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Issues:	*Rate of Return/Cost of Capital*
Witness:	*Matthew J. Barnes*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case Nos.:	*ER-2006-0314*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

MATTHEW J. BARNES

KANSAS CITY POWER AND LIGHT COMPANY

CASE NO. ER-2006-0314

Jefferson City, Missouri
October 2006

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Service to Begin the Implementation of Its Regulatory Plan.	))))	Case No. ER-2006-0314

AFFIDAVIT OF MATTHEW J. BARNES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Matthew J. Barnes, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 12 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Matthew J. Barnes

Subscribed and sworn to before me this 5th day of October 2006.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

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MATTHEW J. BARNES

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Q. Please state your name.

A. My name is Matthew J. Barnes.

Q. Are you the same Matthew J. Barnes who filed direct and rebuttal testimony in this proceeding for the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am.

Q. In your direct testimony, did you provide your expert opinion on what you considered to be a fair and reasonable rate-of-return on the Missouri jurisdictional electric utility rate base for Kansas City Power & Light (KCP&L or Company)?

A. Yes, I did.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Dr. Samuel C. Hadaway. Dr. Hadaway sponsored rate-of-return direct and rebuttal testimony on behalf of KCP&L.

EXECUTIVE SUMMARY

Q. Can you please identify the issues you will address in your surrebuttal testimony?

A. In rebuttal testimony, Dr. Hadaway addresses issues in my direct testimony ranging from the trends in interest rates to the Company's request for a 50 basis point increase in return on equity (ROE) due to KCP&L's construction risk.

I have addressed the following issues in my surrebuttal testimony:

1. ROE's authorized by this Commission and other states;
2. Trends in interest rates;
3. Capital structure;
4. Comparable group selection;
5. DCF growth rate analysis;
6. Inputs for the capital asset pricing model (CAPM);
7. KCP&L expected pension returns;
8. Company's request for a 50 basis point increase in ROE;
9. Kansas Corporation Commission's (KCC) ROE recommendation.

RESPONSE TO DR. HADAWAY'S REBUTTAL TESTIMONY

Q. Table 1 on page 4 of Dr. Hadaway's rebuttal testimony shows the average authorized ROE's for 2004, 2005 and the first and second quarter of 2006 of 10.75%, 10.54%, and 10.57% respectively and compares those averages to your recommendation. What is your response?

A. I believe the use of other states average authorized ROE's as a benchmark to measure the reasonableness of my recommended ROE should be approached with extreme caution. Staff has reviewed cases in other states in which the recommendations of the other states' Staff have been below what the Commission has authorized.

Q. On page 5, line 8 through page 6, line 8, of his rebuttal testimony, Dr. Hadaway provides his explanation for why he believes that interest rates in the past year are an "increasing trend". Have there been short-term periods of interest rate increases (at least one-year or more) during the past 25 years of generally downward-trending interest rates?

A. Yes. A review of Schedules 5-1 and 5-3 attached to my direct testimony shows that there have been three other short-term periods of interest rate increases of a year or more, within a longer general downward trend in interest rates. Public utility bond yields increased from 6.88 percent in September 1998 to 8.55 percent in May 2000, which is approximately a year and a half of interest rate increases. Public utility bond yields increased from 6.99 percent in October 1993 to 9.00 percent in November 1994, which is just a little over a year. Public utility bond yields increased from 13.00 percent in May 1983 to 15.16 percent in June 1984, which, again, is just a little over a year. Consequently, one can find short-term periods of interest rate increases in the past 25 years, but the stronger, more permanent trend, has been that of falling interest rates.

Q. On page 8, line 2 through line 3 of his rebuttal testimony, Dr. Hadaway says your "historical approach is not consistent with the Company's actual capital structure as of June 30, 2006, or with the projected capital structure for September 30, 2006 that the Company has requested." Do you have a response?

A. Yes. Because I received the June 30, 2006 information close to Staff's filing date, I used the test year December 31, 2005 capital structure. Staff consistently uses actual data to determine a company's capital structure and embedded cost of preferred stock and long-term debt. In my rebuttal testimony I updated my capital structure and embedded cost

of long-term debt to reflect the actual capital structure and embedded cost of long-term debt as of June 30, 2006.

Q. Please explain your updated capital structure and embedded costs.

A. As of June 30, 2006, KCP&L had a consolidated capital structure that consisted of 53.24 percent common equity, 1.54 percent preferred stock, and 45.22 percent long-term debt. I am still recommending a cost of common equity in the range of 9.32 percent to 9.42 percent with a mid-point of 9.37 percent. The embedded cost of preferred stock remained at 4.29 percent and the embedded cost of long-term debt was 6.08 percent. Now that I have updated my capital structure with the actual June 30, 2006 data, there should not be a material difference between the parties' capital structures.

Q. Was the Company aware that you were going to update your capital structure as of June 30, 2006 before you filed rebuttal testimony in this proceeding?

A. Yes. A settlement conference was held the week of August 28 through September 1, 2006 and Staff presented the updated capital structure to the Company during that time.

Q. Beginning on page 10, line 1 of his rebuttal testimony, Dr. Hadaway explains why he believes your comparable group of 5 electric companies is "problematic both in terms of statistical reliability and representativeness." What is your response?

A. First, Dr. Hadaway did not provide any statistical analysis to support his position. Regardless, I do not believe that his comparable group is a good sample of predominately regulated vertically-integrated electric utilities. Dr. Hadaway chose 24 companies as his sample group and still arrives at a single-stage constant growth DCF of 9.40, which is at the high end of my range of 9.32 percent to 9.42 percent. In this case, even

Dr. Hadaway's less representative proxy group supports a lower cost of common equity. Some of Dr. Hadaway's companies in his sample group have non-regulated operations and/or are diversified, which I believe are not truly comparable to KCP&L.

Q. Has it become more difficult to select pure play vertically-integrated electric utilities because of the restructuring of the electric utility industry in certain states and because of some electric utility companies' involvement in significant non-regulated operations?

A. Yes. This is why I chose to rely on S&P's CreditStats publication to choose companies that S&P classifies as vertically-integrated electric utilities.

Q. On page 12, lines 8 through 22 of his rebuttal testimony, Dr. Hadaway discusses some criticisms he has about your DCF growth rate analysis. How do you respond?

A. Dr. Hadaway criticizes my DCF growth rate analysis because I used Value Line's 3-5 year growth rate forecasts and IBES and Standard and Poor's 5-year forecasts. The reason I chose to use growth rate forecasts is because the historical growth rates have been somewhat volatile. If I chose to give some weight to the historical growth rates, my recommended growth would have been a rate lower than my recommendation of 4.70 percent to 4.80 percent, which I believe is optimistic for a mature regulated electric utility such as KCP&L.

Q. Dr. Hadaway claims that analysts' near-term earnings forecasts for utility companies have been lower in recent years and that the use of a nominal GDP growth rate is the appropriate rate to add to the dividend yield in the DCF model. How do you respond?

A. It would make sense that analysts' near-term earnings forecasts for mature, regulated utility companies are low because investors expect it to be low in the long-term. The organic growth for mature electric utilities is lower than the growth of the overall economy.

Q. What is organic growth?

A. According to www.investopedia.com organic growth is:

> The growth rate that a company can achieve by increasing output and enhancing sales. This excludes any profits or growth acquired from takeovers, acquisitions or mergers. Takeovers, acquisitions and mergers do not bring about profits generated within the company, and therefore, are not considered organic.

Q. Should one assume that a mature electric company will grow at the same rate as the economy as a whole?

A. No. To assume that a mature electric utility will grow at the same rate as the economy as a whole is an overstatement. Dr. Hadaway provides no evidence that investors expect a mature electric utility to grow 6.6 percent over the long-term. It appears that he is merely trying to inflate his ROE recommendation and the Commission should dismiss his growth rate and as a result, his recommended ROE.

Q. On page 13, lines 1 through 21 of his rebuttal testimony, Dr. Hadaway discusses some criticisms he has about your capital asset pricing model (CAPM) analysis. How do you respond?

A. I do not agree that a forecasted yield should be used to estimate the risk-free rate component of the CAPM. There have been many times in the last few years when there have been predictions that long-term interest rates may increase and this never happened. Because investors can easily observe current long-term risk-free interest rates and apply their current required equity risk premiums to these interest rates, using current yields allows for a

more reliable measure of the current cost of common equity. While it is possible that long-term interest rates may increase in the future, it is also possible that they will decrease. If KCP&L's cost of capital should increase dramatically because of an increase in long-term interest rates, then they can file a rate case and have all revenues and expenses of the Company reviewed at that time. In fact, the Experimental Regulatory Plan in Case No. EO-2005-0329, identifies four rate cases planned for KCP&L through the in-service of Iatan 2 in 2010, this case being the first one filed. It is expected that KCP&L will file its next rate case February 1, 2007.

Q. Are you aware of any discussions regarding the complexities of attempting to estimate future risk-free interest rates for use in the CAPM?

A. Yes. Dr. Roger A. Morin discussed these complexities in his book *Regulatory Finance Utilities' Cost of Capital*, 1994. The specific excerpt follows:

> Over the last 50 years, the Treasury bill rate has approximately equaled the annual inflation rate, as demonstrated in Fama (1975) and Ibbotson Associates (1993). Refined techniques to forecast inflation based on the current shape of the yield curve could thus be employed to obtain the expected risk-free rate.[5] Alternately, the consensus inflation forecast by economists over the requisite horizon could be employed to derive the risk-free rate estimate. However, none of these techniques is likely to provide superior estimates to that supplied by current yield data. The complexity and computational costs are likely to outweigh their marginal usefulness.

Q. Do you have any evidence to test the reasonableness of your recommended ROE and the unreasonableness of Dr. Hadaway's recommended ROE?

A. Yes. In response to Data Request 0229, Great Plains Energy provided projected returns for the Company's Pension Plans and Other Employee Benefits. The historical real equity (S&P 500) return was calculated to be in the range of 5.40 percent for 40 years and 7.10 percent for 80 years as compiled by Ibbotson Associates and referenced in

Ibbotson Associates Stocks, Bonds, Bills, and Inflation 2006 Yearbook Market Results for 1926-2005. The expected inflation rate of 3.0 percent to 3.5 percent is added to the historical real equity return to arrive at an estimated nominal return on equity for the Company's pension assets of 8.40 percent to 10.60 percent. My ROE range of 9.32 percent to 9.42 percent is in-between the estimated nominal equity return on the Company's pension assets. Dr. Hadaway's recommended ROE of 11.50 percent is higher than the returns projected for the broader stock market. Staff received this information in response to Staff Data Request 0229.

Q. Do you know what asset-class allocation is included in the Company's expected nominal equity return on their pension assets? As an example, is the S&P 500 included?

A. Yes. Ibbotson Associates' Large Company Stock Returns (S&P 500) is used as the benchmark for the estimated return on the Company's pension assets.

Q. Is a regulated utility company less risky than the S&P 500?

A. Yes. Regulated utility companies tend to be less risky than the S&P 500. The S&P 500 represents the market as a whole that include different business sectors, many of which are not granted monopoly powers that utility companies enjoy.

Additionally, betas of publicly traded stock represent the amount of market risk that investors associate with the company underlying the stock. If the beta of a company is below one, then it is considered to have less market risk than the overall market, such as the S&P 500. Consequently, if this is the case, then one would not expect a higher return for the less risky stock of a utility company. As shown on Schedule 18 attached to my direct testimony, my comparable group has an average beta of 0.81, which is below one.

Considering the above, my ROE recommendation of 9.32 percent to 9.42 percent is much more reasonable when compared to the pension plan consultant's estimate of market returns for the plan assets. It certainly is more reasonable than Dr. Hadaway's ROE recommendation of 11.50 percent.

Q. On page 14 lines 5 through 17, of his rebuttal testimony, Dr. Hadaway discusses why you should have included a 50 basis point adjustment in your ROE to compensate the Company for its construction risk. What is your response?

A. I do not believe an increase of 50 basis points should be added to my ROE because KCP&L faces construction risk relative to my or Dr. Hadaway's comparable group. KCP&L entered a Stipulation and Agreement in Case No. EO-2005-0329, for an Experimental Regulatory Plan which was approved by the Commission that provides for additional amortization to meet certain credit ratios to allow the opportunity to keep the Company's credit rating investment grade. Without the possibility of additional amortization to meet the credit ratios, it is possible that credit rating agencies would lower KCP&L's credit rating during the construction phase. The Experimental Regulatory Plan was meant to reduce the risk the Company may face during the construction phase. Adding an additional 50 basis points to ROE because of construction risk calls into question the need for the Experimental Regulatory Plan.

Q. Does Dr. Hadaway mention in his direct or rebuttal testimony anything about the Experimental Regulatory Plan or the amortization that may be allowed to meet credit ratios to allow the opportunity to keep the Company's credit rating investment grade?

A. No. Dr. Hadaway is silent about the regulatory plan in his direct and rebuttal testimony.

Q. On page 4 lines 8 through 11 of his rebuttal testimony, Dr. Hadaway says, "More recently, on August 18, 2006, the Staff of the Kansas Corporation Commission recommended an ROE of 10.55 percent for KCPL (Docket 06-KCPE-828-RTS, Pre-filed Direct Testimony of Adam H. Gatewood)." What is your response to Dr. Hadaway's statement?

A. Mr. Gatewood has significantly increased his ROE recommendation for KCP&L compared to his previous recommendations in the Kansas Corporation Commission's (KCC) last Aquila and Westar case.

Q. What ROE did Mr. Gatewood recommend in the KCC's last Aquila electric rate case, Docket No. 04-AQLE-1065-RTS?

A. Mr. Gatewood recommended an ROE in the range of 9.35 percent to 10.00 percent with a final recommendation of 9.50 percent giving the most weight to the DCF model and using the Capital Asset Pricing Model (CAPM) as a check of reasonableness.

Q. What ROE did Mr. Gatewood recommend in the KCC's last Westar rate case, Docket No. 05-WSEE-981-RTS?

A. Mr. Gatewood recommended an ROE in the range of 9.60 percent to 10.60 percent using an average of his DCF and CAPM results. Mr. Gatewood's final recommendation was 9.60 percent. It is not clear in his Westar direct testimony why he changed his methodology to use an average of his DCF and CAPM results while he strictly relied on the DCF model in the Aquila case Docket No. 04-AQLE-1065-RTS.

Q. What ROE did Mr. Gatewood recommend in the KCC's current KCP&L rate case, Docket No. 06-KCPE-828-RTS?

A. Mr. Gatewood recommended an ROE in the range of 10.05 percent to 11.05 percent with a mid-point of 10.55 percent. Again it is not clear why he uses the average of his DCF and CAPM model, when in the Aquila case Docket No. 04-AQLE-1065-RTS he strictly relies on his DCF result.

Q. What are the differences in Mr. Gatewood's CAPM recommendations between the Aquila, Westar, and KCP&L cases?

A. Mr. Gatewood's CAPM results for Aquila, Westar and KCP&L are 8.24 percent, 9.63 percent, and 12.30 percent respectively. The difference between the Aquila case and the KCP&L case is 406 basis points or 4.06 percent higher in the last two years.

Q. Why do you think Mr. Gatewood's CAPM results have increased so much?

A. Mr. Gatewood uses a volatile input for his CAPM model. Mr. Gatewood uses a 90-day Treasury Bill as the risk-free rate component. He also uses the arithmetic average return from large company stocks minus U.S. Treasury bills as his risk premium. Staff does not believe that the change in the cost of common equity is as volatile as Mr. Gatewood's CAPM analysis attempts to demonstrate. If Mr. Gatewood had used long-term treasury bonds as an input in his CAPM, his estimated cost of common equity would not have changed so much over the previously mentioned rate cases.

Q. Please provide a simple example to illustrate why you don't believe investors use arithmetic means when determining the amount of risk premium they will require on a given stock or a portfolio of stocks.

A. Suppose that an investor makes a $1 stock investment over a three-year period. If an investor pays $1 for a stock in year 1 and in year 2 the stock increases to $1.50,

then the investor would have a 50 percent growth rate. In year three the price of the stock decreases by 50 percent to $.75. If an investor performed a simple arithmetic average of these two returns, then they would think that they received 0 percent [(50 percent + -50 percent)/2] growth in their investment over the three-year period. However, in reality the investor actually had a 25 percent decline in their investment over this three-year period. This is why using the arithmetic mean is questionable.

Q. Do you believe that Mr. Gatewood should use a short-term treasury rate as the risk-free rate in the CAPM model?

A. There is much debate among analysts as to which risk-free rate is appropriate to use in the CAPM model. I believe that a long-term rate such as the 30-year Treasury bond is the appropriate rate to use when measuring the cost of equity for a utility company because of the volatility in short-term interest rates. Investors try to measure the cost of equity of a utility company assuming that one invests for the long-term, so using a short-term (less than one year) interest rate would not be the appropriate component to use in the CAPM model as I believe that this would be an apples to oranges comparison.

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your surrebuttal testimony.

A. My recommended cost of common equity, which is in the range of 9.32 percent to 9.42 percent, would produce a fair and reasonable rate of return of 7.60 percent to 7.65 percent for KCP&L's Missouri jurisdictional electric utility rate base.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.