

**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	§	Case No. ER-2014-0370
A General Rate Increase for Electric Service	§	

**INITIAL POST-HEARING BRIEF OF THE UNITED STATES DEPARTMENT OF
ENERGY AND THE FEDERAL EXECUTIVE AGENCIES**

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COME NOW the United States Department of Energy (“DOE” or “the Department”) and the Federal Executive Agencies (“FEA”), collectively referred to as DOE/FEA, by and through counsel, and for their initial post-hearing brief in the above-captioned proceedings state as follows:

I. INTRODUCTION

The U.S. Department of Energy has been delegated the authority by the U.S. General Services Administration (“GSA”) to intervene in Kansas City Power & Light (“KCPL” or “Company”) electric rate cases in Missouri on behalf of federal government facilities taking service from KCPL. Large federal facilities taking service from KCPL in Missouri include: the Richard Bolling Federal Complex and Whitaker Courthouse located in downtown Kansas City, Missouri, and the Bannister Federal Complex located south of the metropolitan area. DOE, under its GSA-delegated authority, intervenes in several other states on behalf of the federal government. The Department adheres to the principle that electric rates should be reasonable and cost based.

This brief addresses two matters. First, DOE/FEA supports the Non-Unanimous Stipulation and Agreement on Certain Issues filed in this docket by the stipulating parties on June 16, 2015. (Non-Unanimous Stipulation and Agreement on Certain Issues, Docket No. ER-2014-0370, June 16, 2015). Specifically, DOE/FEA urges the Commission to adopt the stipulation that any increase to revenue requirement resulting from this case be allocated to all classes as an equal percentage increase (Id., ¶3). No party objected to this stipulation and DOE/FEA urges the Commission to find it a reasonable revenue allocation method.

Second the remainder of this brief addresses the highly-contested issue of the appropriate return on equity (“ROE”) for KCPL. DOE/FEA recommends that the Commission adopt an ROE for KCPL of 9.0%, an ROE that is within the range of reasonableness of multiple expert witnesses who submitted testimony in this case and best reflects current and foreseeable market conditions. The Department’s recommendation captures what everyone with a bank account knows – this country has experienced, for several years, historically-low interest rates; and thereby, the low cost of capital.

II. RETURN ON EQUITY

A. Summary of Argument

DOE/FEA recommends that the Commission adopt an ROE of 9.0% for KCPL, an ROE that is within the range of reasonableness of the majority of witnesses that presented testimony in this case. In its most recent electric utility rate case order, this Commission approved an ROE for Ameren Missouri of 9.53%, a number that is within the range recommended by DOE/FEA witness Reno (8.2% - 9.6%); and very close to the ranges recommended by Missouri Industrial Energy Consumers and Midwest Energy Consumers’ Group (“MIEC/MECG”) witness Gorman (8.8% - 9.4%); and Staff witness Marevangapo (9.0% - 9.5%). Only KCPL witness Hevert’s range of reasonableness (10.0% - 10.6%) falls substantially outside the range of the other experts and the ROE approved by the Commission in *Ameren*. (*Ameren*, ER-2014-0258, Report and Order, April 29, 2015)

The reason that Mr. Hevert’s ROE calculations are so out-of-step with the other experts is because he used flawed assumptions and inflated inputs when running his Discount Cash Flow Model (“DCF”), Risk Premium Analysis and Capital Asset Price Model (“CAPM”), rejecting reasonable results that did not support his recommendation and inputting unreasonably-inflated

growth rates. DOE/FEA urges the Commission to reject Mr. Hevert's recommendation as an unreasonable outlier that does not reflect current and foreseeable market conditions and that is not based on sound assumptions.

B. Setting the Return on Equity

This Commission has noted that determining an appropriate return on equity is "the most difficult part of determining a rate of return." (*Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 61). In line with principles established by the United States Supreme Court in *Federal Power Comm'n. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Bluefield Water Works & Improvements Co. v. P.S.C.*, 262 U.S. 679 (1923), this Commission has explained that its duty in setting ROE is to consider investors' expectations and requirements at the time they choose to invest their money in the subject utility rather than in some other investment opportunity. (*Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 61).

The Commission must determine the approximate ROE that KCPL stockholders are seeking *at this time* to incent them to invest in or retain the Company's common stock. Because it is impossible to determine an ROE in any direct manner, standardized methodologies for estimating cost of equity have gained currency. Three such methodologies, DCF, Risk Premium Analysis, and the CAPM, have been presented by one or more witnesses in this proceeding and are discussed here. Importantly, the Constant-Growth DCF model is the model usually considered appropriate for mature industries such as the regulated utility industry.¹ (*Staff Report, Revenue Requirement – Cost of Service*, Staff Ex. No. 200, p. 42).

¹ The DCF model is the most commonly used model for estimating the cost of common equity for public utilities. (DOE Ex. 701, fn. 1, citing *The Cost of Capital – A Practitioner's Guide*, by David C. Parcell, prepared for the Society of Utility and Regulatory Financial Analysts (2010 edition) page 124).

C. Witness Recommendations

Based upon the use of a combination of DCF, Risk Premium Analysis and CAPM, expert witnesses arrived at the following ROE recommendations:

- Ms. Maureen Reno, on behalf of the DOE and FEA, recommended an ROE of 9.0% (DOE Ex. 701, p. 1).
- Mr. Michael Gorman, on behalf of the MIEC and MECG, recommended an ROE of 9.10% (MIEC/MECG Ex. 551, p. 5)
- Mr. Zephania Marevangeo, on behalf of Staff, recommended an ROE of 9.25% (Staff Ex. 200, p. 58).
- Dr. Robert Hevert, on behalf of KCP&L, recommended an ROE of 10.30% (KCPL Ex. 117, p. 3)

It is not a coincidence that the ROE recommendations of staff and interveners range from 9.0%-9.25%. Rather, these parties have accounted for historically-low interest rates. KCPL's recommendation, on the other hand, is an outlier that does not reflect the low cost of capital.

D. Current and Foreseeable Market Conditions Indicate that 8.2% - 9.6% is a Reasonable ROE Range

DOE/FEA has presented direct and surrebuttal testimony of Ms. Reno, (DOE Exs. 700, 701) an expert on utility ROE and related matters. (DOE Ex. 700, Appendix A). Ms. Reno explained and demonstrated that capital costs have been, and continue to be, at historic lows. (DOE Ex. 701, p. 5). Staff and Missouri Industrial Energy Consumers and Midwest Energy Consumers' Group ("MIEC/MECG") expert witnesses Marevangeo and Gorman respectively confirm that capital costs remain at very low levels. (Staff Ex. 200, p. 27-58; MIEC/MECG Ex. 550, p. 4).

As this Commission noted in *Ameren*, interest rates have declined by approximately 37 basis points since 2012, utility stock prices have increased and their dividend yield have gone down. (*Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 65). “This indicates that utilities’ cost of capital has decreased because they need to sell fewer shares to generate the capital they need to support their investments.” (Id.)

KCPL witness Robert Hevert asserts that recent indicators show these trends are likely to change. However, while current stock price trends do show a correction in the market from the high prices from 2013 and 2014, when electricity stocks saw significant gains from investors seeking attractive dividend yields in a low interest rate environment, in 2015 the price of almost every electric utility issue has declined. (DOE Ex. 701, pp. 5-6). These market trends show a correction in the market as investors move towards higher-risk equities. (DOE Ex. 701, p. 6).

In testimony, Ms. Reno pointed to a number of sources to affirm that utility access to capital and costs of debt will remain near historic lows over the long term. Specifically, she pointed to a recent Federal Open Market Committee (FOMC) press release which indicated that “the current 0 to ¼ percent target range for the federal funds rate remains appropriate” and that an “increase in the federal funds rate remains unlikely at the April FOMC meeting.” (DOE Ex. 700, p. 6 and Exhibit B, p. 9). She also noted that short-term interest rates and bond yields remain at historic lows and that investors anticipate a slower rate of inflation and low interest rates over the long term (“The 30-day average rate for the period ending March 12, 2015 equals 1.9% and represents the market’s most recent expectations on long-term inflation,” DOE Ex. 700, p. 8 citing Schedule MLR-2b). Ms. Reno concludes that expectations for low inflation coupled with accommodative monetary policy reinforce investors’ expectations of a low opportunity cost of purchasing utility stocks. (DOE Ex. 700, p. 9).

This Commission recognized these market trends in its most recent rate case Order (*Ameren*, Docket *ER-2014-0258*, Report and Order, April 29, 2015) when it adopted an ROE of 9.53% as “a fair and reasonable return on equity for Ameren Missouri.” (*Id.*, p. 68). As noted during the hearing, the range of reasonableness recommended by Ms. Reno has an upper bound of 9.6%, a number that encapsulates this Commission's decision in *Ameren*. (*Tr.*, p. 144, lines 1-4).

E. The Majority of ROE Calculation Methodologies in the Record Support an ROE within the Range of Staff and Intervener Recommendations: 9.0% – 9.25%.

1. The Discount Cash Flow Model

The Methodology. The DCF model posits that a stock price is valued by summing the present values of expected future cash flows discounted at the investor’s required rate of return or cost of capital. (MIEC/MECG Ex. 550, p. 14). In its simplest form, the Constant-Growth DCF model expresses the cost of equity as the discount rate that sets the current price equal to expected cash flows. (*Ameren*, *ER-2014-0258*, Report and Order, April 29, 2015, p. 64). The DCF model requires a current stock price, expected dividends, and expected growth rate in dividends. (MIEC/MECG Ex. 550, p. 15). The rate of return on equity capital is the sum of the dividend yield (anticipated dividend payments divided by the market price) and the expected growth in dividend income. (DOE Ex. 700, p. 18)

Ms. Reno’s DCF analysis and recommendation. At the outset, Ms. Reno adjusted the proxy group Company ROE witness Dr. Robert Hevert originally selected by removing three companies: Cleco Corporation, NextEra Energy (“NextEra”), and Hawaiian Electric Industries (“Hawaiian”), all of which are involved in mergers and no longer meet Mr. Hevert’s proxy group selection criteria. Ms. Reno’s general acceptance of Mr. Hevert’s group has the advantage of

eliminating potential controversies over sample company selection, and allows more direct comparison of the two witnesses' respective DCF studies. (DOE Ex. 700, p. 4).

Ms. Reno used variants of the Single-Stage and Three-Stage DCF model.² She derived the dividend yield for her DCF analysis by using the annual dividends per share in the next period divided by the 90-day stock price average for the period ending March 25, 2015. (Id., p. 18). Ms. Reno calculated the estimated earnings growth rate by averaging analyst's forecasts from *Value Line*, *Zacks Investment Research*, and *Yahoo Finance* and arrived at a value of 5.27% (Id., pp. 19-20). Ms. Reno also developed an alternative growth rate by averaging *Value Line's* dividends per share ("DPS"), and book value per share ("BPS") with the previously-estimated earnings per share ("EPS") figure, and arrived at a value of 4.5%.³ (Id., pp. 20-22). Thus using three different methodologies, Ms. Reno calculated ROE's under the single-stage DCF model of 9.00%, 8.31% and 8.20%. (Id., p. 22).

Ms. Reno also produced a Three-Stage DCF model so that the growth rate of DPS, EPS and BVPS are allowed to change over time. (DOE Ex. 700, p. 23). Whereas the Single-Stage DCF model assumes that the value of a common stock can be expressed as the present value of a stream of dividends that grows at the same rate into infinity, often times investors expect the short-run growth rate of a company to differ from its long-run growth rate. Ms. Reno's use of the Three-Stage DCF model takes into account the fact that expected growth rates of financial publishing companies reflect expectations in the short-run (three to five years) and are not intended to reflect expectations in the long-run. The Three-Stage DCF model accounts for this

² The Three-Stage DCF model is an enhancement of the Single-Stage DCF model as it assumes that dividends and earnings grow at different rates over time. (DOE Ex. 700, p. 16).

³ Ms. Reno includes these alternate measures because investors are not only concerned with dividend growth but also earnings and book value growth as an assurance that dividend growth will be sustained. (DOE Ex. 700, p. 20).

inherent limitation in the data by allowing dividends to grow at a different rate in the long-run. Using an average of earnings, dividends, and book value growth, Ms. Reno derived an estimated ROE result of 9.01 percent, testing two final-stage growth rate sensitivities of 4.8%, a consensus expected nominal GDP figure, and 5.5%, an estimate of real GDP adjusted for inflation. (Id., pp. 21-27).

Mr. Gorman's DCF analysis and recommendation. MECG/MIEC witness Mr. Gorman's DCF analysis produced a return on equity of 8.60%. (MIEC/MECG Ex. 550, p. 27). Mr. Gorman stated that the DCF model requires a current stock price, an expected dividend, and an expected growth rate in dividends. Mr. Gorman relied on the average of the weekly high and low stock prices of the utilities in his proxy group over a 13-week and 26-week period ending on March 6, 2015.⁴ (Id., p. 15). Mr. Gorman used the most recently paid quarterly dividend as reported in *Value Line*, annualized and adjusted for the next year's growth. For his dividend growth rate, Mr. Gorman relied on a consensus or mean of professional security analysts' earnings growth estimates as a proxy for investor consensus dividend growth rate expectations (utilizing *Zacks, SNL, and Reuters*).⁵ The results of Mr. Gorman's Constant-Growth DCF model are 8.44% (average) and 8.42% (median) returns for his 13-week analysis and 8.60% (average) and 8.55% (median) returns for his 26-week analysis. (Id., p. 17).

Mr. Gorman also produced a long-term sustainable growth rate and his estimated returns based on the Sustainable-Growth DCF model are 8.39% (average) and 7.97% (median) for his 13-week analysis and 8.48% (average) and 8.01% (median) for his 26-week analysis.

⁴ According to Mr. Gorman, an average stock price reflects a period that is still short enough to contain data that reasonably reflects current market expectations, but the period is not so short as to be susceptible to market price variations that may not reflect the stock's long-term value. (MIEC/MECG Ex. 550, p. 15).

⁵ Security analysts' growth estimates have been shown to be more accurate than growth rates derived from historical data (MIEC/MECG Ex. 550, p. 16).

(MIEC/MECG Ex. 550, p. 20). In terms of estimating a maximum long-term sustainable growth rate, Mr. Gorman noted importantly that the long-term sustainable growth rate for a utility stock cannot exceed the growth rate of the economy in which it sells goods and services and, as such, 4.6% is a reasonable proxy of long-term sustainable growth. (Id., p. 18).

Mr. Gorman also produced a Multi-Stage DCF model.⁶ Using the GDP growth projection as a reasonable proxy for the maximum sustainable long-term growth rate (relying upon the consensus analysts' projections of long-term GDP growth),⁷ Mr. Gorman arrived at returns of 8.19% (average) and 8.23% (median) in his 13-week analysis and 8.36% (average) and 8.41% (median) for his 26-week analysis. (MIEC/MECG Ex. 550, p. 26).

Mr. Hevert's DCF analysis and recommendation. Mr. Hevert calculated his dividend yield figure by averaging closing stock prices for his proxy group over the 30, 90 and 180-trading day periods as of September 12, 2014. (KCPL Ex. 115, p. 16). As opposed to Ms. Reno, Mr. Hevert noted that for purposes of the Constant-Growth DCF model, growth in EPS represents the appropriate measure of long-term growth, and he ignored DPS and BVPS values.⁸ Mr. Hevert's Constant-Growth DCF analysis yielded mean ROE figures of 9.54% (30-day), 9.52% (90-day) and 9.59% (180-day). (Id., p. 20).

⁶ The limitation on the Constant-Growth DCF model is that it cannot reflect a rational expectation that a period of high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth. (MIEC/MECG Ex. 550, p. 20).

⁷ Mr. Gorman used growth rates of 4.7% to 4.4% over the next ten years.

⁸ DOE counsel emphasized this point at hearing:

Mr. Hevert would have us believe that the sophisticated investors only focus on a single indicator when making their investment decisions. That indicator being projected earnings growth. Ms. Reno, on the other hand, has run a series of different DCF Models to reflect that prudent investors look to a number of factors when making investment decisions, including dividends, book values, earnings, and sustainable growth rates. Ms. Reno's use of the variety of DCF Models reflects the reality that prudent investors base their investment decisions on all available information. (Tr., p. 145, lines 11-21).

Mr. Hevert also produced a Multi-Stage DCF Model which sets the company's stock price equal to the present value of future cash flows received over three stages. (KCPL Ex. 115, p. 21). Using a long-term growth rate of 5.65%, Mr. Hevert's Multi-Stage DCF model yielded mean ROE figures of 9.99% (30-day), 9.95% (90-day) and 10.03% (180-day). (Id, p. 25).

2. Risk Premium-Based Analysis and Recommendations

The Methodology. Risk premium models are based on the principle that investors expect higher returns on equity securities than on debt; or, require a higher return to assume higher risk. (MIEC/MECG Ex. 550, p. 27). The model assumes that the investor's required return on an equity investment is equal to the interest rate on a long-term bond plus an additional equity risk premium needed to compensate the investor for the additional risk of investing in equities compared to bonds. (*Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 64). The equity risk premium should reflect the relative market perception of risk in the utility industry today. (Id., p. 30). Ms. Reno did not rely upon an equity risk premium model, although she utilized a risk premium in her Capital Asset Pricing Method (CAPM) calculation (discussed below).

Mr. Gorman's risk premium analysis and recommendation. Mr. Gorman calculated the risk premium using two estimates: (1) the difference between the return on utility common equity and U.S. Treasury bonds; and (2) the difference between Commission-authorized returns on equity and contemporary "A" – rated utility bond yields by Moody's. (MIEC/MECG Ex. 550, p. 28). Mr. Gorman calculated an average equity risk premium of 5.37% using his first estimate method and an average equity risk premium of 3.98% using the second estimate method. (Id., pp. 28-29). Mr. Gorman's Risk Premium Model produced a return on equity range of 9.21% to 9.56% with a midpoint of 9.40%. (Id., p. 33).

Mr. Hevert's risk premium analysis and recommendation. In his Bond Yield Plus Risk Premium analysis, Mr. Hevert defined Risk Premium as the difference between authorized ROE and the then-prevailing level of long-term Treasury yield. He then gathered data for over 1430 electric utility rate proceedings between January 1980 and September 12, 2014. (KCPL Ex. 115, p. 30). Finding that the long-term average Equity Risk Premium of 4.44% would understate the cost of equity, Mr. Hevert calculated an implied ROE between 10.12% and 10.86%. (Id., p. 31).

3. CAPM-Based Analyses and Recommendations

The Methodology. The CAPM assumes the investor's required rate of return on equity is equal to a risk-free rate of interest plus the product of a company-specific risk factor, Beta,⁹ and the expected risk premium on the market portfolio. (*Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 64). It recognizes that common equity capital is more risky than debt from an investor's perspective, and investors require higher returns on stocks than on bonds to be compensated for the additional risk. (DOE Ex. 700, p. 28). When stocks are held in a diversified portfolio, firm-specific risks can be eliminated by balancing the portfolio with securities that react in the opposite direction to firm-specific risk factors. (MIEC/MECG Ex. 550, pp. 33-34). The CAPM theory suggests that the market will not compensate investors for assuming risks that can be diversified away, and so investors will only be compensated for systematic or non-diversifiable risks, which are measured by Beta. (Id., p. 34).

Ms. Reno's CAPM analysis and recommendation. Ms. Reno relied on the *Value Line* Betas because *Value Line* is widely used by the utility regulatory community, and used a Beta value of 0.74 for her proxy group. This value indicates that the stock price is less volatile than the market as a whole. (DOE Ex. 700, pp. 28-29). In calculating her equity risk premium, Ms.

⁹ Beta is a company-specific measure which reflects the movement in a company's stock price relative to movements in a composite group of companies representing the stock market. Beta measures the investment risk that cannot be eliminated by holding a diverse portfolio of assets (DOE Ex. 700, p. 28).

Reno applied two risk-free rates based upon the 30-year Treasury bond yield observed over the last month (2.64%) and the forecasted yield on the 10-year Treasury bond (3.9%), and subtracted these values from the Duff & Phelps Large Stock Arithmetic Average Return to derive respective risk premiums of 8.99% (current 30-year Treasury bond) and 7.33% (forecasted 10-year Treasury bond). (Id., pp. 29-30). Multiplying the risk premiums times the sample-specific Betas, and then adding the risk-free rates, yielded ROEs of 9.26% (current 30-year Treasury bond) and 9.59% (forecasted 10-year Treasury bond). (Id., p. 30).

Mr. Hevert's CAPM analysis and recommendation. Mr. Hevert's measures of the risk-free rate included the current 30-day average yield on 30-year Treasury bonds (3.21%) and the projected 30-year Treasury yield (3.80%). (KCPL Ex. 115, p. 27). Mr. Hevert used Beta coefficients from *Bloomberg* and *Value Line* and calculated an ROE range of 10.64% to 12.09%. (Id., p. 28).

Mr. Gorman's CAPM analysis and recommendation. Mr. Gorman used the *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield of 3.70% for the estimate of the market risk-free rate in his CAPM analysis. (MIEC/MECG Ex. 550, p. 34). Mr. Gorman took his Beta value from the proxy group average in *Value Line*. (Id., p. 35). Finally, Mr. Gorman derived two market risk premium estimates: a forward-looking estimate of approximately 7.6% and a historical estimate of 6.2% for an average market risk premium estimate of 6.90%. (Id., p. 36). Mr. Gorman's market risk premium, risk-free rate and Beta figures yield an ROE range of 8.27% to 9.30%, from which he applies a 75% weight to his high-end estimate and 25% weight to his low-end estimate, deriving a CAPM ROE of 9.05%. (Id., p. 38).

4. Staff's ROE Analysis and Conclusions

Staff noted that “while the proportion and cost of most components of the capital structure are a matter of record, the cost of common equity must be determined through expert analysis.” (Staff Ex. 200, p. 18). Staff estimated the cost of KCP&L’s cost of common equity using the DCF method and checked the reasonableness of its result against the CAPM method. (Id., p. 21). Staff stated that authorizing an allowed return on common equity based upon the cost of common equity is consistent with the principles set forth in Hope and Bluefield.¹⁰ (Id., p. 22). Staff characterized its role as providing the Commission an estimate of the relative change in cost of equity in general and KCP&L’s in particular and determined that the cost of equity has declined since KCP&L’s last rate case. (Id., p. 22).

In applying the Constant-Growth DCF method, staff estimated a growth rate considering the DPS, EPS and BVPS for each comparable company in its proxy group settling on values of 5.74% (broader proxy group) and 5.57% (refined proxy group).¹¹ (Staff Ex. 200, p. 43). Noting that it would be unreasonable to conclude that such a growth rate is sustainable in perpetuity because a utility company should grow at a rate less than the overall economy, Staff settled on a growth rate range of 3.5% – 4.5%, yielding a cost of equity range of 7.08% to 7.97% with a mid-point of 7.53%. (Id., pp. 44-45).

Staff also ran a Multi-Stage DCF model. Stating that it extensively researched actual realized electric utility growth rates over a 30-year period, Staff settled on a proxy growth rate

¹⁰ Staff distinguishes between the cost of common equity and *allowed* return on equity. Cost of common equity is the return required by investors, determined by expert analysis of market data relating to a carefully-constructed group of proxy companies. The allowed return on equity, on the other hand, is the value selected by the Commission for use in calculating a utility’s forward-looking rates for implementation at the end of a rate case. (Staff Ex. 200, fn. 11).

¹¹ Staff refined the proxy group it had used for KCP&L in its 2012 rate case by removing Cleco Corporation and Wisconsin Energy Resources due to their stock prices being influenced by announced mergers and acquisitions. (Staff Ex. 200, p. 38).

range of 3.00%-4.00%, with an average DPS, EPS and BVPS growth rate of 3.59%. (Staff Ex. 200, p. 47).¹² Staff updated its proxy group by eliminating Cleco Corporation and Wisconsin Energy Resources due to the impact of current merger activity on their respective stock prices. With this update, the Multi-Stage DCF produced an estimated cost of equity range of 7.02% - 7.81%. (Id., p. 51).

Staff performed a CAPM analysis and used other evidence to check the reasonableness of its DCF results. For its CAPM analysis risk-free rate, Staff used the average yield on a 30-year U.S. Treasury bond for the three-month period ending February 28, 2015, which was 2.78%. Staff adopted its Beta value from Value Line. (Staff Ex. 200, p. 55). Staff indicated that it is not improbable that investors are only requiring returns on common equity in the 6%-7% range for utility stocks. (Id.) Staff also considered additional checks on its DCF results and determined that the Commission should reduce KCP&L's cost of equity in this rate case, settling on a range of 9.0% - 9.5%. (Id., p. 58).

F. The Record Evidence Demonstrates that DOE/FEA's, MIEC/MECG's and Staff's ROE Reasonableness Ranges are Valid whereas KCPL's ROE Figure is an Outlier which the Commission Should Disregard.

Mr. Hevert's characterization of market conditions, and particularly cost of equity, is flawed. His claim that quickly-increasing investment rates and rapidly-decreasing utility stock prices suggest increasing capital costs is unsupported. (KCPL, Ex. 116, p. 2). As Staff witness Marevangepo noted, Mr. Hevert uses a very short time-frame for the context of his discussion. "While the events between January and April 2015 should not go unnoticed, it is paramount to recognize that the context of most relevance to making determination of a fair and reasonable allowed ROE in this case is a comparison of capital markets in early 2012 to the capital markets

¹² Staff noted that the growth rate it used was higher than the average 10-year compound growth rates in DPS, EPS and BVPS over the past 30 years for Missouri electric utilities, which it calculated as 2.39% (Staff Ex. 200, p. 49).

now.” (Staff Ex. 228, p. 6). In fact, as Staff points out, Mr. Hevert acknowledges that there has been a decline in cost of equity for electric utility companies by recommending a lower ROE in this case than he did for the 2014 Ameren Missouri case. (Staff Ex. 228, p. 5).

Mr. Hevert’s concerns with the use of the DCF model are also unfounded (KCPL Ex. 116, p. 50), especially when considering this Commission’s preference for the DCF model; a preference it indicated in KCPL’s last Rate Order (stating that the Risk Premium and CAPM are useful only as a check on the results of the DCF.) (*KCPL Report and Order*, Docket No. ER-2012-0174, January 9, 2013, p. 17).

Further, Mr. Hevert included in his ROE calculation certain assumptions that inflated his results. First, he used growth rates that were higher than the growth rate of the economy as a whole. (DOE Ex. 700, pp. 26-27; MIEC/MECG Ex. 550, p. 22). Specifically, Mr. Hevert adopts growth rates of 5.64% and 6.81% in his DCF model while the GDP growth of the US economy is between 4.4% and 4.7%. According to MIEC/MECG witness Gorman, “[i]t is simply not rational to expect that these companies can grow considerably faster than the economies in which they provide service over a long period of time.” (MIEC/MECG Ex. 551, p. 10).

Second, Mr. Hevert relies on historical authorized returns, which place greater weight on historical market conditions and in most cases are the result of settlement negotiations where utilities sought to retain existing or inflated ROEs by adjusting other components in their cost of service. (DOE Ex. 700, p. 31). As Staff notes, allowed returns determined in the context of settled cases are not as reliable because parties make adjustments to other elements of the ratemaking formula in order to arrive at an overall reasonable number. Further “it has been Staff’s experience that some companies do not want a lower ROE published in a settlement because this is a headline number. Consequently, companies may compromise on a more

obscure area of the rate case in order to have a higher ROE published in the settlement. (Staff Ex. 200, p. 57).

Each of the methods Mr. Hevert employed to estimate the Company's ROE used inflated figures. According to Mr. Gorman, whom this Commission referred to as "a reliable rate of return expert,"¹³ Mr. Hevert's Constant-Growth DCF results were based on "excessive and unsustainable" long-term growth rates; his multi-state DCF was based on an inflated GDP growth estimate; his CAPM analysis was based on inflated market risk premiums; and his Bond Yield Plus Risk Premium was based on inflated utility equity risk premiums.¹⁴ (MIEC/MECG Ex. 551, pp. 6-7). Thus, the Commission should view Mr. Hevert's analyses with skepticism and disregard his ROE recommendation as an unreasonable outlier.

Finally, Mr. Hevert expresses a concern that the ROE ordered in this case should be in line with ROEs authorized in other jurisdictions. (KCPL Ex. 116, p. 51). While competitiveness should be one factor in determining a utility's ROE, current and foreseeable market trends should be given greater weight so that rates are grounded in real economic circumstances and so inflated ROEs, which have little analytical basis, are not perpetuated. In fact, there has been a decreasing trend in the allowed ROE in recent rate cases, particularly in 2014, reflecting public utility commissions' cautious expectations about the economic recovery and the low opportunity cost of utility stocks in allowed ROEs. (DOE Ex. 700, p. 31).

While this Commission has noted that a utility's return on its investment should be comparable to that earned by other companies with "corresponding risks and uncertainties."

¹³ *Ameren, ER-2014-0258*, Report and Order, April 29, 2015, p. 66.

¹⁴ Regarding risk premiums, Ms. Reno and Mr. Gorman note that if the Commission adopts KCP&L's Fuel Adjustment Clause (FAC) proposal, the company's risk would be further reduced. (DOE Ex. 700, pp. 13-14; MIEC/MECG Ex. 551, p. 5).

(*Ameren*, ER-2014-0258, Report and Order, April 29, 2015, p. 67), the Commission should consider the decreasing trend noted above when setting the allowed ROE in this case. The Court in *Bluefield* noted that a “rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.”¹⁵

In authorizing an ROE of 9.17% in Connecticut Light & Power’s most recent rate case, the Connecticut Public Utility Rate Authority (“PURA”) stated it “has determined that investors expect less of a return today than in 2010, when the return was established at 9.40%....that the Company has strengthened its financial capability and has less risk, both financially and operationally, which provides further support that CL&P is performing well in an environment that expects lower returns.”¹⁶ Importantly, Mr. Hevert was CL&P’s ROE witness in that case and recommended an ROE of 10.20%.¹⁷ In that case, the Connecticut PURA made certain findings that directly challenge Mr. Hevert’s credibility on ROE recommendations:

The Authority also contrasts the Company’s recommended ROE of 10.20% to the current economic trends and recently awarded ROEs. In reviewing the full list of all utility rate cases, in which, the Company’s witness provided expert cost of capital testimony, Mr. Hevert’s recommended ROE has been much higher than the actually allowed ROE awarded in every case. CL&P Response to Interrogatory FI-65. Mr. Hevert testified that it is fairly unusual for a commission to adopt any one witness’ ROE. Tr. 9/10/14, pp. 1766 – 1769. Upon closer inspection of 16 of the most recent cases where Mr. Hevert provided expert testimony, all of the final authorized ROEs were below Mr. Hevert’s recommended ROE ranges. Late Filed Exhibit No. 35. In fact, in this proceeding, the Authority finds that Mr. Hevert’s recommended ROE range of 10.20% to 10.70% is well outside even his own results. Out of the

¹⁵ Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm’n of W. Va., 262 U.S. 679, 693 (1923)

¹⁶ *Decision*, Connecticut Public Utility Regulatory Authority, Docket No. 14-05-06, *Connecticut Power & Light*, December 17, 2014, p. 145.

¹⁷ *Id.*, p. 107.

81 total estimates computed by the Company, only 11 of those estimates fell within Mr. Hevert's recommended ROE range for CL&P. Tr. 9/10/14, pp. 1804 – 1808.

(*Decision*, Connecticut Public Utility Regulatory Authority, Docket No. 14-05-06, *Connecticut Power & Light*, December 17, 2014, pp. 136-137) (emphasis added).

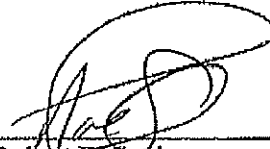
In addition to taking note of current economic trends, the Connecticut PURA's findings regarding the credibility of Mr. Hevert's ROE analysis should inform the Commission's ROE determination so that inflated or overstated ROE's, that are not based on the best record evidence or reflective of current market conditions, are not perpetuated.

III. CONCLUSION

The Company's 10.3% ROE recommendation is unacceptable and an outlier when compared to the majority of testimony presented in this case; this Commission's most recent decision in the Ameren Missouri case, which authorized an ROE of 9.53% (*Ameren*, ER-2014-0258, April 29, 2015); and the historically-low cost of capital. The Commission should disregard KCPL's recommendation and adopt an ROE of 9.0%, which is both based upon current and foreseeable market conditions and based upon reasonable inputs and assumptions.

In addition, DOE/FEA supports the Non-Unanimous Stipulation and Agreement on Certain Issues filed in this docket by the stipulating parties on June 16, 2015. (Non-Unanimous Stipulation and Agreement on Certain Issues, Docket No. ER-2014-0370, June 16, 2015). DOE/FEA urges the Commission to adopt the stipulation that any increase to revenue requirement resulting from this case be allocated to all classes as an equal percentage increase (*Id.*, ¶3). No party objected to this stipulation and DOE/FEA considers it a reasonable revenue allocation method.

Respectfully submitted,



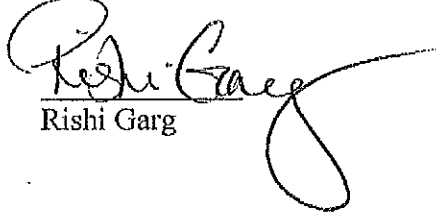
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Dated: July 22, 2015

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this 22nd day of July, 2015, filed the foregoing Initial Post Hearing Brief of the United States Department of Energy and the Federal Executive Agencies via the e-filing system of the Missouri Public Service Commission in accordance with all applicable procedures, and emailed a copy of the same to the attorneys of record for all of the parties.


Rishi Garg