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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

FINANCIAL ANALYSIS

REBUTTAL TESTIMONY

OF

JEFFREY SMITH

KANSAS CITY POWER & LIGHT COMPANY

CASE NO. ER-2018-0145

and

KCP&L GREATER MISSOURI OPERATIONS COMPANY

CASE NO. ER-2018-0146

Jefferson City, Missouri
July 2018

** Denotes Confidential Information **

TABLE OF CONTENTS

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EXECUTIVE SUMMARY.......... 2

SUMMARY OF MR. GORMAN'S AND MR. HEVERT'S COST OF EQUITY ESTIMATES.......... 2

CAPITAL MARKET UPDATE.......... 3

CAPITAL STRUCTURE.......... 5

EMBEDDED COST OF DEBT.......... 8

SUMMARY AND CONCLUSIONS.......... 9

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Q. Please state your name.

A. My name is Jeffrey Smith.

Q. Are you the same Jeffrey Smith who prepared the Rate of Return Section of the Staff's Cost of Service Report?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Robert B. Hevert (Mr. Hevert), and Michael P. Gorman (Mr. Gorman). Mr. Hevert sponsored rate-of-return ("ROR") testimony on behalf of Kansas City Power & Light Company, and KCP&L Greater Missouri Operations Company ("KCPL" and "GMO", respectively). Mr. Gorman sponsored ROR testimony on behalf of The Midwest Energy Consumers Group ("MECG"). I will address the issues related to a fair and reasonable capital structure and allowed ROR to be applied to KCPL's and GMO's electric utility rate base for ratemaking purposes in this proceeding.

EXECUTIVE SUMMARY

Q. What are the fundamental disagreements you have with Mr. Gorman's and Mr. Hevert's testimony?

A. I have fundamental disagreements with each of the witnesses' recommended capital structures, as well as their recommended embedded costs of debt for KCPL. I also disagree with Mr. Gorman's recommended cost of debt for GMO. Each of these issues is expanded upon within its respective section of this testimony. Although I have fundamental disagreements with the inputs and results of each witness's cost of equity ("COE") analyses, their recommended ROEs are within the range of reasonableness; therefore, I will not expand on those fundamental disagreements.

Q. Have events in the capital markets the past two months caused a change in the utility industries' cost of capital?

A. No. Broader markets have maintained earnings momentum against the backdrop of international trade disputes. Although trade issues have added to uncertainty and volatility in the markets, they have had a minor impact on the cost of capital. Increased volatility has helped utility stocks perform well, marginally increasing their valuation levels. Although this could imply a marginal decrease in the cost of equity, increases in utility bond yields imply an increase in capital costs. I will provide a brief update on the capital markets later in this testimony.

SUMMARY OF MR. GORMAN'S AND MR. HEVERT'S COST OF EQUITY ESTIMATES

Q. Please summarize Mr. Gorman's estimated COE and resulting recommended allowed ROE.

A. Mr. Gorman's recommended allowed ROE is 9.30%, which is the midpoint of his estimated COE range of 9.10% to 9.50%. Mr. Gorman's COE methodologies included a Discounted Cash Flow ("DCF") model, a Multi-Stage DCF, a Sustainable Growth DCF, a Risk Premium Approach, and a Capital Asset Pricing Model ("CAPM"). Mr. Gorman bases the low end of his range on his DCF and CAPM results, and bases the high end of his range on his risk premium results. Mr. Gorman notes that his recommendation "must be inherently reasonable" because it is the ROE agreed to in the comprehensive settlement of the GPE/Westar merger in Kansas.[1]

Q. Please summarize Mr. Hevert's estimated COE and the resulting ROE recommendation.

A. Mr. Hevert's recommended ROE is 9.85%, which is the low end of his range of COE estimates of 9.75% to 10.50%. Mr. Hevert's COE methodologies included a Constant Growth DCF, a Multi-Stage DCF, a CAPM, and a Bond Yield Plus Risk Premium Approach. Mr. Hevert does not state the basis of the low or high end of his range. However, he does state that he gives more consideration to his CAPM and Risk Premium approaches.[2] Mr. Hevert notes that, in his opinion, his recommendation is a conservative estimate of the companies' COE, but that he has taken into consideration this Commission's recent decisions.[3]

CAPITAL MARKET UPDATE

Q. Have there been significant capital market issues in the past two-months?

[1] Gorman, Direct Testimony, p. 5, ll. 8-9.

[2] Hevert, Direct Testimony, p. 62, ll. 3-7.

[3] *Ibid*, p. 5, ll. 3-7.

A. No. However, on June 13, 2018, the U.S. Federal Reserve Open Market Committee raised the Federal Funds Rate from 1.50% - 1.75% to 1.75% - 2.00% as had been anticipated.

Q. How have regulated utility stocks performed during the past two-months?

A. Similar to the broader markets, although slightly lagging. The average total return for the electric utility proxy group ("electric proxy") and the S&P 500, from the beginning of May to the end of June, were 1.18% and 2.78%, respectively. This compares to average total returns for the first four months of 2018 of -0.76% and -1.20%, respectively. Average dividend yields for the electric proxy group, from the beginning of May to the end of June, increased 2 basis points, to 3.44% from 3.42%, compared to the first four months of 2018. From the beginning of May to the end of June, Average Price to Last Twelve Month Earnings ("P/E") ratios for the electric proxy increased to 19.98x, compared to the average P/E ratio of 19.61x for the first four months of 2018.[4]

Q. How have utility bonds performed in the past two-months?

A. Average utility bond yields have increased approximately 24 basis points, since Staff filed its Cost of Service Report.[5]

Q. Have events in the capital markets since Staff filed Direct Testimony changed Staff's recommendation?

A. No.

[4] SNL Financial.

[5] Mergent Bond Record.

CAPITAL STRUCTURE

Q. Do the parties agree on the appropriate capital structure for purposes of determining a fair and reasonable allowed ROR to apply to KCPL's rate base?

A. No. Although Mr. Gorman and Mr. Hevert agree on KCPL's capital structure, based on a *pro forma* estimate of KCPL's per books subsidiary capital structure as of June 30, 2018, Staff relied on the actual March 31, 2018, capital structure based on Great Plains Energy's ("GPE") 10Q for its proposed capital structure. KCPL anticipates that Balance Sheet information to June 31, 2018 will be available August 21, 2018. Staff will update its recommended capital structure for KCPL in Surrebuttal Testimony to reflect updated information and KCPL's actual capital structure as of June 31, 2018.

Q. Do the parties agree on the appropriate capital structure for purposes of determining a fair and reasonable allowed ROR to apply to GMO's rate base?

A. No. Mr. Hevert's recommendation does not exclude goodwill from GMO's capital structure, causing a higher than reasonable common equity ratio, excessively burdening ratepayers. Although Mr. Gorman removes approximately $169 million of goodwill from GMO's capital structure, he removes the amount of goodwill reflected on GPE's balance sheet, not the amount reflected on GMO's balance sheet. GMO's balance sheet reflects ** __________ ** of goodwill. Mr. Gorman's failure to remove the correct amount of goodwill from GMO's balance sheet results in a higher than reasonable common equity ratio, excessively burdening ratepayers.

Q. Has the Commission ever ruled on whether or how much goodwill should be removed from GMO's capital structure?

A. Yes. In the Report and Order of the Great Plains Energy/Westar Energy merger case, Case No. EM-2018-0012, the Commission noted the key points of financing conditions in the January 12, 2018 non-unanimous stipulation and agreement, specifically, that goodwill shall not be included in the revenue requirement of KCPL or GMO.[6]

Q. Why is it important to remove goodwill from the capital structure?

A. From a regulatory perspective, it is important to remove goodwill from the capital structure because it protects ratepayers from having to pay higher rates because of changes to utility ownership. Ratepayers will be forced to unreasonably pay higher rates if the goodwill balance from GMO's balance sheet is not removed because goodwill arbitrarily inflates the value of assets on a company's balance sheet, distorting the value of equity in its capital structure, leading to a capital structure unequally weighted with a higher cost of capital component, resulting in a higher revenue requirement.

Q. How does the CFA Institute characterize goodwill?

A. The Chartered Financial Analyst curriculum states:

> When one company acquires another, the purchase price is allocated to all the identifiable assets (tangible and intangible) and liabilities acquired, based on fair value. If the purchase price is greater than the acquirer's interest in the fair value of the identifiable assets and liabilities acquired, the excess is described as goodwill and is recognized as an asset… The subject of recognizing goodwill in financial statements has found both proponents and opponents among professionals. The proponents of goodwill recognition assert that goodwill is the present value of excess returns that a company is able to earn. This group claims that determining the present value of these excess returns is analogous to determining the present value of future cash flows associated with other assets and projects. Opponents of goodwill recognition claim that the prices paid for acquisitions often turn out to be based on unrealistic expectations, thereby leading to future write-offs of goodwill… The recognition

[6] ***In the Matter of the Application of Great Plains Energy Incorporated for Approval of its Merger with Westar Energy, Inc.*** Case No. EM-2018-0012, (***Report and Order***, issued May 24, 2018) at p. 13.

> and impairment of goodwill can significantly affect the comparability of financial statements between companies. Therefore, analysts often adjust the companies' financial statements by removing the impact of goodwill. Such adjustments include: excluding goodwill from balance sheet data used to compute financial ratios, and excluding goodwill impairment losses from income data used to examine operating trends.[7]

Q. ** **

A. ** [8] .[9] **

Q. ** **

A. **

[7] Henry, E., Robinson, T., *Understanding Balance Sheets*, FINANCIAL REPORTING AND ANALYSIS, Reading 25, CFA Program Curriculum, Level I, Volume 3, 2017, p. 233-235.

[8] SEC Form 8-K/A, Filing Date 2008-08-14, Document ex99-3.htm, GPE FINANCIALS 12/31/07 AND 3/31/08, https://www.sec.gov/Archives/edgar/data/54476/000114306808000062/ex99-3 htm at p. 16.

[9] Case Number EM-2000-292 (Second Report and Order), ***In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions,*** 12 Mo.P.S.C.3d 388, p. 389 (2004), effective March 7, 2004.

_____________________________________ — ____
____
____
____[10] **

<u>EMBEDDED COST OF DEBT</u>

Q. What embedded costs of debt are proposed by Mr. Gorman and Mr. Hevert?

A. Mr. Gorman does not state his recommended cost of debt for KCPL. For GMO, Mr. Gorman recommends a cost of debt of 4.79%, based on his calculations of hypothetical refinancing cost for affiliate loans payable to GPE. Mr. Hevert recommends a cost of debt of ** _____ ** for both KCPL and GMO.

Q. Do you agree with Mr. Gorman's proposed cost of debt for GMO?

A. No. Mr. Gorman's proposal is not based on known and measurable costs. I recommend the Commission adopt my updated cost of debt, updated to May 31, 2018, reflecting GMO's actual cost of debt of ** _____ . **

Q. Do you agree with Mr. Hevert's cost of debt recommendation for KCPL and GMO?

A. I agree with Mr. Hevert's proposed cost of debt for GMO. However, I do not agree with Mr. Hevert that the cost of debt for KCPL is the same as that of GMO. Although Mr. Hevert chose two separate and distinct capital structures for each company, he failed to consider differences in their costs of debt, ascribing GMO's higher cost of debt of ** _____ ** to both companies. KCPL's actual cost of debt, updated to May 31, 2018, is ** _____ . **

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[10] ** ____
____________________ **

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your rebuttal testimony.

A. Mr. Hevert's and Mr. Gorman's recommended ROEs of 9.85% and 9.30%, respectively, are within the range of what Staff considers fair and reasonable, considering the Commission's recent ROE decision in the Spire rate cases.

The Commission should reject both Mr. Hevert's and Mr. Gorman's recommended capital structures for KCPL because they were based on KCPL's *pro forma* estimated capital structure. Actual capital structure data is available as of March 31, 2018. Staff will update its capital structure recommendation for KCPL in Surrebuttal Testimony to reflect actual capital structure data to June 31, 2018. The Commission should reject Mr. Hevert's and Mr. Gorman's recommended capital structures for GMO because they do not consider the full effects of goodwill on customers or GMO, and allow GMO excess returns.

The Commission should disregard Mr. Gorman's adjusted cost of debt for GMO because it is not known and measurable. Instead, the Commission should set GMO's cost of debt at its actual cost, ** _____. ** The Commission should disregard Mr. Hevert's recommended ** _____ ** cost of debt for KCPL. Instead the Commission should set KCPL's cost of debt at its actual cost, ** _____. **

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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-2018-0145
		and
In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement a General Rate Increase for Electric Service	))))	Case No. ER-2018-0146

AFFIDAVIT OF JEFFREY SMITH

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

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

Further the Affiant sayeth not.

Jeffy Smith

JEFFREY SMITH

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 25th day of July 2018.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2020
Commission Number: 12412070

D Suzie Mankin

Notary Public