Exhibit No.:	
Issue:	*Rate of Return*
Witness:	*Jeffrey Smith*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case Nos.:	*ER-2018-0145 and ER-2018-0146*
Date Testimony Prepared:	*September 4, 2018*

MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

FINANCIAL ANALYSIS DEPARTMENT

SURREBUTTAL 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
September 2018

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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, and Rebuttal Testimony in this case?

A. Yes, I am.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to Robert B. Hevert's, Michael P. Gorman's, Darrin R. Ives's, and Robert E. Schallenberg's rebuttal testimonies, and to true-up my capital structure recommendations and corresponding embedded costs. All witnesses sponsored rate-of-return ("ROR") testimony. Mr. Hevert and Mr. Ives sponsored testimony on behalf of Kansas City Power & Light and KCP&L Greater Missouri Operations ("KCPL" and "GMO," respectively). Mr. Gorman sponsored testimony on behalf of Midwest Energy Consumers Group ("MECG"). Mr. Schallenberg sponsored testimony on behalf of the Office of the Public Counsel ("OPC"). Mr. Hevert's and Mr. Gorman's rebuttal testimonies primarily focused on a fair and reasonable allowed return on equity ("ROE"). Mr. Ives's and Mr. Schallenberg's rebuttal testimonies are related to GMO's capital structure.

EXECUTIVE SUMMARY

Q. What are Mr. Hevert's primary disagreements with your ROR testimony?

A. Mr. Hevert's disagreements with my ROR testimony are related to the inputs I used in my cost of equity ("COE") estimation models, the resultant outputs of those models, and the low end of my recommended ROE range, which he believes to be unreasonable. Mr. Hevert notes that although he does "not entirely agree with [my] application of certain models, our recommended ranges do overlap," and that my "point estimate of 9.85 percent is equal to the Company's proposed ROE."[1] Although Mr. Hevert also disagrees with my recommended capital structure, he defers to Mr. Ives's; therefore, I will address their concerns in my response to Mr. Ives's capital structure contentions.

Q. What are Mr. Gorman's primary disagreements with your ROR testimony?

A. Mr. Gorman's primary concerns with my ROR testimony revolve around policy issues and economic factors. Mr. Gorman reviewed evidence from Great Plains Energy's ("GPE") merger case, as well as KCPL's last rate case to compare and contrast evidence presented in those cases to the evidence present in these cases. Mr. Gorman asserts that my ROE recommendation is unreasonable because it precludes ratepayers from receiving benefits agreed to in the GPE merger case, and because he does not believe that the evolution of economic and capital market conditions since KCPL's last rate case justify allowing an ROE higher than the 9.50% previously allowed KCPL.

Q. What is Mr. Ives's disagreement with your ROR testimony?

A. Mr. Ives's addresses my recommended capital structure for GMO. Mr. Ives's disagrees with the amount of goodwill I recommend removing from GMO's capital structure. Mr. Ives does not agree with my recommendation to remove $351.6 million of "Goodwill that

[1] Hevert Rebuttal Testimony, p. 9, ll. 4-7.

is booked on GMO's legal entity stand-alone financial statements." Instead, he recommends removing $168.97 million of "Goodwill that is reported in Great Plains Energy's consolidated financial statements."[2]

Q. What is Mr. Schallenberg's disagreement with your ROR testimony?

A. Mr. Schallenberg addresses my recommended capital structure for GMO. Mr. Schallenberg disagrees with the amount of short-term debt, or lack thereof, in my recommended capital structure. Mr. Schallenberg recommends including short-term debt in GMO's capital structure. My recommended capital structure does not include short-term debt.

Q. Does Staff recommend updating the capital structure and embedded costs of capital through the true-up period?

A. Yes. Evergy (formerly GPE) has provided KCPL's and GMO's financial information through June 30, 2018, allowing Staff to update its capital structure and embedded costs of capital inputs.

RESPONSE TO MR. HEVERT'S REBUTTAL TESTIMONY

Q. Is Mr. Hevert's critique of your ROR testimony warranted?

A. No. Having acknowledged that our ranges overlap and that my point estimate is equal to the Company's proposed ROE, Mr. Hevert's contentions stray from the "end result" doctrine established in Federal Power Commission et. al. v. Hope Natural Gas Company (320 U.S. 591), which states that, "how the rate of return and rate base are determined are not important as long as the end result is reasonable."[3] Mr. Hevert's reservations with my analysis arise from his belief that the low end of my recommended ROE

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[2] Ives Rebuttal Testimony, p. 16, ll. 11-13.
[3] Parcell, D., The cost of capital – A practitioner's guide, p.30, (2010), SURFA.

range of 9.00% – 10.00% is too low and unreasonable.[4] To adhere to the "end result" doctrine and limit needless testimony, I will refrain from commenting on Mr. Hevert's critiques about how the low end of my recommended ROE range was determined. Instead, I will highlight the reasonableness of the low end of my ROE range.

Information provided by KCPL in its most recent nuclear decommissioning trust fund case, Case No. EO-2018-0062, shows that the Company's expected return for its decommissioning trust and pension funds range from 8.51% for large capitalized equities to 8.78% for small capitalized equities.[5] My recommendation appears reasonable and adequate to attract capital in light of the fact that the low end of my range, 9.00% is above what the Company has stated are reasonable return expectations for its investments. A look at Regulatory Research Associates ("RRA") data further accentuates the reasonableness of the low end of my range. In the three years ending August 31, 2018, more ROEs for vertically integrated electric utilities were authorized below 9.75% than above 9.75%, approximately 56% compared to 44%, respectively.

<u>RESPONSE TO MR. GORMAN'S REBUTTAL TESTIMONY</u>

Q. How do you respond to Mr. Gorman's rebuttal critiques of your ROE recommendation?

A. The policy critiques offered by Mr. Gorman fail to consider the dynamics of continued investment. Mr. Gorman references several paragraphs from the Final Order of the GPE/Westar Merger Case, Case No. EM-2018-0012, to contend that allowing the company a 9.85% ROE is bad policy because it negates the benefits of the merger:

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[4] Mr. Hevert's stated range for a reasonable allowed ROE is from 9.75% - 10.50%.
[5] Evergy, KCPL's and GMO's parent company is considered a medium capitalized firm.

- The merger will create a stronger combined company with more customers, more diversification, no transaction-related merger debt, and the prospects for higher earnings growth rates for both GPE and Westar."
- The merger will provide "an opportunity to reduce the upward pressure on customers' rates from increasing cost and exacerbated by flat or declining customer usage."
- The merger has "the opportunity to create merger-related savings of $28 million in 2018, and increasing to $160 million for years 2022 and beyond."
- Merger "Applicants pledged to make merger-related credits to Missouri customers in the amount of $14.9 million to KCPL customers, and $14.2 million to GMO customers."
- "[T]he merger would serve to reduce cost of service and delay rate increases to retail customers."[6]

Mr. Gorman concludes that Staff's recommendation to increase the return on equity will have the effect of reversing customer benefits achieved in the merger agreement.

Mr. Gorman's critique implies mutual exclusivity: that merger related savings can only be realized if rates or the allowed ROE are lower. This analysis fails to consider incremental effects of investment on rate base. For example, comparing GMO's rate base in its last rate case, Case No. ER-2016-0156, to GMO's rate base in the current case reveals that GMO's rate base has increased by approximately $522 million.[7] Using Mr. Gorman's suggested capital structure and ROE shows that, absent merger related savings, these investments require approximately $37 million of additional revenue requirement.[8] Allocating half of the $28 million of merger related savings to GMO and giving consideration to $14.2 million in credits to customers, the increased investment still requires approximately $9 million of additional revenue requirement. This accounting shows the positive effects of

[6] Gorman Rebuttal, p. 5, ll. 1–22.
[7] The amount of rate base presented in Staff's Direct Accounting Schedules in GMO's last rate case was $1,376,903,949, compared to $1,898,690,342 presented in Staff's Accounting Schedules for the current case.
[8] Mr. Gorman's Direct Testimony recommended a 9.30% COE and a 4.79% cost of debt, applied to a capital structure consisting of 50.9% equity and 49.1% debt, resulting in a ROR of 7.09%.

merger related savings in the face of investment, highlighting that upward pressure on the cost of service and rates would be greater without merger related savings.

Mr. Gorman attempts to buttress his position that the COE has not increased since KCPL's and GMO's last rate cases by pointing to the COE results of Staff's DCF analysis in KCPL's last rate case, comparing it to the COE results of Staff's current analysis, and concluding that because Staff's COE results then were lower than Staff's current calculations, that the COE has gone down. Mr. Gorman's comparison is invalid because it compares different witnesses' testimony. Staff hired consultant Randall J. Woolridge to provide Cost of Capital analysis in KCPL's last rate case. Comparing Staff's current analysis to that of Mr. Woolridge's is not an apple to apple comparison, and is no different than comparing my analysis to his own. This measure of comparison has the same effect as changing the makeup of the proxy group, or changing the growth rates used in the estimation parameters, among other possible permutations.

As other evidence to stress that the COE has not increased, Mr. Gorman also provides figures from Regulatory Research Associates ("RRA") for average authorized ROE's for 2016, 2017, and the first half of 2018. Portending a downward trend, Mr. Gorman states that Staff's ROE recommendation "is in diametric opposition to the trend in authorized returns on equity for electric utility companies."[9] However, close scrutiny of Mr. Gorman's testimony reveals that the average authorized ROE for electric utilities was 9.60% in 2016,[10] and 9.68% in 2017,[11] discrediting Mr. Gorman's downward trend assessment. Although Mr. Gorman showed that the average authorized ROE for electric utilities for the first half of 2018 was

[9] Gorman Rebuttal, p. 9, ll. 15–16.
[10] *Id.* p. 8, ll. 18.
[11] *Id.* p. 9, ll. 11–12.

9.58%,[12] updated data show that the average authorized ROE for vertically integrated utilities has increased to 9.72%. The chart below shows the average authorized ROE and authorized equity ratio for vertically integrated electric utilities for 2018 through the end of August.

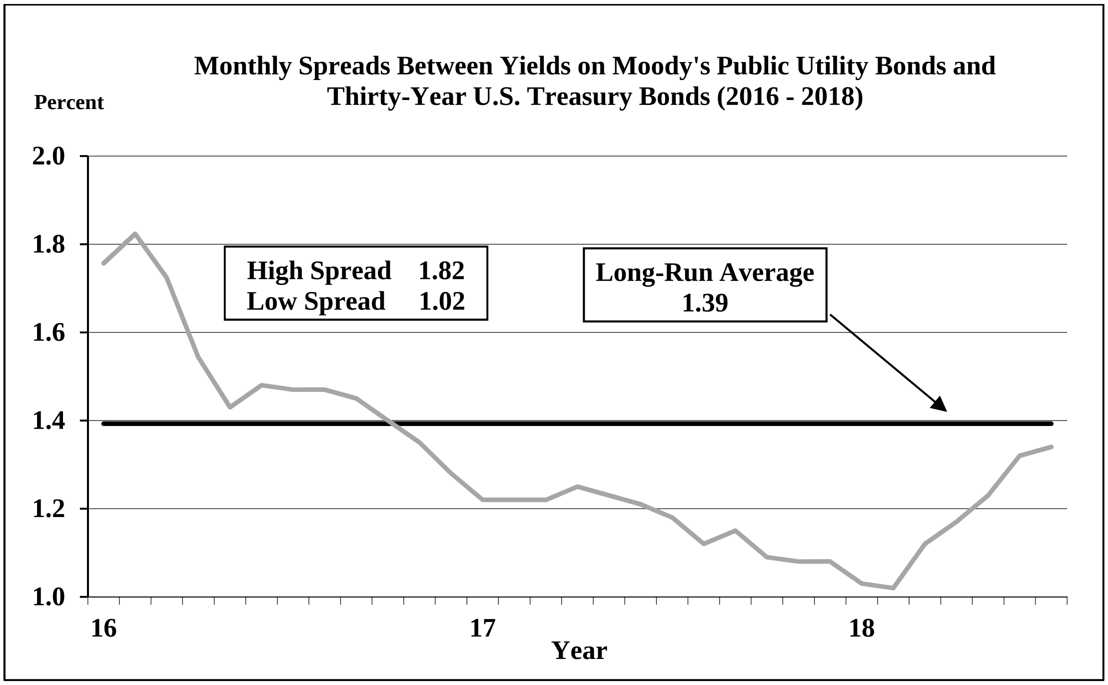
Authorized ROE and Equity Ratio for Vertically Integrated Electric Utilities

January 1, 2018 to August 31, 2018	All cases	Fully Litigated Cases
Number of Cases	17	8
Average Authorized ROE	9.72%	9.67%
Average Authorized Equity Ratio	47.03%	44.88%

Source: Regulatory Research Associates

Mr. Gorman also comments on capital market data to indicate that utility security costs have not increased significantly since KCPL / GMO's last rate case. Mr. Gorman notes that "[w]hile short-term interest rates have been moving up, long-term interest rates have not,"[13] and that shrinking spreads between utility bond yields and Treasury bond yields indicate the "market's appetite for higher risk securities."[14] However, markets are not evolving as Mr. Gorman supposes. Although spreads between public utility bonds and long-term Treasuries had been falling since 2016, they changed course and have been expanding since February 2018, as the chart below shows.

[12] *Id*. p. 9, ll. 10.
[13] *Id.* p. 11, ll. 12–13.
[14] *Id.* p. 11, ll. 18–20.



Although spreads between short and long-term Treasuries are likely to continue shrinking in the short-term, it is unlikely that spreads between utility bonds and Treasuries will display similar behavior because of increasing borrowing costs and a reversion toward the mean of 1.39%.

Contrary to Mr. Gorman's statement that "[w]hile Treasury yields have been increasing, long-term interest rates for utility bonds have remained fairly stable over the last few years," data for 2018 show increasing interest rates in utility bonds. From the beginning of January to the end of July, average yields on A-rated utility bonds and BBB-rated utility bonds increased by 41 basis points and 49 basis points, respectively. During the same time period, the average spread between A-rated and BBB-rated utility bonds was 39 basis points. Considering savings from lower borrowing costs associated with a better credit rating,[15] increases in interest rates appear to have outweighed those savings during the first half of 2018.

[15] KCPL's and GMO's credit rating was upgraded from BBB+ to A- by S&P after the GPE/Westar merger.

RESPONSE TO MR. IVES'S REBUTTAL TESTIMONY

Q. How do you respond to the section of Mr. Ives's Rebuttal Testimony disagreeing with your recommendation to remove $351.6 million of goodwill reported at the GMO stand-alone entity; and instead, recommending removal of $168.97 million of goodwill reported in GPE's consolidated financial statements?

A. I agree with Mr. Ives's description of why there is a difference in the amount of goodwill between the stand-alone GMO legal entity and the GPE consolidated entity. The difference is the amount of net operating loss carryforwards ("NOL") that GMO is expected to realize from its revenues compared to the amount that GPE is expected to realize from its revenues. I also agree that the NOLs are a result of Aquila's nonregulated losses prior to the merger.

I do not agree with Mr. Ives's dichotomy, that because the NOLs were a result of "the transactions of the historical nonregulated ventures of Aquila" and that because they are "not included in the consolidated financial statement" that they "should be excluded."[16] During the GPE/Aquila merger, GPE's subsidiary, Gregory Acquisition Corporation, merged with Aquila, leading to Aquila becoming a wholly-owned subsidiary of GPE and being renamed GMO. The NOLs in question were part and parcel of the merger transaction. Calculations at the time of the merger estimated that on a stand-alone basis GMO's income would be insufficient to take advantage of all the NOLs; however, because GPE files income taxes on a consolidated basis it was determined that GPE would be able to take advantage of the NOLs, therein lay the difference in goodwill between GMO stand-alone and GPE consolidated, approximately $183 million of goodwill.[17] To say that the transactions of the historical

[16] Ives Rebuttal, p. 17, ll. 14–17.
[17] Response to Data Request 0418.1 in 2016 GMO Rate Case, Case No. ER-2016-0156.

nonregulated ventures of Aquila are not included in the consolidated financial statements obfuscates the issue and is a moot point. They are in fact included in the consolidated financial statements. However, they are not reflected in goodwill because they are utilized at the consolidated level, and are instead reflected in deferred income taxes.[18]

The fact that all parties recommend using operating company capital structures is, a fortiori, reason to use the goodwill reflected on the operating company's balance sheet. Apart from the implication discussed above, if GMO retains the $183 million of goodwill in its capital structure, as Mr. Ives's suggests, GMO ratepayers will be unduly burdened because the benefits of NOLs accrue to shareholders; effectively, ratepayers would be forced to provide more income to GMO in rates because of a goodwill asset that GMO's parent company already takes advantage of, by retaining more of its earnings in lieu of paying taxes. The realization of excess profits by GMO's shareholder through machination of assets distinct in each entity's financial statements is unfair and unreasonable to ratepayers, and does not serve the public interest, because said assets are not involved in the provision of safe and reliable service.

Q. Can you compare GMO's capital structure when the amount of goodwill on GMO's balance sheet is removed compared to when the amount of goodwill on GPE's balance sheet is removed, as of the true-up date?

A. The table below displays the effects of removing GMO's goodwill compared to removing GPE's goodwill from GMO's updated capital structure.

[18] *Id.*

Using GMO Financial Statement Goodwill

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.30%**	**9.85%**
Common Stock Equity	47.43%		4.41%	4.67%
Long-Term Debt	52.57%	5.06%	2.66%	2.66%
Total	**100.00%**		**7.07%**	**7.33%**

Using GPE Financial Statement Goodwill

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.30%**	**9.85%**
Common Stock Equity	51.73%		4.81%	5.10%
Long-Term Debt	48.27%	5.06%	2.44%	2.44%
Total	**100.00%**		**7.25%**	**7.54%**

RESPONSE TO MR. SCHALLENBERG'S REBUTTAL TESTIMONY

Q. Can you respond to Mr. Schallenberg's proposal to include short-term debt in GMO's capital structure?

A. Mr. Schallenberg's proposal to include short-term debt in GMO's capital structure appears reasonable when considering the recent past. I am aware that GMO's short-term debt has recently exceeded construction work in progress and I agree with Mr. Schallenberg's assessment of how the two variables interact. However, I reviewed several rate case cycles when forming my recommendation, and determined that GMO's use of short-term debt to support rate base had not been persistent. I maintain my initial recommendation, but note that a company's persistent use of short-term debt to support rate base would warrant short-term debt being included in a company's capital structure.

Q. How would the inclusion of short-term debt affect GMO's capital structure?

A. The table below displays the effects of including short-term debt in GMO's updated capital structure using Mr. Schallenberg's suggested calculations for the different goodwill scenarios discussed above.

Using GMO Financial Statement Goodwill

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.30%**	**9.85%**
Common Stock Equity	45.94%		4.27%	4.53%
Long-Term Debt	49.47%	5.06%	2.50%	2.50%
Short-Term Debt	4.59%	2.38%	0.11%	0.11%
Total	**100.00%**		**6.88%**	**7.14%**

Using GPE Financial Statement Goodwill

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.30%**	**9.85%**
Common Stock Equity	50.12%		4.66%	4.94%
Long-Term Debt	45.64%	5.06%	2.31%	2.31%
Short-Term Debt	4.24%	2.38%	0.10%	0.10%
Total	**100.00%**		**7.07%**	**7.35%**

TRUE-UP CAPITAL STRUCTURES AND EMBEDDED COSTS

Q. What are your true-up capital structures for KCPL and GMO?

A. The table below displays my recommended true-up capital structures and embedded costs for KCPL and GMO with updated information to June 30, 2018.

KCPL

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.85%**
Common Stock Equity	49.10%	9.85%	4.84%
Long-Term Debt	50.90%	4.93%	2.51%
Total	100.00%		**7.34%**

GMO

Capital Component	Percentage of Capital	Embedded Cost	Allowed Rate of Return Common Equity Return of: **9.85%**
Common Stock Equity	47.43%	9.85%	4.67%
Long-Term Debt	52.57%	5.06%	2.66%
Total	100.00%		**7.33%**

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your surrebuttal testimony.

A. Mr. Hevert and I disagree over what the appropriate lower bound for an allowed ROE should be. His belief that an appropriate lower bound is 9.75% conflicts with my recommendation of 9.00%. Evidence shows that Commissions have more frequently authorized returns below 9.75% than returns above 9.75%, and that 9.00 is within the zone of reasonableness when considering the average of those Commissions' decisions. The fact that KCPL and GMO expect returns of less than 9.00% for their own investments further highlights the reasonableness of the lower bound of my recommendation.

Mr. Gorman disagrees with the policy implications of my recommended allowed ROE, as well as my account of capital market conditions. Contrary to Mr. Gorman's statements that my recommended allowed ROE precludes customers from receiving merger benefits, evidence shows that customers' rates are not solely based on the ROE and that customers savings from the merger are not contingent on the ROE. Similarly, Mr. Gorman's contentions that security costs to utilities have remained stable are dispelled by evidence from debt markets showing that costs have increased.

Mr. Ives's stance against removing the amount of goodwill on GMO's balance sheet runs contrary to using a stand-alone capital structure and stand-alone embedded cost of debt. Evidence shows that the amount of goodwill on GMO's balance sheet is the appropriate amount to remove from its capital structure because it is the amount attributed to GMO as a stand-alone entity when taking into account the excess price paid for Aquila assets during the merger.

Mr. Schallenberg's recommendation to include short-term debt in GMO's capital structure is not misguided. However, Staff has not seen manipulation of short-term debt in GMO's records persistent enough to warrant its inclusion in the current capital structure recommendation.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of 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 *Surrebuttal Testimony* and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

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 31st day of August 2018.

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

Notary Public