mr. Bryant claims that Staff's  
19 "unsubstantiated statement that GPE has managed its utility finances on a consolidated basis  
20 is false." Does Mr. Bryant provide any specific evidence to substantiate his position that GPE  
21 has not managed KCPL's, GMO's, and GPE's finances for the ultimate benefit of GPE?

22 A. No. In fact, he even mentions one of the primary concerns Staff has discussed  
23 in several of its past testimonies, which is the fact that GPE has used the credit capacity  
24 created by KCPL in order to issue debt on behalf of GMO. Although this example, in and of

Surrebuttal Testimony of  
David Murray

1 | itself, provides evidence of GPE's consolidated financial management of its subsidiaries, this  
2 | is not the only example.

3 |         While there is significant amount of history and complexity to GPE's financial  
4 | transactions since it acquired GMO, these past events must be considered when setting a fair  
5 | and reasonable allowed ROR for KCPL. Mr. Bryant's position that if KCPL, GMO, and  
6 | GPE issue their own debt they should be viewed as separately financially managed entities  
7 | lacks depth. Consequently, Mr. Bryant's testimony indicating that Staff's "unsubstantiated  
8 | statement that GPE has managed its utility finances on a consolidated basis is false," should  
9 | be rejected. Later in my testimony, I will discuss a clear and specific example of an instance  
10 | in which KCPL issued 30-year debt (longer tenors come at higher costs), because  
11 | management indicated it would help lengthen the weighted-average maturity of GPE's  
12 | consolidated debt portfolio. While this is a fairly measurable example of KCPL's capital  
13 | costs being increased by GPE's financial condition and activities, there are other more subtle  
14 | issues, such as strains on KCPL's credit rating since GPE acquired Aquila, that are not easily  
15 | measurable.

16 |         Q.       What appears to be Mr. Bryant's primary standard for his claim that KCPL's  
17 | and GMO's finances are managed separate and distinct from each other and GPE?

18 |         A.       His standard appears to be that because each company has issued its own debt  
19 | since 2013, they are financially managed separately.

20 |         Q.       Is this the standard accepted by credit rating agencies, specifically Standard  
21 | & Poor's ("S&P")?

22 |         A.       No. S&P has consistently rated GPE and its subsidiaries based on GPE's  
23 | consolidated risk profile, which is based on GPE's consolidated capital structure. Even if

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1 KCPL and GMO issue their own debt on a going-forward basis, there is insufficient  
2 separation to ensure that KCPL and GMO are ultimately rated based on their stand-alone risk  
3 profiles. This situation will cause KCPL's and GMO's debt issuances to have a higher cost,  
4 even if GPE issues its "own debt."

5 Q. What standard language does S&P consistently use in its rating reports on  
6 GPE, KCPL, and GMO?

7 A. The following language from S&P's May 31, 2016, report on the GPE/Westar  
8 Energy transaction is consistently stated in all reports discussing GPE's, KCPL's, and  
9 GMO's credit ratings:

10 There are no meaningful insulation measures in place that  
11 protect KCP&L and GMO from their parent and therefore,  
12 KCP&L's and GMO's issuer credit ratings are in line with  
13 GPE's group credit profile of 'bbb+'.<sup>1</sup>

14 Q. Are you aware of any actions/steps GPE, KCPL, and/or GMO have taken  
15 since May 31, 2016, that would allow for KCPL and GMO to receive stand-alone credit  
16 rating recognition by S&P?

17 A. No.

18 Q. Has the Commission had to make a determination on the use of KCPL's  
19 capital structure and capital costs versus GPE's capital structure and capital costs to set  
20 KCPL's authorized ROR in a recent rate case?

21 A. Yes. In KCPL's most recent rate case, Case No. ER-2014-0370, the  
22 Department of Energy's and Federal Executive Agencies' ROR witness, Maureen L. Reno,  
23 recommended the use of KCPL's subsidiary capital structure. In its Report and Order, the  
24 Commission ordered the use of GPE's consolidated capital structure for purposes of setting

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<sup>1</sup> "Great Plains Energy Inc. Ratings Affirmed, Outlook Revised To Negative On Proposed Acquisition Of Westar Energy," May 31, 2016, S&P Capital IQ.

Surrebuttal Testimony of  
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1 KCPL's allowed ROR, because it was consistent with the Commission's past practice, as  
2 well as the Kansas Corporation Commission's past practice.<sup>2</sup>

3 Q. Have the Staff, KCPL, and GMO ("the Companies") typically recommended  
4 the use of GPE's consolidated capital structure to set the authorized ROR?

5 A. Yes. Staff and the Companies have recommended the use of GPE's  
6 consolidated capital structure. In fact, Staff and KCPL recommended the use of GPE's  
7 capital structure before GPE acquired GMO.

8 Q. Has the Staff sponsored testimony in past cases explaining how GPE's  
9 consolidated financial management decisions have been detrimental to KCPL ratepayers due  
10 to GPE's financial condition subsequent to its acquisition of GMO?

11 A. Yes. At the time Staff's testimony addressed proposed downward  
12 adjustments to the costs of certain GPE securities as well as whether lower-cost, short-term  
13 tenor debt should be included in KCPL's authorized debt return. However, these issues are  
14 also relevant for evaluating the appropriate capital structure to use to set KCPL's rate of  
15 return.

16 Q. Can you discuss some of the issues from past testimonies?

17 A. Yes. Staff discussed the first example in its surrebuttal testimony in KCPL's  
18 rate case in 2012, Case No. ER-2012-0174. This example is particularly relevant to  
19 evaluating whether KCPL's current embedded cost of debt is higher than would be the case  
20 absent GPE's other investment activities. When KCPL issued \$400 million of 30-year debt  
21 in 2011 at a coupon rate of 5.30%, according to information from the GPE Board of  
22 Directors meetings on August 1 and 2, 2011, GPE's support for issuing the 30-year debt was  
23 that it would \*\* \_\_\_\_\_

<sup>2</sup>Commission's Report and Order in Case No. ER-2014-0370, pp. 20-21.

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\*\* This proves that GPE's financing decision for KCPL was based on consideration of GPE's consolidated debt portfolio. If this financing decision was based purely on KCPL's weighted-average maturity, then this would have justified a shorter tenor debt issuance.

Q. If KCPL had issued 10-year bonds rather than 30-year bonds, how much lower could the cost of this debt be?

A. KCPL used Scotia Capital to provide indicative pricing estimates at the time KCPL decided to issue the 30-year bonds. According to Scotia Capital, the spread between the cost of 10-year debt and 30-year debt was approximately 150 basis points.<sup>3</sup> If KCPL had issued 3.8% coupon 10-year debt rather than the 5.3% coupon 30-year debt, its embedded cost of debt for purposes of this rate case would have been 5.26% rather than the 5.48% KCPL claims is its "independent" cost of debt. While it is true that KCPL directly issued this debt, this is just one factor to consider when determining if a company is financially managed on a stand-alone basis. This is one of the more obvious examples of how KCPL's capital costs have been detrimentally impacted by its affiliation with GPE and its need to lengthen the weighted-average maturity of GPE's portfolio of debt rather than focusing on KCPL in isolation.

Q. Have you discussed other issues in past cases that illustrate the consolidated nature of GPE's financial management and its impact on KCPL?

A. Yes, but I will discuss these examples in a more general sense and reference my testimony from past KCPL and GMO cases to allow the reader to verify my position. Although the use of GPE's embedded cost of debt results in a lower revenue requirement for

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<sup>3</sup>David Murray Surrebuttal, KCPL Case No. ER-2012-0174, p. 36.



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1 KCPL than if only KCPL's cost of debt were used to set KCPL's allowed ROR, in past rate  
2 cases, Staff consistently argued that this cost of debt would have been even lower if GPE had  
3 not had to issue debt on behalf of GMO, and this debt had not been linked to esoteric capital  
4 GPE issued to avoid a credit rating downgrade to junk status. Because GMO's regulated  
5 utility assets were not held in a ring-fenced subsidiary, separate and apart from its previous  
6 parent company, Aquila, it did not have separate financial statements and was not rated as a  
7 separate entity. If GMO's regulated utility assets had been held in a ring-fenced subsidiary,  
8 then it would already have its own financial statements and possibly even an investment  
9 grade credit rating. If so, then it could have continued to issue its own debt even after GPE  
10 had acquired these assets from Aquila. However, because this was not the case, GPE created  
11 GMO for purposes of acquiring Aquila's Missouri regulated utility assets and the assumption  
12 of Aquila's debt. Because GMO's Missouri-regulated utility assets had not been held in a  
13 stand-alone subsidiary, it did not have audited financial statements. Therefore, in order to be  
14 able to issue debt directly, it had to establish at least three years of audited financial  
15 statements.

16 While GPE's efforts to establish GMO's ability to issue debt capital should be  
17 commended, neither KCPL's ratepayers nor GMO's ratepayers should have had to pay for  
18 costs associated with this process, which included direct higher costs of financings at the  
19 parent company level and indirect financial effects on KCPL's credit ratings. It is not fair to  
20 pass along higher capital costs caused by other failed businesses to captive customers. Even  
21 if GPE did not cause these higher costs, these higher costs were not a function of GMO's  
22 low-risk Missouri regulated utility assets. GPE's creative financing techniques, and their  
23 accompanying higher costs, were necessary because it acquired Aquila during a period of

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1 significant capital expenditures (see Experimental Alternative Regulatory Plan (“EARP”) in  
2 Case No. EO-2005-0329), as well as amid the financial crisis of 2008 and 2009. It’s clear  
3 from evidence Staff presented in previous cases that this pressure on GPE’s financial  
4 situation caused it to have to take dramatic steps to attempt to shore up its financial condition  
5 to avoid having its (GPE’s) credit rating downgraded to junk status. Again, the focus was on  
6 GPE’s consolidated financial condition, not KCPL’s. In fact, during the period of KCPL’s  
7 EARP, KCPL collected a cumulative amount of \$146.7 million<sup>4</sup> from its ratepayers above its  
8 normal cost of service in order to support KCPL’s ability to meet S&P’s funds from  
9 operations to debt (“FFO/debt”) benchmark for a ‘BBB+’ credit rating.<sup>5</sup> Although KCPL’s  
10 S&P credit rating was not downgraded during the period of the EARP; GMO’s credit metrics  
11 were more strained than KCPL’s, causing GPE’s consolidated metrics to be lower, which  
12 suppressed the ability of KCPL to be rated more consistent with its stand-alone risk profile.  
13 Although GPE’s and KCPL’s S&P credit rating was not downgraded during the period of the  
14 EARP, Moody’s did reduce its ratings on both companies on March 11, 2009.<sup>6</sup>

15 In order to avoid being downgraded to junk status, GPE cut its dividend<sup>7</sup> and issued  
16 equity units, which carried a very high-embedded cost of 13.59%.<sup>8</sup> Although the equity units  
17 have since been converted in 2011 to GPE debt, this debt is still outstanding and carries a  
18 cost that is higher than the cost would have been if an investment grade utility subsidiary had  
19 directly issued this debt.<sup>9</sup>

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<sup>4</sup> Staff’s Cost of Service Report in Case No. ER-2012-0174, p. 188.

<sup>5</sup> David Murray Rebuttal in Case No. ER-2010-0355, pp. 25-26.

<sup>6</sup> For more details, please see Staff’s Recommendation in Case No. EO-2010-0353.

<sup>7</sup> David Murray Surrebuttal in Case No. ER-2010-0355, Schedule 6, p. 3.

<sup>8</sup> April 23, 2009 Memorandum from Michael Cline to Members of Great Plains Energy Board of Directors..

<sup>9</sup> David Murray Surrebuttal in Case No. ER-2012-0174, p. 38.

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1 Q. Has GPE managed GMO's and KCPL's dividend payouts as if they were  
2 stand-alone entities?

3 A. No. In recent periods, GMO has been paying a much more significant amount  
4 of the dividends GPE ultimately distributes to its shareholders. In 2015, GMO distributed  
5 \$157 million in dividends, which was slightly in excess of the dividend distributed to  
6 GPE's shareholders, as compared to its \$65.39 million in net income. This equates to a  
7 240% dividend payout ratio. For the most recent three quarters in 2016, GMO distributed  
8 \$92 million in dividends as compared to its \$69.19 million in net income. This equates to a  
9 133% payout ratio.

10 In contrast, KCPL did not pay any dividends in 2015 and paid \$77 million in  
11 dividends for the first three quarters in 2016, as compared to its net income of \$208.20  
12 million. This equates to a 37% payout ratio.

13 Q. What does the above shift in the burden of the proportion of dividends paid by  
14 each subsidiary demonstrate?

15 A. That GPE is financially managing its companies on a consolidated basis. GPE  
16 recognizes that it has been expending more capital at KCPL as compared to GMO, and there  
17 is a significant discrepancy in the two subsidiaries' capital structures. Because GPE must  
18 ensure that its consolidated capital structure consistently remains balanced, much more so  
19 than its subsidiary capital structures, Staff considers this to be the most market-tested and  
20 consequential capital structure for purposes of estimating the capital costs incurred by GPE's  
21 subsidiaries and the capital structure targeted to minimize GPE's overall cost of capital.

22 Q. Are you confident that you have covered all areas in which GPE's  
23 consolidated focus impacts KCPL's capital structure and/or capital costs?

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David Murray

1           A.     No.  Consequently, this is why I still recommend the Commission adopt  
2 GPE's consolidated capital structure and capital costs, to the extent that it produces a lower  
3 revenue requirement than using KCPL's capital structure and capital costs.  Considering the  
4 significant uncertainty as to how much lower KCPL's capital costs could have been absent its  
5 affiliation to GPE and its financial difficulties, Staff considers this to be a fair and objective  
6 recommendation, even if it doesn't reflect a potential lower cost of capital KCPL may have  
7 been able to achieve as a true stand-alone entity.

8           Q.     Mr. Bryant claims GMO's ratepayers would be subsidizing KCPL's  
9 ratepayers if KCPL's allowed ROR is based on GPE's capital structure and consolidated cost  
10 of debt.  What evidence does Mr. Bryant rely on for purposes of making this claim?

11          A.     Mr. Bryant is simply comparing the mechanical calculations of the debt issued  
12 by KCPL and the debt issued by GMO or on behalf of GMO by GPE.  As I explain above,  
13 this analysis simply lacks depth and understanding of the significant contributions KCPL  
14 ratepayers paid in excess of the traditional cost of service to attempt to preserve a 'BBB+'  
15 credit rating.  If it were not for the additional financial pressure GPE incurred with its  
16 acquisition of Aquila during the EARP, then it is highly unlikely that GPE would have been  
17 on the brink of having its credit ratings downgraded to junk status.  Although Staff  
18 recommended downward adjustments to the cost of the capital GPE had to issue maintain  
19 GPE's investment grade credit rating, the Commission allowed the full cost of this capital to  
20 be passed onto KCPL and GMO ratepayers.  While Staff is confident that but for GPE's  
21 decision to acquire GMO, KCPL's debt costs would have been lower due to the ratepayer  
22 support provided to KCPL's credit rating during the EARP; it would be fairly subjective to  
23 attempt to adjust the cost of each of KCPL's debt issuances subsequent to GPE's decision to

1 acquire GMO. However, an analysis and understanding of the history of GPE and its  
2 financial decisions supports Staff's position that if anything, KCPL's ratepayers subsidized  
3 GPE and its acquisition of GMO.

4 Q. Mr. Bryant indicates that using GPE's capital structure through the true-up  
5 period, December 31, 2016, will result in a disproportionate amount of equity in GPE's  
6 capital structure. Should the Commission use GPE's capital structure through December 31,  
7 2016?

8 A. No. Staff recommends KCPL's ROR be authorized based on GPE's capital  
9 structure through the updated test year, June 30, 2016. GPE's capital structure as of  
10 December 31, 2016, contains only a portion of the capital GPE plans to issue for purposes of  
11 its proposed acquisition of Westar. GPE plans to issue \$4.4 billion of debt to complete the  
12 acquisition of Westar. After all capital is issued if the transaction closes, GPE's expects its  
13 consolidated equity ratio will be approximately 41%.<sup>10</sup> However, these matters can be  
14 debated in future KCPL and/or GMO rate cases, since it is not necessary to true-up the  
15 capital structure in this case.

16 Q. Do you believe it is appropriate to eliminate GPE's preferred stock in light of  
17 your decision not to use true-up data for the capital structure?

18 A. Yes, because this capital has been permanently eliminated.

19 Q. Mr. Bryant disagrees with Staff's position that the Company double counted  
20 issuance expenses, discounts, and premiums when it used the yield-to-maturity ("YTM")  
21 method to calculate the cost of debt. However, he indicates that the Company agrees that  
22 either the YTM method or simple interest/amortization can be used. How do you respond?

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<sup>10</sup>Kevin E. Bryant's Direct Testimony in Case No. EE-2017-0113, p. 18

Surrebuttal Testimony of  
David Murray

1           A.     Because the Company is willing to accept the simple interest/amortization  
2 method, Staff recommends the Commission use the results from this method, which is 5.49%  
3 for KCPL on a stand-alone basis and 5.42% for GPE on a consolidated basis. However, if  
4 the Commission uses the YTM method, then it should accept Staff's calculation because it  
5 fixes the error made in the Company's calculations.

6     **SUMMARY AND CONCLUSIONS**

7           Q.     What are the key takeaways from your surrebuttal testimony?

8           A.     It is easy to identify separate debt costs if one assumes that debt issued by  
9 each subsidiary or on behalf of each subsidiary is based on each subsidiary's individual  
10 financial situation, but this fails to consider the more complex financial interaction of the  
11 subsidiaries with their parent companies. It is impossible to know at this point how KCPL's  
12 capital structure, debt issuances, and dividend payments would have been managed absent its  
13 affiliation with GPE. However, given that GPE has a fiduciary duty to manage its capital  
14 structure, debt issuances, and dividend payments to create the most value for GPE's  
15 shareholders, this capital structure is not hypothetical and is market-tested. It is the  
16 Company's burden to prove that KCPL's capital structure and capital costs are managed to  
17 their lowest cost absent its affiliation with GPE. Because GPE's capital structure and capital  
18 costs result in a lower ROR charged to KCPL's ratepayers, it is the fairer and more  
19 reasonable approach to set KCPL's allowed rate of return.

20          Q.     Does this conclude your surrebuttal testimony?

21          A.     Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

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

**AFFIDAVIT OF DAVID MURRAY**

STATE OF MISSOURI )  
 ) ss.  
COUNTY OF COLE )

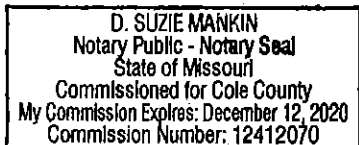
**COMES NOW DAVID MURRAY** and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony; and that the same is true and correct according to his best knowledge and belief.

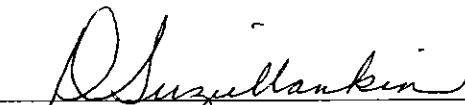
Further the Affiant sayeth not.

  
\_\_\_\_\_  
**DAVID MURRAY**

**JURAT**

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 27<sup>th</sup> day of January, 2017.



  
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Notary Public