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Issue: Rate of Return on Equity  
Witness: Samuel C. Hadaway  
Type of Exhibit: Surrebuttal Testimony  
Sponsoring Party: Kansas City Power & Light Company  
Case No.: ER-2012-0174  
Date Testimony Prepared: October 8, 2012

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO.: ER-2012-0174**

**SURREBUTTAL TESTIMONY**

**OF**

**SAMUEL C. HADAWAY**

**ON BEHALF OF**

**KANSAS CITY POWER & LIGHT COMPANY**

**Kansas City, Missouri  
October 2012**

KCP&L Exhibit No. 21  
Date 10-23-12 Reporter KF  
File No. ER-2012-0174

**SURREBUTTAL TESTIMONY**

**OF**

**SAMUEL C. HADAWAY**

**Case No. ER-2012-0174**

1           **I.     INTRODUCTION AND SUMMARY OF RECOMMENDATIONS**

2   **Q.     Please state your name and business address.**

3   A.     My name is Samuel C. Hadaway. My business address is FINANCO, Inc., 3520  
4           Executive Center Drive, Suite 124, Austin, Texas 78731.

5   **Q.     Are you the same Samuel C. Hadaway who prefiled Direct and Rebuttal**  
6           **testimony in this matter?**

7   A.     Yes. I previously filed direct and Rebuttal Testimony on behalf of Kansas City  
8           Power & Light Company (“KCP&L” or the “Company”) in this matter.

9   **Q.     What is the purpose of your Surrebuttal Testimony?**

10  A.     The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimony  
11           concerning the return on equity (“ROE”) filed by Missouri Public Service  
12           Commission Staff (“Staff”) witness David Murray. To the extent that I have  
13           responded, in my Rebuttal Testimony to the arguments set forth by Mr. Murray, I will  
14           note my previous responses and not comment further on those arguments.

15  **Q.     Have the parties changed their initial ROE recommendations?**

16  A.     Yes. Based on the updated analysis I presented in my Rebuttal Testimony, the  
17           Company reduced its requested ROE from 10.4 percent to 10.3 percent. Mr. Murray  
18           did not adjust his recommendation; he continues to recommend an ROE of 9.0  
19           percent.



1 **Q. Did Mr. Murray's growth rate discussion add any new information to the debate**  
2 **about what the long-term DCF growth rate should be?**

3 A. No. As I explained in my Rebuttal Testimony on page 13, lines 9 through 19:

4 Mr. Murray's 3.5 percent rate is below the average rate of inflation in  
5 the U.S. economy over the past 60 years (3.7%) and only barely above  
6 the annual change in the GDP price deflator (3.4%). See Schedule  
7 SCH-11. I have consistently shown in my GDP growth estimates  
8 (Schedules SCH-4 and SCH-11) that the current GDP forecasts from  
9 the various government agencies use estimates of permanently low  
10 inflation and lower real growth rates that do not reflect the long-term  
11 U.S. economy. For Mr. Murray to rely on these low GDP growth rate  
12 forecasts, which are the product of the most severe economic  
13 downturn since the Great Depression of the 1930s, and then to select  
14 an even lower growth rate for his multi-stage DCF analysis is  
15 indicative of a biased and unrealistic approach.

16 Additionally, in his Rebuttal Testimony Mr. Murray again attempts to misuse  
17 valuation data from "fairness opinions" and asset impairment tests to estimate  
18 investors' growth expectations. These are the very same kind of data from Mr.  
19 Murray's analysis that the Missouri Public Service Commission ("Commission")  
20 flatly rejected in prior Ameren Missouri rate case proceedings. See Case No. ER-  
21 2011-0028, Report and Order at 69-70 (July 13, 2012); Case No. ER-2010-0036,  
22 Report and Order at 20 (May 28, 2010). Mr. Murray's historical growth rate  
23 calculations are incorrect, and his use of analysts' and accountants' discount rates,  
24 which are often confidential and entirely unknown to the investing public, is  
25 inappropriate. As the Commission has in past cases, it should continue to reject Mr.  
26 Murray's inappropriate analysis.

27 **Q. At pages 5-6 of his Rebuttal Testimony, Mr. Murray says that four of your**  
28 **comparable companies should have been excluded. How do you respond?**

1 A. First, Mr. Murray acknowledges on page 5, lines 18-19 that he is “not focusing on Dr.  
2 Hadaway’s proxy group for purposes” of his Rebuttal Testimony. As such, he  
3 provides no analysis or explanation of why our respective proxy groups are so  
4 different. Additionally, it is Mr. Murray who has a different proxy group; Mr.  
5 Gorman, Mr. Kahal, and I use the same group.

6 I disagree with the reasons Mr. Murray states for removing the four  
7 companies, because his reasons are *ad hoc* and could lead to “selectivity” criticism.  
8 While it is generally not possible to pick a perfect proxy group, to the extent that  
9 reasonable selection criteria are applied consistently and a reasonably large group is  
10 chosen, the results should not be significantly affected by additional details like those  
11 noted by Mr. Murray. Finally, as I explained in my Rebuttal Testimony DCF update,  
12 I evaluated the comparable group based on the most recent data and eliminated two of  
13 the four companies that Mr. Murray complains about. Those companies, Edison  
14 International and Vectren, were removed because they no longer met my selection  
15 criteria. Mr. Murray’s comparable company comments are misplaced and should be  
16 disregarded.

17 **Q. At page 9 of his Rebuttal Testimony, Mr. Murray offers an example based on**  
18 **your GDP growth rate and the dividend yield for the S&P 500 Index. How do**  
19 **you respond to this example?**

20 A. In his example, Mr. Murray adds my initial GDP growth rate estimate (5.8%) to the  
21 recent S&P 500 dividend yield (2.24%) to obtain a “yield plus growth” DCF estimate  
22 for the S&P 500 of 8.04 percent. While his math is correct, his logic is entirely  
23 wrong. The simple, constant growth DCF model, which Mr. Murray uses for this

1 purpose, should not be applied to the S&P 500 index. Many of the companies in the  
2 index currently pay little or no dividends, but they have (relative to GDP) very high  
3 expected growth rates. Under these circumstances, the DCF model cannot be applied  
4 without assuming a multi-stage growth approach, or by assuming that current  
5 analysts' growth rates are expected to be blended, at some point in the future, with  
6 lower perpetual growth rates and with, currently unknown, higher future dividend  
7 yields. A correct application of the DCF model and principles of finance to  
8 companies in the S&P 500 is much more complex than Mr. Murray's GDP growth  
9 plus current yield approach. His S&P 500 analogy is, therefore, inappropriate and  
10 misleading. As a result, Mr. Murray's conclusion at page 9 that his example  
11 illustrates how my methodologies "defy" basic principles of finance should be  
12 disregarded.

13 **Q. What other parts of Mr. Murray's GDP discussion do you disagree with?**

14 A. I additionally disagree with the second portion of Mr. Murray's GDP discussion,  
15 which appears on pages 9-10 of his Rebuttal Testimony. In this discussion, Mr.  
16 Murray mistakenly claims that GDP growth "... is often used for a company or an  
17 industry in its 'growth phase,' i.e., experiencing 'supernormal' growth." In fact, the  
18 opposite is true. In my Direct Testimony at page 38, I provided the following  
19 quotation from the well respected Brigham and Houston textbook:

20 Expected growth rates vary somewhat among companies, but  
21 dividends for mature firms are often expected to grow in the future at  
22 about the same rate as nominal gross domestic product (real GDP plus  
23 inflation). On this basis, one might expect the dividend of an average,  
24 or "normal," company to grow at a rate of 5 to 8 percent a year.  
25 (Eugene F. Brigham and Joel F. Houston, *Fundamentals of Financial*  
26 *Management*, 11th Ed. 2007, page 298 [emphasis added].)

1           In addition to his misstatements about “supernormal” growth versus expected  
2 growth for “mature” firms, Mr. Murray again refers to his flawed historical growth  
3 rate studies to support his contentions.

4 **Q. On page 19, Mr. Murray criticizes your risk premium study. How do you**  
5 **respond to these criticisms?**

6 A. Mr. Murray’s criticisms of my analysis are misplaced. First, he says that my use of  
7 allowed ROE data to interpret the market’s required rate of return is of questionable  
8 value. His opinion in this regard is exactly opposite of the Commission’s opinion in  
9 the July 2011 Ameren Missouri Report and Order:

10           The Commission mentions the average allowed return on equity  
11 not because the Commission should, or would slavishly follow the  
12 national average in awarding a return on equity to Ameren  
13 Missouri. However, Ameren Missouri must compete with other  
14 utilities all over the country for the same capital. Therefore, the  
15 average allowed return on equity provides a reasonableness test for  
16 the recommendations offered by the return on equity experts.  
17 (Case No. ER-2011-0028, Report and Order at 67, ¶ 12).

18 Additionally, Mr. Murray is incorrect in his criticism of my risk premium adjustment,  
19 which accounts for the inverse relationship between risk premiums and interest rate  
20 levels. My data, spanning the 1980-2011 timeframe, clearly demonstrate this inverse  
21 relationship. *See* Schedules SCH-6 and SCH-13 at page 3 and Hadaway Rebuttal  
22 Testimony at page 21, Graph 2). During periods of high interest rates, regulators  
23 have allowed and investors have come to expect, lower risk premiums. Similarly,  
24 during periods of low interest rates, risk premiums tend to be expanded. Mr.  
25 Murray’s criticism of this fundamental relationship is simply a further effort to reduce  
26 ROE in lockstep with current, artificially low interest rates. Finally, Mr. Murray is  
27 incorrect in his criticism of my use of projected interest rates. I use both actual and

1           projected rates in my risk premium analysis because investors are fully aware of both.  
2           The risk premium approach is an effort to gauge the cost of equity by reviewing debt  
3           costs and the relationship between debt costs and the cost of equity. Interest rate  
4           forecasts are an integral part of what investors expect and, therefore, such forecasts,  
5           along with existing actual interest rates, provide additional information about what  
6           investors expect their ROE to be. Mr. Murray's criticisms should be dismissed.

7   **Q.   Does this conclude your testimony?**

8   **A.   Yes, it does.**

