Exhibit No.:	
Issues:	Cost of Capital; Capital Structure; Return on Equity
Witness:	Ann E. Bulkley
Exhibit Type:	True-Up Rebuttal Testimony
Sponsoring Party:	Evergy West
Case No.:	ER-2024-0189
Date:	September 18, 2024

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2024-0189

TRUE-UP REBUTTAL TESTIMONY

OF

ANN E. BULKLEY

ON BEHALF OF

EVERGY MISSOURI WEST, INC.

Kansas City, Missouri

September 2024

TRUE-UP REBUTTAL TESTIMONY

OF

ANN E. BULKLEY

Case No. ER-2024-0189

I. INTRODUCTION

Q: Are you the same Ann E. Bulkley that previously filed direct testimony on February 2, 2024, rebuttal testimony on August 6, 2024, and surrebuttal testimony on September 10, 2024 in this proceeding ("Bulkley Direct Testimony," "Bulkley Rebuttal Testimony," and "Bulkley Surrebuttal Testimony," respectively)?

A: Yes. I previously submitted direct testimony, rebuttal testimony, and surrebuttal testimony before the Missouri Public Service Commission ("Commission") in this proceeding on behalf of Evergy Missouri West, Inc. d/b/a Evergy Missouri West ("EMW" or the "Company"), a wholly-owned subsidiary of Evergy, Inc. ("Evergy").

Q: What is the purpose of your true-up rebuttal testimony?

A: The purpose of my true-up rebuttal testimony is to respond to an issue raised in the true-up direct and surrebuttal testimony of David Murray on behalf of the Office of the Public Counsel ("OPC") regarding the appropriate capital structure for the Company in this proceeding.[1] To the extent that I do not address a particular issue raised by Mr. Murray in this true-up rebuttal testimony should not be viewed as acceptance of that issue.

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[1] Missouri Public Service Commission, Case No. ER-2024-0189, Surrebuttal and True-Up Direct Testimony of David Murray, September 10, 2024 ("Murray True-Up Direct Testimony").

Q: Are you sponsoring any exhibits in support of your true-up rebuttal testimony?

A: No.

II. RESPONSE TO MR. MURRAY

Q: Has Mr. Murray updated his proposed capital structure recommendation for the Company?

A: Yes. Mr. Murray initially recommended a capital structure that consisted of 47.2 percent equity, which he stated reflected Evergy's consolidated equity ratio of 44.7 percent as of December 31, 2023 plus 2.50 percent.[2] In his true-up direct testimony, Mr. Murray now recommends a capital structure that consists of 46.37 percent equity because Evergy's capital structure has become "slightly more levered" and also noted that the Company employs double leverage.[3] The basis of Mr. Murray's updated recommended equity ratio is that Evergy is increasing its leverage and thus benefitting from "double leverage" to the detriment of ratepayers since the equity ratio of the parent (*i.e.*, Evergy) is lower than the equity ratio of the utility subsidiary (*i.e.*, EMW).[4] While Mr. Murray is not specifically recommending that EMW's equity ratio be calculated on the basis of a double leverage adjustment, he nonetheless bases his proposal to utilize the consolidated parent company's equity ratio for EMW on the fact that Evergy uses double leverage.

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2 Missouri Public Service Commission, Case No. ER-2024-0189, Direct Testimony of David Murray, June 27, 2024 ("Murray Direct Testimony), at 31.

3 Murray True-Up Direct Testimony, at 1, 15.

4 Murray True-Up Direct Testimony, at 1, 15.

Q: Does Mr. Murray acknowledge that the Commission has shown a preference for using the capital structure of the utility operating subsidiary?

A: Yes. As I noted in my rebuttal testimony, Mr. Murray acknowledges that the Commission has shown a preference for using a subsidiary capital structure if that subsidiary issues its own long-term debt. Despite this recognition, Mr. Murray suggests that Evergy's utility subsidiaries' capital structures may not be a consequence of arms-length transactions that optimize the subsidiary capital structure. Specifically, he suggests that the capital structure does not minimize costs charged to ratepayers to preserve the subsidiaries' credit capacity.[5]

Q: Is Mr. Murray's proposal to use the equity ratio of the parent company for EMW's ratemaking equity ratio consistent with financial theory?

A: No. The basis for Mr. Murray's recommendation to use of Evergy's equity ratio for EMW, which is that Evergy uses double leverage, runs counter to financial theory.[6] While the capital structure and the cost of capital are intended to reflect the risks of the operations of the company, which in this case is EMW, the double leverage argument suggests that the required return should be based on the *source of funds*, not the *risk of the investment*. The double leverage argument, therefore, suggests that the value of the equity in a company would differ based on the investor's source of funds, which is illogical.

Q: Can you provide an example to explain why Mr. Murray's proposal is flawed?

A: Yes. Consider the scenario where an investor borrows funds to invest in a stock, such as Apple Inc. ("AAPL"). The expected return to that investor on the AAPL stock is not the cost of the debt that the investor undertook to make the investment, but rather the return

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[5] Murray Direct Testimony, at 43.

[6] *See, e.g.*, Dr. Roger A. Morin, *Modern Regulatory Finance*, Public Utilities Reports, Inc., 2021, Chapter 20.

afforded all AAPL investors for that same period of investment.[7] In contrast, Mr. Murray's position as applied to this example suggests that the required return to that investor would be a debt return because of the source of the funds, which is irrational, given that this investor would bear all the risk of repayment that is inherent in holding equity in AAPL. Consistent with financial theory, the proper return in this example is based on the risk associated with the use of funds, which is the equity return, not the source of the funds, which is the debt cost.

Q: Are there academic publications that support the view that the cost of capital should be established for each investment on a stand-alone basis?

A: Yes. Several financial textbooks support this position. For example, Brealey, Myers and Allen note:

> In principle, each project should be evaluated at its own opportunity cost of capital; the true cost of capital depends on the use to which the capital is put. If we wish to estimate the cost of capital for a particular project, it is project risk that counts.[8]

Similarly, Modern Corporate Finance indicates:

> Each project has its own required return, reflecting three basic elements: (1) the real or inflation-adjusted risk-free interest rate; (2) an inflation premium approximately equal to the amount of expected inflation; and (3) a premium for risk. The first two cost elements are shared by all projects and reflect the time value of money, whereas the third component varies according to the risks borne by investors in the different projects. For a project to be acceptable to the firm's shareholders, its return must be sufficient to compensate them for all three cost components. This minimum or required return is the project's cost of capital and is sometimes referred to as a hurdle rate. In discussing how to calculate the project's cost of capital, we begin by assuming the firm is all-equity financed and later relax that assumption.

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7 Assumes stock investments occurred at the same time period.

8 Richard A. Brealey, Stewart C. Myers, Franklin Allen, Principles of Corporate Finance, McGraw-Hill Irwin, 8th Ed., 2006, at 234.

> The preceding paragraph bears a crucial message: *The cost of capital for a project depends on the riskiness of the assets being financed, not on the identity of the firm undertaking the project.* … the risk-required return trade-off is set in the financial marketplace is based on the yields available to investors on other investments with similar risk characteristics. Consequently, the required return on a project (the project's cost of capital) is an opportunity cost, which depends on the alternative market investment that investors must forgo.[9]

Finally, the use of double leverage versus an independent capital structure was studied by Pettway and Jordan (1983)[10] and Lerner (1973).[11] Pettway and Jordan (1983) evaluated the use of these two capital structures in achieving three goals of rate of return regulation, which are that the allowed return must: (1) be sufficiently low as to eliminate monopoly rents or producer's surplus; (2) be sufficiently high to attract capital and guide the allocation of capital resources in a socially desired fashion; and (3) exactly compensate the investors of capital for the risk of their investment in the public utility. The conclusions reached by Pettway and Jordan (1983) were as follows:

> The "double leverage" approach to estimate the allowed rate of return would be incorrect and inappropriate when parents diversify into subsidiaries of unequal risk and/or use parent debt. The use of "double leverage" (1) does not eliminate "monopoly rents" or "producer's surplus" in the regulated operating company, (2) does not provide the proper rate of return to attract capital and to guide the allocation of capital resources in a socially desirable fashion, and (3) does not correctly compensate the investors of capital for the riskiness of their investments in the public utility. In the section, the two approaches are compared in a theoretical framework with tax effects specifically considered. The "independent company" approach is found to be universally correct, whereas the "double leverage" approach is only correct in specific areas. When a public utility holding company has a diversified group of subsidiaries of unequal risk and/or parent debt, a "double leverage" approach which uses the parent's WACC as an estimate of the cost of equity capital of the regulated subsidiary is incorrect and should not be employed. The results of this paper, using both a series of

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9 Alan C. Shapiro, Modern Corporate Finance, Wiley, 1st Ed., 1990, at 276.

10 Richard H. Pettway and Bradford D. Jordan, "Diversification, Double Leverage, and the Cost of Capital," *The Journal of Financial Research*, Vol VI, No. 4 Winter 1983.

11 Eugene M. Lerner, "What are the Real Double Leverage Problems," Public Utilities Reports, Inc., June 7, 1973.

> examples and a theoretical framework analysis, reaffirm the "independent company" approach as satisfying the three standards of rate of return regulation. The analysis finds no valid support for the "double leverage" approach; the "independent company" approach is shown to be universally correct.[12]

Lerner (1973) concluded that the double leverage adjustment should be rejected because it discriminates among classes of security holders, is contrary to the basic principles of financial theory and, if applied, would lead to consequences that are not in the public interest. The author, who was a finance professor at Northwestern University at the time the report was published, noted that it is well-established in financial theory that the cost of equity capital is the risk-adjusted opportunity cost to the investor and that the sources of shareholder funds do not enter into the cost of equity calculation. Further, Lerner (1973) recognized that it is:

> […]illogical to equate a corporation's cost of equity with its shareholders' sources or costs of funds. The relevant considerations are the alternatives available to the shareholders and the returns and risks associated with those alternatives. Where or how the shareholder obtained the funds used to purchase the shares, or the cost of those funds to the shareholder, are totally irrelevant to the calculation of the cost of equity to the corporation.
>
> This is also true whether the corporation has one or many shareholders and whether the shareholders are individuals or corporations. There is no basis in financial theory for estimating the cost of equity by one procedure for corporations whose shares are owned by individuals and by a different procedure - e.g., using the double leverage adjustment - for corporations whose shares are owned by a holding company. To do so is discriminatory. The mere transfer of ownership of an operating company from the public to a holding company or the reverse should not logically in and of itself result in a change in the operating company's allowable rate of return. Nor should the cost of capital of a parent holding company determine the cost of equity of the subsidiary.[13]

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[12] *Id.*

[13] Eugene M. Lerner, "What are the Real Double Leverage Problems," Public Utilities Reports, Inc., June 7, 1973, at 22.

Q: What do you recommend regarding Mr. Murray's proposed adjustment to EMW's capital structure?

A: As discussed previously, because the basis for Mr. Murray's proposal is inconsistent with financial theory and would be discriminatory by resulting in a different return for an investment in Evergy and its subsidiaries relative to other comparable utility investments, I recommend that the Commission reject Mr. Murray's proposal.

Q: Does this conclude your true-up rebuttal testimony?

A: Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Evergy Missouri West, Inc. d/b/a Evergy Missouri West's Request for Authority to Implement A General Rate Increase for Electric Service	))))	Case No. ER-2024-0189

AFFIDAVIT OF ANN E. BULKLEY

COMMONWEALTH OF MASSACHUSETTS)
) ss
COUNTY OF SUFFOLK)

Ann E. Bulkley, being first duly sworn on his oath, states:

1. My name is Ann E. Bulkley. I work in Boston, Massachusetts, and I am employed by The Brattle Group, Inc. as Principal.

2. Attached hereto and made a part hereof for all purposes is my True-Up Rebuttal Testimony on behalf of Evergy Missouri West consisting of seven (7) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Ann E. Bulkley
Ann E. Bulkley

Subscribed and sworn before me this 18th day of September 2024.

Gerard M Rooney
Notary Public

My commission expires: 6/30/2028

GERARD M. ROONEY
NOTARY PUBLIC
MY COMMISSION EXPIRES 6/30/2028
COMMONWEALTH OF MASSACHUSETTS

Gerard M. Rooney
NOTARY PUBLIC
Commonwealth of Massachusetts
My Commission Expires
6/30/2028