

**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

DIRECT TESTIMONY

OF

TONY SOMMA

WESTAR ENERGY

DOCKET NO. 18-WSEE-328 - RTS

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. Tony Somma, 818 S. Kansas Avenue, Topeka, Kansas.

3 **Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?**

4 A. Westar Energy, Inc. (Westar). I am Senior Vice President, Chief
5 Financial Officer and Treasurer.

6 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND
7 BUSINESS EXPERIENCE.**

8 A. I hold a B.B.A. in accounting from Bellevue University and an M.B.A.
9 from the University of Nebraska at Omaha. I passed the certified
10 public accountant exam and I am a member of the American Institute
11 of Certified Public Accountants, the Association of Financial
12 Professionals and Financial Executives International. I have worked
13 in the energy and utility industry for nearly 25 years. I left Westar in
14 1999 to serve in various senior financial positions at another public

1 company, rejoining Westar in 2004. In 2006, I was named Treasurer,
2 and in 2009, I became Vice President and Treasurer. I held that
3 position until August 2011 when I became Senior Vice President,
4 Chief Financial Officer and Treasurer.

5 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

6 A. I will provide a recommendation of a fair return on equity (ROE) for
7 ratemaking purposes.

8 **Q. PLEASE SUMMARIZE YOUR RECOMMENDATION REGARDING**
9 **A FAIR ROE?**

10 A. I am recommending a 9.85% ROE in this application. My
11 recommendation is based on the application of three estimation
12 models of ROE, comparing those results with recently authorized
13 ROEs for vertically-integrated electric utilities, and using my
14 professional judgment based on years of experience interacting
15 directly with utility investors.

16 **Q. IN YOUR ROLE AS CHIEF FINANCIAL OFFICER AND**
17 **TREASURER, DO YOU FREQUENTLY INTERACT WITH THE**
18 **FINANCIAL COMMUNITY?**

19 A. I do. As noted earlier, my responsibilities include raising external
20 capital; managing relationships with rating agencies, bondholders,
21 equity investors, and equity analysts; deciding how capital is best
22 invested to advance the interests of our customers and investors;
23 and managing Westar's financial liquidity and overall financial profile.

1 All those activities require constant, substantive interactions with
2 diverse members of the financial community. Through those
3 interactions, I have developed a deep, practical understanding of
4 how both debt and equity investors assess utilities, what they expect
5 and require before they will invest, and how prices for capital are set
6 in the debt and equity markets.

7 **Q. WHY IS THAT PRACTICAL EXPERIENCE IMPORTANT IN**
8 **DEVELOPING ROE ESTIMATES?**

9 A. It is important to remember that the ROE set in this proceeding is
10 meant to measure the returns that equity investors (*i.e.*,
11 shareholders) require. Therefore, it is important to use the methods
12 investors use, and to interpret the results as investors would, which
13 incidentally, is consistent with longstanding case law on the subject,
14 as well. I can say that investors do not develop their required returns
15 based solely on a mechanical application of one or two highly
16 simplified models. To the contrary, my experience has taught me
17 that investors use models to help inform their judgment, but only as
18 approximations to the real world. The real world is simply too
19 complicated to relegate it to just a mechanical model. Market prices
20 and returns are set by human investors. It would be a mistake to
21 assume that investors' objectives and concerns can be captured in
22 the average results of one or two simplified models, although such
23 models can help inform that more complex judgment.

1 **Q. HOW SHOULD SUCH MODELS BE USED – OR NOT BE USED –**
2 **TO INFORM THE JUDGMENTS IN THE REGULATORY**
3 **PROCESS?**

4 A. Expert witnesses in regulatory proceedings use models to estimate
5 the ROE, as do investors. That is not a problem. The issue is how
6 investors apply the models, how they view the results, what data they
7 look at in determining whether the results make sense, and how they
8 incorporate their own views of risks when they determine what return
9 they will require. My experience tells me that investors do not take
10 model results as given – they look at those results relative to other
11 data points, and relative to other investment alternatives.

12 **Q. DO YOU THINK INVESTORS RELY HEAVILY ON ONE MODEL,**
13 **NO MATTER THE CIRCUMSTANCES?**

14 A. No, investors are very aware that models can become unreliable
15 when market conditions change. For that reason, they do not limit
16 themselves to one approach. Regardless of how theoretically
17 appealing a model might be, if it does not produce results that are
18 relevant to investors, it has little practical meaning. Using the results
19 of a model that does not reflect how investment decisions are made
20 in the real world to set the ROE in a rate proceeding would place the
21 Company at a competitive disadvantage in the market.

22 **Q. HOW IMPORTANT IS IT FOR THE COMPANY’S ROE TO BE**
23 **COMPETITIVE WITH RETURNS AT OTHER UTILITIES?**

1 A. It is essential. Westar, for example, competes directly with other
2 companies for investor capital. When I speak with analysts and
3 investors, they want to understand the drivers of earnings growth,
4 and the risks to those drivers – relative to other investments available
5 to them. They do the same with other companies, in relation to an
6 opportunity to invest in Westar. If, based on those discussions,
7 investors require a certain return but the ROE is set well below that
8 level, they simply invest elsewhere. Every day I am reminded that
9 the capital markets are competitive and if we cannot provide
10 competitive returns for utility investors in Kansas, we may not be able
11 to raise the capital we need to maintain the infrastructure needed to
12 deliver safe and reliable service to our customers. If we are able to
13 raise capital under such circumstances, the cost of such capital to us
14 and our customers is likely to be higher.

15 **Q. WHEN DID YOU LAST RAISE CAPITAL?**

16 A. We issued senior debt in both 2016 and 2017. When we issue debt
17 at attractive yields and terms, that is to the benefit of our customers.
18 Indeed, the lower cost of debt capital we have been able to secure
19 is the reason we can seek a lower overall rate of return in this
20 application than what is currently reflected in rates from the
21 Commission’s last order in a Westar general rate case [cite 15-
22 WSEE-115-RTS]. Our ability to obtain attractive terms depends on
23 constructive regulatory decisions going forward. For example, we

1 recently saw Moody's put OG&E, our neighboring electric utility to
2 the south, on a negative rating outlook due to a regulatory decision
3 in Oklahoma. Negative rating actions, even if they are not full
4 downgrades, make it more difficult to issue debt at attractive terms
5 and more costly for customers in regard to capital costs, the result of
6 which shows up in customer bills. The impact of a downgrade is
7 even more severe when markets begin to tighten.

8 **Q. IS ISSUING DEBT CAPITAL THE SAME AS ISSUING EQUITY**
9 **CAPITAL?**

10 A. No. There are similarities, but also striking differences. The
11 securities are different, and so are the investors. It would be a
12 mistake to assume that because we recently were able to issue debt
13 on favorable terms, that equity investors also see less risk and would
14 be willing to accept lower returns. In general, utilities, can almost
15 always issue debt, especially if they finance with mortgage bonds.
16 However, even with debt, the debt could be more costly if the
17 regulatory environment were viewed as less constructive for
18 investors compared to that in other jurisdictions.

19 **Q. DON'T DEBT AND EQUITY INVESTORS LOOK AT RISK AND**
20 **RETURNS THE SAME WAY?**

21 A. Only to a certain extent. An adverse regulatory decision could be
22 harmful to both securities as it would serve as a neon sign to the
23 investment community, "buyer beware" of financial securities

1 associated with such a regulatory jurisdiction. However, debt and
2 equity are fundamentally different securities, with fundamentally
3 different risks. Debt has a limited life, with a contractual requirement
4 to pay a specified rate of interest, along with the return of principal.
5 On the other hand, when an investor buys a share of our common
6 stock, that stock's life is indefinite, and while we have no contractual
7 obligation to pay dividends on it, that obligation is implicit. We must
8 pay our debt holders before we pay dividends. In that respect,
9 earnings – and dividends – are subordinate and residual, which
10 makes an equity investment more risky than debt, which means it
11 carries a higher cost of capital than debt. While debt and equity
12 investors may be concerned with business and financial risks, they
13 view those risks from different perspectives, because by their very
14 nature, equity securities are riskier than debt.

15 **Q. WHY IS THAT DIFFERENCE IMPORTANT?**

16 A. Sometimes people take an improper shortcut by assuming that
17 changes in interest rates or credit spreads also imply a similar
18 change in the cost of equity. That would be an error. That is not the
19 way the market works. Credit spreads can change for many reasons,
20 often not related to equity risk. For example, when we issue debt,
21 the interest rate reflects the supply of other debt coming to market,
22 and the overall demand for that debt. At times, there may be fewer
23 issuances brought to the market, so we can issue the debt at lower

1 credit spreads, and therefore at lower yields. In fact, one tactic we
2 use in issuing debt is to take advantage of that relative scarcity, when
3 we have information to guide us. At other times, a portfolio manager
4 may need to fill a gap in his or her portfolio for a given credit rating
5 and duration. In those cases, the portfolio manager (the investor)
6 may be willing to accept a lower credit spread (and again, a lower
7 yield). The point is that when we issue debt in the market, the yield
8 may be influenced by factors that have little to do with fundamental
9 equity risk. That is the case for other issuers, as well. Therefore, it
10 would be an error to put too much emphasis on changes in credit
11 spreads and debt yields in regard to setting the ROE.

12 **Q. WITH THOSE POINTS IN MIND, WHAT IS YOUR CONCLUSION**
13 **REGARDING THE IMPORTANCE OF PRACTICAL EXPERIENCE**
14 **IN DEVELOPING AN ROE ESTIMATE?**

15 A. Models can be useful to help inform judgment in setting the ROE, but
16 should not be substituted for judgment in setting ROEs. When used,
17 they must to be used and interpreted properly. No one model can
18 capture all the practical, changing, day-to-day factors that affect
19 prices, and still produce a result that always makes sense. Knowing
20 the complex concerns investors have when they consider investing
21 in utility stocks, understanding how competitive the capital markets
22 can be, and managing the multiple factors that affect our ability to
23 issue securities at favorable terms, tells me that financial models are

1 measures of how, only in theory, investors may act. Practical
2 experience, which has shown me how investors often do act, is an
3 important bridge between the theory in underlying financial models,
4 and the practice of how investors make decisions.

5 **Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?**

6 A. My testimony is organized as follows:

- 7 a. Summary of the recommended ROE in this application and
8 how I arrived at a reasonable cost of equity that can be applied
9 as a fair return on equity, including a comparison of our
10 requested ROE with other utilities' authorized returns.
- 11 b. The legal criteria for a fair return on investment.
- 12 c. Peer group and discounted cash flow (DCF) model and
13 unadjusted results.
- 14 d. Capital asset pricing model and unadjusted results.
- 15 e. Risk premium model and results.
- 16 f. Flotation costs.
- 17 g. Summary of model results, which along with my judgment,
18 inform my recommendation for a fair and reasonable return
19 on equity.

20 **Q. ARE YOU SPONSORING ANY SCHEDULES OR EXHIBITS?**

21 A. I am sponsoring the cost of equity capital figure that appears in
22 Section 7 of the Minimum Filing Requirements (MFRs). Westar
23 witness Ms. Susan McGrath will address the cost components other

1 than the cost of equity capital. She also sponsors the overall cost of
2 capital or “rate of return” calculation in Section 7 of the MFRs.

3 **Q. WESTAR IS ALSO PRESENTING THE TESTIMONY OF ROBERT**
4 **HEVERT CONCERNING RETURN ON EQUITY, WHY IS THAT?**

5 A. Because establishing an appropriate return on equity involves a
6 significant amount of judgment, it is useful to have the input of more
7 than one expert on the subject. I provide a perspective as the
8 Company’s Chief Financial Officer and Treasurer. Mr. Hevert’s
9 testimony provides an independent, external perspective, a broader
10 view and further supports our conclusions.

11 A. *Determining an Appropriate Return on Equity Capital*

12 **Q. WHAT IS YOUR RECOMMENDED ROE?**

13 A. I recommend 9.85% as the appropriate and fair return on equity
14 capital for Westar. My recommendation is informed by my multiple
15 models, industry comparisons and by applying my experienced
16 judgment. I used a discounted cash flow (DCF) method applied to a
17 group of electric utility companies with business characteristics and
18 risks similar to Westar. I also used a forward-looking version of the
19 capital asset pricing model (CAPM) and a risk premium model to
20 derive second and third estimates for Westar's cost of equity. I
21 applied customary and appropriate adjustments to these model
22 results, as well. Finally, I corroborated the reasonableness of these
23 estimates by comparing them to other recently requested and

1 commission-authorized returns on equity for electric utilities with
2 whom Westar competes for capital. The latter, perhaps being the
3 most important, as that is one of the more important metrics investors
4 look at when screening various utilities for a potential investment.

5 **Q. HOW DOES THE 9.85% ROE YOU ARE REQUESTING COMPARE**
6 **TO WHAT OTHER UTILITIES ARE CURRENTLY SEEKING FROM**
7 **THEIR REGULATORS AND WHAT REGULATORS ELSEWHERE**
8 **HAVE AUTHORIZED RECENTLY?**

9 A. Figure 1 below shows that, compared to what others are requesting,
10 my recommendation is among the lowest requested by electric
11 utilities. If adopted by the Commission, as shown by Figure 2, our
12 *requested* ROE would be equal to the average of what other
13 vertically-integrated utilities have actually been *authorized* by their
14 regulators. This is important because these are the very companies
15 with which Westar competes most directly for capital. In my
16 analyses, I removed distribution-only and generation-only utilities
17 from the sample. Distribution-only utilities are generally perceived
18 as having lower risk than vertically-integrated utilities. Generation-
19 only utilities are perceived as having higher risk. Removing these
20 utilities from the sample eliminated utilities at both the high and low
21 ends of the spectrum of returns.

22 These data show, as in the past, we are not requesting an
23 ROE on the high end of the spectrum only to have other parties to

1 this case support an ROE on the very low end of the spectrum, with
 2 an expectation of arriving somewhere in the middle. If that were the
 3 case Westar would be requesting a much higher ROE. Instead, we
 4 hope to avoid such gamesmanship by requesting an allowed ROE
 5 that is reasonable and fair considering what companies with whom
 6 we compete for capital have been authorized in recent months.

Figure 1

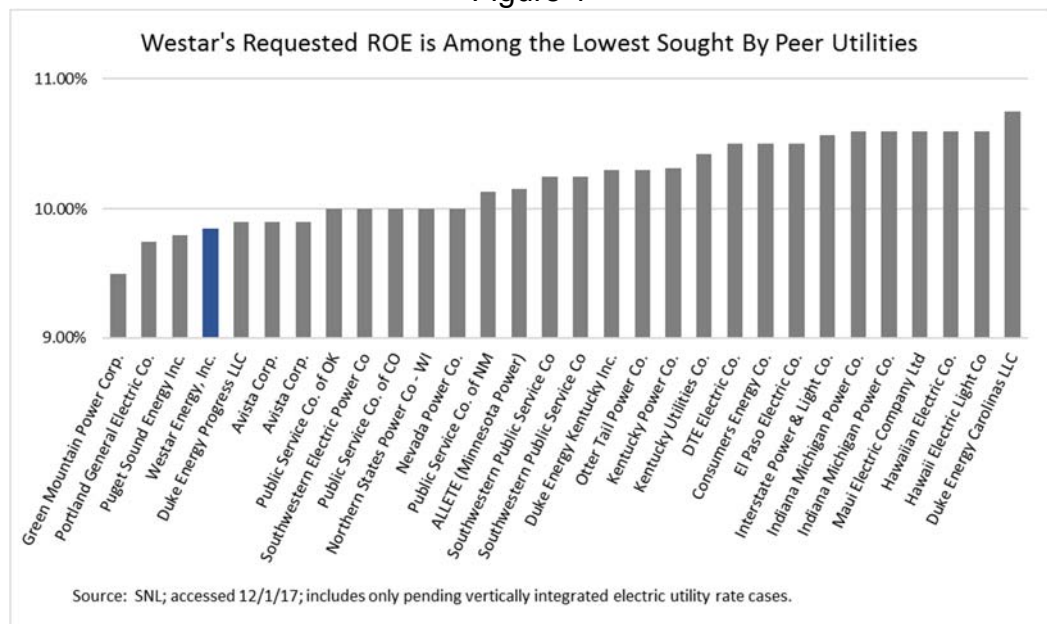
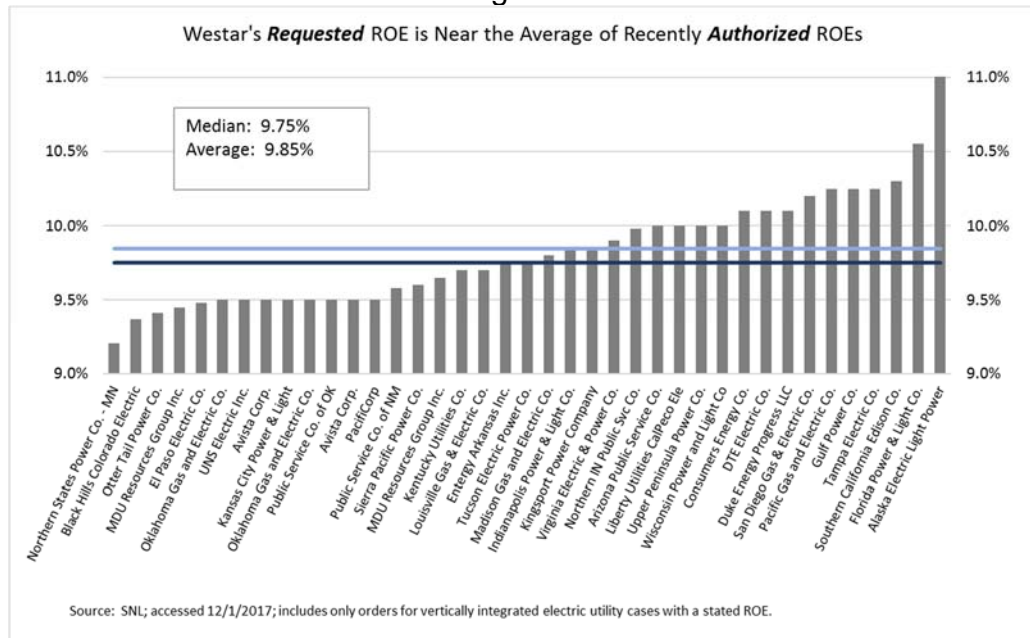


Figure 2



1 Q. BY REFERENCING ROES GRANTED BY OTHER
2 COMMISSIONS, ARE YOU SUGGESTING THAT THE
3 COMMISSION'S DISCRETION IS SOMEHOW LIMITED BY THE
4 ACTION OF OTHER COMMISSIONS?

5 A. No. The Commission alone has the authority to decide this matter,
6 in the context of an established legal framework. That same legal
7 framework recognizes the inherent competition for capital among
8 utilities; that is, firms with similar business risks. The authorized
9 returns for other companies are important because they also inform
10 our judgment about how investors have choices concerning where
11 they invest their money – or not. They make those choices every
12 day. Those choices affect the cost of Westar's equity capital.

13 That Westar's *request* is equal to the average of returns
14 actually *authorized* in other jurisdictions provides assurance that it is

1 inherently reasonable in the context of competition for equity capital.
2 Because, unlike other cost components, the cost of equity cannot be
3 readily observed, such as by contract terms, it must be estimated, by
4 inference. This comparison is one useful inference, and I might add,
5 an important one.

6 **Q. HOW MIGHT THE COMMISSION ISSUE AN ORDER WHICH SETS**
7 **AN AUTHORIZED ROE THAT BALANCES THE INTERESTS OF**
8 **BOTH CUSTOMERS AND INVESTORS?**

9 A. The Commission can inform its judgment using traditional methods
10 of estimating the return on equity, along with the judgments offered
11 by experienced practitioners, such as Mr. Hevert and myself, and
12 analysis by other parties. Applications of models or methods based
13 on factors not considered by utility investors should have no bearing
14 on utility cost of capital and thus should be excluded.

15 While tempting, because it could result in an artificially lower
16 initial rate increase, setting an unreasonably low ROE would send a
17 clear negative signal to investors about the Kansas regulatory
18 environment and our state's commitment to a healthy electrical
19 infrastructure – for years to come. Such a ruling would put at risk the
20 stability and reliability essential to meeting our customers' needs and
21 would create a structural problem that would not serve customers or
22 the public interest.

1 The ROE I recommend in this application strikes the
2 appropriate balance between Westar's customers and investors and
3 will enable Westar to continue its mission of providing clean, safe,
4 reliable service at just and reasonable rates.

5 B. *Criteria for a Fair Return on Investment*

6 **Q. WHAT CRITERIA DID YOU USE TO ESTABLISH A FAIR RATE**
7 **OF RETURN?**

8 A. I employed the economic guidelines set forth in two decisions of the
9 U.S. Supreme Court that have long established the legal framework
10 for utility ratemaking. Those cases are *Bluefield Waterworks Imp. Co.*
11 *v. PSC*, 262 U.S. 679 (1923) (*Bluefield*) and *FPC v. Hope Natural*
12 *Gas Co.*, 320 U.S. 591 (1944) (*Hope*). I interpret the language of
13 those cases to mean that a regulated utility should be afforded the
14 opportunity to collect revenues sufficient to cover all the legitimate
15 costs of providing regulated utility service, including sums sufficient
16 to compensate investors for the use of their money to support the
17 business. And, for the use of their money, investors should have an
18 opportunity to earn a return that takes into consideration the risks to
19 which their investment is exposed; that is, risks corresponding to
20 risks of similarly situated companies; in this case, other similarly
21 sized regulated electric utilities.

22 **Q. WHAT ARE THE STANDARDS ESTABLISHED BY THE**
23 **BLUEFIELD AND HOPE CASES?**

1 A. The standard has two parts. The first, established in the *Bluefield*
2 case, is referred to as the comparable earnings standard. The
3 second – the capital attraction standard – is addressed by both
4 cases.

5 The comparable earnings standard states that:

6 A public utility is entitled to such rates as will permit it
7 to earn a return on the value of the property which it
8 employs for the convenience of the public equal to that
9 generally being made at the same time and in the same
10 general part of the country on investments in other
11 business undertakings which are attended by
12 corresponding, risks and uncertainties. (*Bluefield*,
13 *supra*, 262 U. S. at 679).

14 The capital attraction standard states:

15 The investor interest has a legitimate concern with the
16 financial integrity of the company whose rates are
17 being regulated. From the investor or company point of
18 view it is important that there be enough revenue not
19 only for operating expenses but also for the capital
20 costs of the business. These include service on the
21 debt and dividends on the stock. Cf. *Chicago & Grand*
22 *Trunk R. Co. v. Wellman*, 143 U.S. 339, 345, 346, 12
23 S.Ct. 400, 402, 36 L.Ed. 176. By that standard the
24 return to the equity owner should be commensurate
25 with returns on investments in other enterprises having
26 corresponding risks. That return, moreover, should be
27 sufficient to assure confidence in the financial integrity
28 of the enterprise, so as to maintain its credit and to
29 attract capital. See *State of Missouri ex rel.*
30 *Southwestern Bell Tel. Co. v. Public Service*
31 *Commission*, 262 U.S. 276, 291, 43 S.Ct. 544, 547, 67
32 L.Ed. 981, 31 A.L.R. 807 (Mr. Justice Brandeis
33 concurring). (*Hope, supra*, 320 U. S. at 603.)

34 At the heart of these two standards is a single principle: a
35 reasonable return for a regulated utility is commensurate with returns
36 available on competing investments with similar risks. If the

1 authorized return meets that test, the enterprise will be paying the
2 market cost of capital and should be able, at reasonable cost, to
3 compete for, attract and hold the capital necessary to continue
4 operations in accordance with its public utility obligations.

5 **Q. WHAT DO THESE STANDARDS MEAN TO YOU?**

6 A. Simply put, the setting of the allowed ROE is a two-step process and
7 both steps must be performed reasonably. The first step is to perform
8 appropriate financial analyses based on sound financial theory to
9 inform as to a reasonable level or range of levels for an authorized
10 ROE. Second, to comport with the *Hope* and *Bluefield* standard,
11 such analyses should also be informed by practical reality observed
12 in the market and the regulatory arena. Ultimately, the authorized
13 ROE issued by the Commission must be reasonably comparable to
14 the ROEs authorized to other utilities of comparable risk.

15 **Q. YOU STATE THAT IF THE TEST IS MET, THE UTILITY WILL BE**
16 **ABLE TO RAISE, MAINTAIN AND HOLD EQUITY CAPITAL "AT**
17 **REASONABLE COST." WHAT WOULD BE THE RESULT IF THE**
18 **TEST IS NOT MET?**

19 A. If the authorized ROE were set too low to meet the test, that utility
20 would be put at an economic disadvantage in raising and holding
21 equity capital. It may not be that the utility could never attract capital,
22 which would be the most extreme negative outcome, but it certainly
23 would not be able to attract capital on comparable terms and at

1 comparable costs, which of course, is the long-established guiding
2 standard.

3 If the ROE were set too low, we would expect an increase in
4 the cost of that equity capital due to investor concerns about the
5 regulatory compact in Kansas. Additionally, rating agencies would
6 view such actions negatively and debt holders would respond
7 accordingly, thereby increasing the utility's borrowing costs and
8 ultimately, customers' bills.

9 The Commission has on prior – and recent – occasions noted
10 its concerns with such a negative set of events, and the possible
11 negative effects they might entail for customers. But even before
12 that, to manage such hardship, management would almost assuredly
13 have to make short term decisions to address the exigencies created
14 by such a decision instead of focusing on the long-term best interests
15 of the business.

16 **Q. WITH WHOM DOES WESTAR COMPETE FOR CAPITAL?**

17 A. Primarily, Westar competes for capital with utilities, principally
18 regulated utilities, all over the country.

19 **Q. WHAT IS THE MEASURE OF SUCCESS IN THE COMPETITION
20 FOR CAPITAL?**

21 A. Successful competition for capital means we are able to raise equity
22 capital at a reasonable cost – that is, at a cost comparable to that
23 experienced by other utilities with similar business and financial risks.

1 **Q. WHAT DOES IT TAKE FOR WESTAR TO BE SUCCESSFUL IN**
2 **ITS COMPETITION FOR CAPITAL?**

3 A. It requires that Westar be viewed by investors as a firm that will
4 provide a reasonable opportunity to earn a return comparable to their
5 expectations for a utility company.

6 We must be seen as providing a return at least as good as
7 that provided by firms of similar risk profiles. For Westar to be so
8 perceived, that means two things: (1) that the Commission
9 authorizes a reasonable return; and (2) that the Company (under
10 sound management) has a reasonable opportunity to earn the return
11 that is authorized.

12 **Q. WHY IS IT IMPORTANT FOR WESTAR TO BE AUTHORIZED A**
13 **COMPETITIVE RETURN ON CAPITAL, EVEN IF AT ANY POINT**
14 **IN TIME IT IS NOT SEEKING TO RAISE CAPITAL?**

15 A. Because of our public service obligation, the commensurately large
16 capital requirements of our business and the uncertainties
17 associated with the timing of our need for capital, we cannot always
18 choose when we go to the capital markets. Unlike any other
19 business, we cannot simply refuse service if the timing of the request
20 is economically inconvenient. We have a legal obligation to serve,
21 regardless of capital market conditions. In addition, we cannot delay
22 installing costly pollution control equipment to comply with
23 environmental laws and regulations or defer other capital spend that

1 is required to meet a legal mandate. If investors thought they might
2 only get a reasonable return when we were actually raising new
3 capital, and that when we are not raising capital we could simply
4 ignore their expectations, that ruse would end very quickly.
5 Consequently, Westar's need to maintain its financial integrity is a
6 continuing need, especially since capital market conditions are
7 unpredictable. Meeting that need is good for customers because it
8 reduces our cost of capital, our revenue requirements and,
9 consequently, our customers' bills.

10 C. *Theoretical Underpinnings of the "Cost of Capital"*

11 **Q. WHAT IS THE COST OF CAPITAL?**

12 A. The cost of capital is the competitive price that must be paid to
13 investors to entice them to let someone else use their money. Thus,
14 dividends and interest paid for the use of money are not unlike the
15 payment of rent that permits one to use another's real estate.

16 **Q. WHAT DETERMINES THE COST OF CAPITAL?**

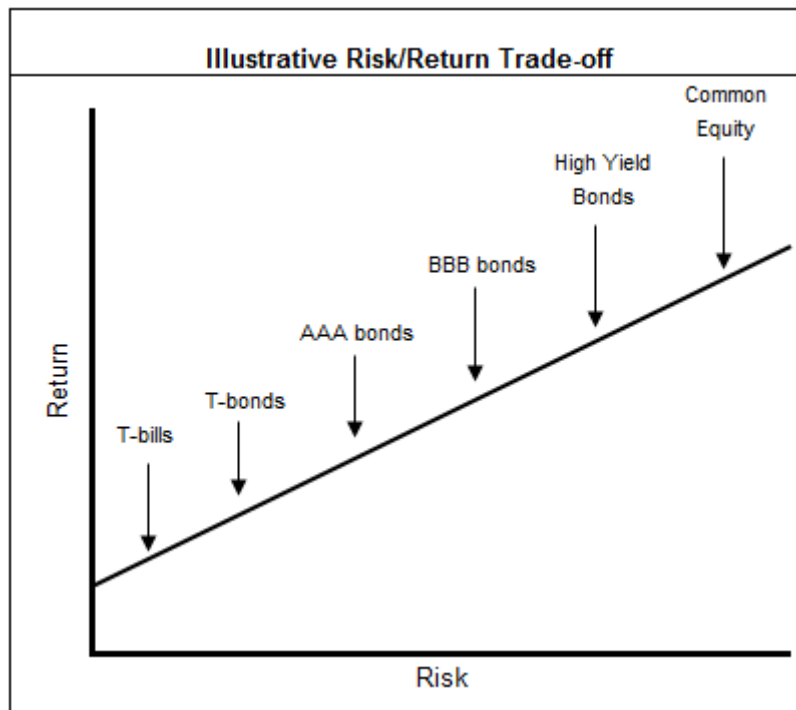
17 A. The cost of capital is based on the time value of money, the
18 uncertainty or risk associated with the investment and the supply and
19 demand for capital.

20 **Q. HOW IS THE COST OF COMMON EQUITY CAPITAL**
21 **DETERMINED?**

22 A. The same time value of money and risk premium concepts apply to
23 equity as they do to debt, but unlike debt securities, with common

1 equity there are no underlying contractual obligations setting forth
2 terms for paying returns. Equity returns are the residual left for
3 shareholders after all the bills have been paid and the more senior
4 claims of debt and preferred stockholders have been satisfied. Their
5 subordination -- that is, the fact that equity holders get paid last --
6 and the lack of contractual obligations to pay returns are the reasons
7 that the cost of equity capital is far higher than the cost of debt. The
8 risk-return trade off illustrated in Figure 3 below shows this
9 relationship.

Figure 3



10 **Q. IF THERE ARE NO CONTRACTUAL, DIRECT WAYS OF**
11 **ASCERTAINING THE COST OF EQUITY, HOW DOES ONE**
12 **DETERMINE ITS COST?**

1 A. The cost of equity has to be estimated indirectly or through inference.
2 Because there is no single method of estimating the cost of equity
3 capital, the process of calculating such an estimate is often
4 controversial with different experts offering differing opinions and
5 different applications of the same estimation methods. The most
6 often-used methods are the constant growth dividend discount
7 model or discounted cash flow (DCF) approach and the capital asset
8 pricing model (CAPM). In addition to the DCF and CAPM
9 approaches, I've also applied another risk premium approach to
10 estimate the cost of equity. Then I used the recently authorized
11 ROE's for electric utilities in Figure 2 as a reasonableness check of
12 my work.

13 D. *DCF Analysis and Peer Group*

14 **Q. PLEASE DESCRIBE THE THEORY UNDERLYING THE DCF**
15 **MODEL.**

16 A. An illustration using bonds provides a good starting point. Let's
17 assume a company is able to issue bonds at \$1,000 each with the
18 promise to return this sum plus interest of \$100 one year later. In the
19 example, investors require a rate of return of 10% per annum for
20 tying up their \$1,000. In this example, the present value today of
21 \$1,100 to be received a year from now is \$1,000 ($\$1,100/1.10 =$
22 \$1,000). The discount rate (10%) is the rate which equates the
23 expected *future* value of an investment to its *present* value.

1 **Q. SPECIFICALLY, HOW DID YOU IMPLEMENT THE DCF MODEL**
2 **AS PART OF YOUR RECOMMENDED ROE FOR WESTAR?**

3 A. I applied the DCF to a group of publicly-traded electric utilities with
4 businesses and risks similar to those of Westar. Because Westar
5 remains a smaller regulated electric utility with a straightforward
6 business model and financial profile, I screened companies to
7 identify those with similar characteristics. Specifically, I started with
8 the universe of Edison Electric Institute (EEI) member electric
9 utilities, of which there are 43 that are publicly-traded. I then
10 screened them to ensure they met the following requirements:

- 11 1. The markets they serve continue to be retail rate
12 regulated as categorized by EEI;
- 13 2. Market capitalization had to be between approximately
14 \$2 and \$16 billion (Westar's market capitalization is
15 approximately \$8 billion);
- 16 3. The companies had to have investment grade credit
17 ratings from either Standard and Poor's or Moody's
18 that fall within one notch above or below Westar, that
19 is from A- to BBB (Westar's rating is BBB+/Baa1);
- 20 4. The companies must pay a common stock dividend;
- 21 5. The companies must have similar business models to
22 Westar in which at least 50% of revenue comes from
23 electric sales;

1 6. The companies had to have regulated generation and
2 distribution and/or transmission operations (vertically-
3 integrated); and

4 7. The companies could not currently be involved in a
5 merger transaction.

6 This resulted in the eleven companies identified in Table 1
7 below, with the averages for size and credit quality remarkably close
8 to Westar:

Table 1

	Company	Ticker	(\$ in billions)		Corporate Ratings	
			Market Cap		S&P	Moody's
1	Alliant Energy Corporation	LNT	\$	10.430	A-	Baa1
2	Ameren Corporation	AEE		15.519	BBB+	Baa1
3	CMS Energy Corporation	CMS		14.076	BBB+	Baa1
4	El Paso Electric Company	EE		2.472	BBB	Baa1
5	Entergy Corporation	ETR		15.588	BBB+	Baa2
6	IDACORP, Inc.	IDA		4.979	BBB	Baa1
7	NorthWestern Corporation	NWE		3.123	BBB	Baa1
8	OGE Energy Corp.	OGE		7.141	A-	A3
9	Pinnacle West Capital Corporation	PNW		10.258	A-	A3
10	PNM Resources, Inc.	PNM		3.624	BBB+	Baa3
11	Portland General Electric Company	POR		4.423	A-	A3
	Peer Group Average		\$	8.330	BBB+	Baa1
	Westar Energy, Inc.	WR	\$	8.129	BBB+	Baa1

9 **Q. DO YOU THINK SIZE (MARKET CAPITALIZATION) IS**
10 **RELEVANT TO YOUR DCF ANALYSIS?**

11 A. Yes. Market capitalization is a relevant selection criterion because
12 size implies a different level of risk. Smaller electric utilities, similar
13 in size to Westar, offer less liquidity, meaning that it is harder for

1 investors to exit or acquire a holding of these stocks without affecting
2 the price. They also tend to raise long-term capital in smaller
3 increments and are therefore less able to negotiate transaction costs
4 and rates because they lack economies of scale. They also tend to
5 lack geographic and regulatory diversification and may be less able
6 to withstand extreme financial demands.

7 For example, SCANA, with a market capitalization of about \$7
8 billion (roughly the same size as Westar), and its partner Santee
9 Cooper (South Carolina's state-owned electric and water utility)
10 recently abandoned the construction of the V.C Sumner Nuclear
11 expansion project after \$9 billion had already been spent. However,
12 Southern Company, with a market capitalization of about \$50 billion,
13 and facing very similar construction challenges, is continuing the
14 construction of two new nuclear units.

15 **Q. HOW DID YOU DETERMINE THE VALUE OF THE VARIABLES**
16 **USED IN YOUR DCF ANALYSIS?**

17 A. The expected dividend (D_1) is the sum of the expected quarterly
18 dividends and additions to these dividends resulting from the
19 reinvestment of the quarterly dividend stream over the annual
20 investment period. D_1 depends on when the quarterly dividend
21 payments are made during the period and in which calendar quarter
22 scheduled dividend increases occur. This gives the model a bit more
23 precision because it takes into consideration the specific time when,

1 throughout the year, utilities adjust and pay their dividends. Part of
2 the intuitive appeal of this model is that utilities typically maintain very
3 predictable quarterly dividend payment and dividend adjustment
4 schedules. This makes the quarterly model more relevant and
5 intuitive.

6 **Q. HAS THIS QUARTERLY DIVIDEND FORMULATION BEEN USED**
7 **IN CASES BEFORE THIS COMMISSION?**

8 A. Yes.

9 **Q. WHAT METHOD DID YOU USE FOR YOUR STOCK PRICE**
10 **INPUTS?**

11 A. For the price, (P_0), I used the average of the companies' stock prices
12 for a 15-day trading period ending November 30, 2017.

13 **Q. HOW DID YOU DETERMINE THE GROWTH RATES USED IN**
14 **YOUR MODEL?**

15 A. I used forecasted long-term – using the same term as investors do,
16 that is three to five years¹ – earnings growth rates published by the
17 major investment and research firms and gathered by *Thomson*
18 *Reuters, Bloomberg*, and forecasted long-term earnings growth rates
19 published by *Value Line*. This enabled me to gather on average
20 about three individual analyst's estimates of long-term growth for
21 each company in the peer group.

¹ For the balance of this discussion, I will use the term “long-term” to mean three to five years.

1 **Q. WHY DID YOU USE LONG-TERM *EARNINGS* GROWTH RATES**
 2 **AS OPPOSED TO LONG-TERM *DIVIDEND* GROWTH RATES IN**
 3 **YOUR DCF MODEL?**

4 A. Most analysts typically concentrate their efforts on forecasting
 5 earnings, and only provide one or two years of dividend forecasts. In
 6 general, dividend growth tends to follow earnings growth because
 7 regulated electric utilities typically have an established payout ratio
 8 range. Consequently, long-term earnings growth rates should
 9 indicate the same general growth rate for dividends if a company is
 10 to maintain a reasonably consistent payout ratio, which the market
 11 suggests utilities strive to do. The illustrative example in Table 2
 12 below demonstrates this relationship.

Table 2

Illustrative Example: Dividend Growth Mirrors Earnings Growth						
Earnings growth rate	5%					
Payout ratio	60%					
	Yr	1	2	3	4	5
Earnings per share	\$	2.50	\$ 2.63	\$ 2.76	\$ 2.89	\$ 3.04
Dividends per share	\$	1.50	\$ 1.58	\$ 1.65	\$ 1.74	\$ 1.82
Annual dividend growth rate			5%	5%	5%	5%
Annual payout ratio		60%	60%	60%	60%	60%

13 **Q. USING THE ABOVE DEFINED VARIABLES FOR YOUR DCF**
 14 **MODEL, WHAT WERE THE RESULTING UNADJUSTED**
 15 **RESULTS?**

16 A. My sample of eleven companies yielded an average of 8.10% and a
 17 median of 8.38%. I excluded results of one company that had

1 negative growth rates and yielded results lower than the cost of debt
 2 that Westar is requesting in this case. This is an example of why
 3 expert judgment of practitioners is needed when simple models yield
 4 illogical outputs. Table 3 below shows the peer group companies and
 5 resulting unadjusted DCF estimate of the cost of equity capital.

Table 3

Company	Unadjusted ROE
Alliant Energy Corp	8.08%
Ameren Corp	9.00%
CMS Energy Corp	10.22%
El Paso Electric Co	7.62%
Entergy Corp	2.38% (excluded)
IDACORP Inc	5.78%
NorthWestern Corp	6.62%
OGE Energy Corp	8.67%
Pinnacle West Capital	8.70%
PNM Resources Inc	8.85%
Portland General Electric Co	7.46%
Peer Group Average	8.10%
Peer Group Median	8.38%

6 E. *CAPM Analysis*

7 **Q. PLEASE DESCRIBE THE FORWARD-LOOKING CAPM.**

8 A. The CAPM analysis is a risk premium method that estimates the cost
 9 of equity for a given security as a function of a risk-free return plus a
 10 risk premium to compensate the investor for the non-diversifiable or
 11 systematic risk of a given equity security. As shown in the equation
 12 below, CAPM is defined by three inputs, each of which, in theory,
 13 must be forward-looking, as the formula is estimating the future

1 expected return on equity. The CAPM, like the DCF analysis needs
2 to be forward-looking because it is estimating investors' expected
3 returns. The CAPM formula is as follows:

$$4 \quad K_e = R_f + \text{Beta} (R_p)$$

5 Where:

6 K_e = return on equity

7 R_f = return on the risk-free security

8 Beta = volatility of the security relative to the volatility of the
9 entire market

10 R_p = market risk premium (market return less the risk-free
11 rate) required for investors to purchase equity securities
12 instead of treasuries.

13 In the equation above, (R_p) represents the market risk
14 premium that equity investors demand, since they are assuming
15 more risk than bond investors. Under CAPM theory, since investors
16 can diversify away unsystematic risk by adding securities to their
17 portfolio, the investor should only be concerned with the systematic
18 risk contributed by the individual security, which is represented by
19 beta. Beta represents the volatility of a security and its correlation to
20 the market.

21 By way of example, a security with a beta of 1 is as volatile
22 (risky) as the market and a security with a beta of less than 1, is less
23 volatile.

1 **Q. WHAT ASSUMPTIONS DID YOU USE IN YOUR CAPM**
2 **ANALYSIS?**

3 A. The infrastructure in the utility industry is composed of assets which
4 typically last for 30, 40 or more years. Consequently, the risk-free
5 rate should be based on investments of a similar lifespan. For that
6 reason, I have relied on the 15-day average ending November 30,
7 2017 and projected 30-year Treasury bond yield for Q3 2018 in the
8 model, the same time period when this case will be reviewed and
9 when updated retail rates, as a result of the case, will become
10 effective.

11 **Q. HOW DID YOU ESTIMATE THE MARKET RISK PREMIUM?**

12 A. This approach is based upon the market required return, less the
13 return on 30-year Treasury bonds. For the market required return, I
14 used a constant growth DCF model utilizing data from Bloomberg. I
15 used companies in the S&P 500 Index for which there are long-term
16 growth estimates. I also used a projected annual dividend for each
17 security to compute the dividend yield for each company.
18 Companies with no projected growth rate or negative growth rate
19 and/or no projected dividend or zero dividend were excluded. Based
20 on those companies and inputs, I calculated the market return and
21 subtracted out the risk-free rate (the 30-year Treasury bond yield).

22 **Q. WHAT BETA COEFFICIENT DID YOU USE IN YOUR ANALYSIS?**

1 A. As shown in Table 4, I used the beta coefficient as reported by
 2 *Bloomberg* and *Value Line* for the same proxy group of companies
 3 used in the DCF analysis.

Table 4

Company Name	Ticker	Bloomberg	Value Line
		Beta	Beta
Alliant Energy Corporation	LNT	0.49	0.70
Ameren Corporation	AEE	0.50	0.65
CMS Energy Corporation	CMS	0.47	0.65
El Paso Electric Company	EE	0.78	0.80
Entergy Corporation	ETR	0.59	0.65
IDACORP, Inc.	IDA	0.71	0.70
NorthWestern Corporation	NWE	0.63	0.70
OGE Energy Corp.	OGE	0.66	0.95
Pinnacle West Capital Corporation	PNW	0.58	0.70
PNM Resources, Inc.	PNM	0.64	0.75
Portland General Electric Company	POR	0.50	0.70
	Average	0.60	0.72
	Median	0.61	0.70

4 **Q WHAT WERE THE RESULTING UNADJUSTED ESTIMATES OF**
 5 **COST OF EQUITY DERIVED USING THE CAPM APPROACH?**

6 A. My forward CAPM analysis yielded a range of 9.46% - 9.99%. The
 7 risk premium will change as interest rates change; that is why I've
 8 provided a range in which I believe the estimated return on equity
 9 falls using the forward CAPM approach. Tables 5 and 6 show the
 10 calculation of the risk premium and the resulting unadjusted
 11 estimates of ROE.

Table 5

Calculation of Risk Premium			
	Treasury	S&P 500 ROE	Risk Premium
15 day average 30-yr	2.80%	12.85%	10.05%

Table 6

Forward CAPM Results							
	Bloomberg Value Line				ROE Range		
	Treasury	Risk Premium	Average Beta	Average Beta	Bloomberg Beta	Value Line Beta	Average Beta
15 day average 30-yr	2.80%	10.05%	0.60	0.72	8.86%	10.06%	9.46%
Projected Q3 2018 30-yr	3.30%	10.05%	0.61	0.72	9.41%	10.57%	9.99%

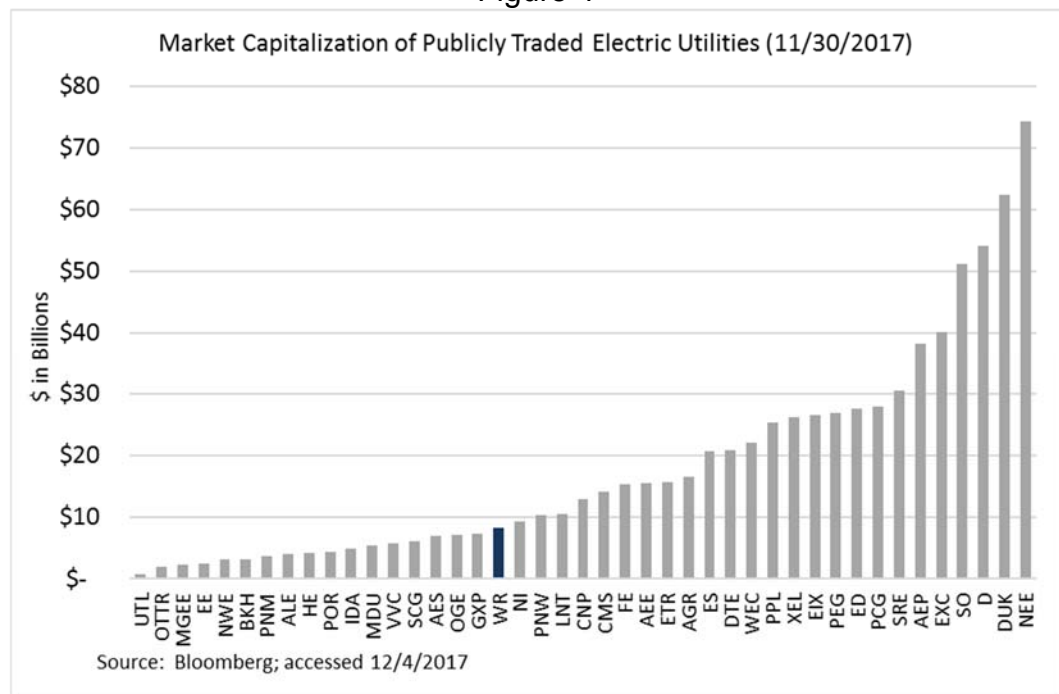
1 **Q. DID YOU MAKE AN ADJUSTMENT TO YOUR CAPM RESULTS**
2 **TO ACCOUNT FOR WESTAR’S RELATIVELY SMALL SIZE**
3 **(MARKET CAPITALIZATION)?**

4 A. No. Because both the existence of the effect and the size of the
5 proper adjustment are not without controversy, I decided not to make
6 such an adjustment. Consequently, I view the results of my CAPM
7 as providing a conservative – that is, low – estimate of Westar’s
8 required ROE. As I said, since each method is an estimation, the
9 reasonableness of each should be corroborated by other factors and
10 expert judgment.

11 **Q. YOU SAID THAT CAPM “UNDERESTIMATES THE COST OF**
12 **EQUITY CAPITAL FOR SMALLER COMPANIES.” WESTAR’S**
13 **MARKET CAPITALIZATION IS APPROXIMATELY \$7 BILLION.**
14 **HOW CAN YOU CHARACTERIZE WESTAR AS “SMALL”?**

1 A. Compared to other firms in the capital markets, including other
 2 utilities, Westar is indeed small. For instance, the market
 3 capitalization of NextEra Energy is over \$70 billion, Duke Energy is
 4 over \$60 billion, and Southern Company is about \$50 billion. Figure
 5 4 below shows where Westar stands versus other investor-owned
 6 utilities in terms of market capitalization.

Figure 4



7 F. Risk Premium Analysis

8 Q PLEASE DESCRIBE THE RISK PREMIUM ANALYSIS.

9 A. The risk premium analysis attempts to estimate the equity risk
 10 premium as compared to the then prevailing long-term interest rates
 11 by comparing how state regulatory commissions have responded to
 12 the change in long-term interest rates (in this analysis the long-term

1 interest rate used was the yield on the 10-year Treasury note) by the
2 ROEs they have authorized.²

3 In the analysis, I relied on the authorized ROEs issued from
4 1990 through the end of November 2017 as reported by Regulatory
5 Research Associates (RRA) a firm owned by SNL Financial (SNL).
6 There were 649 rate rulings related to vertically-integrated electric
7 utilities during this period. I excluded cases where an ROE was not
8 specified. For each case I computed the lag in days between when
9 a case was filed and when the case was ruled on. The average lag
10 of the data set I used was 314 days. I then used the historical daily
11 10-year Treasury yields since 1998, as reported by *Bloomberg*, and
12 computed a 314-day average yield to represent the average 10-year
13 Treasury yield that occurred during each given rate proceeding.
14 Then for each rate case I found the equity risk premium by
15 subtracting the authorized ROE from the average 10-year Treasury
16 yield. Using that data set, I ran a regression with the equity risk
17 premium as the dependent variable (y) and the average 10-year
18 Treasury yield as the independent variable (x). The regression
19 equation produced was:

20
$$y = \text{slope} * \ln(x) + \text{constant}$$

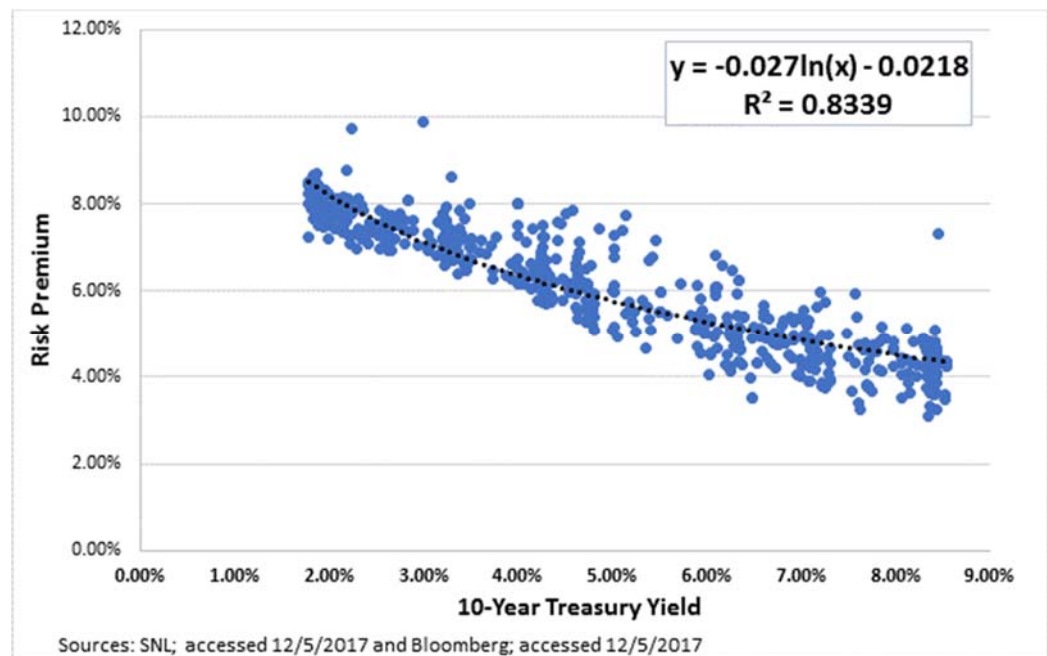
21
$$y = -0.027 * \ln(x) - 0.0218$$

² 30-year Treasuries were not issued between February 2002 and February 2006; otherwise the 30-year Treasury would have been the preferred risk-free rate to use in the analysis.

1

The regression results are displayed below in Figure 8.

Figure 8



2

Q. WHY IS THIS ANALYSIS RELEVANT?

3

A. It is relevant because it shows how past commissions across the United States have reacted to the change in interest rates. This analysis also shows that the relationship between the change in Treasury yields and authorized returns on equity is not constant, or in other words, the risk premium changes and does not remain static as the yields on Treasuries increase and decrease – a common flaw in the application of many risk premium based analyses including the CAPM. The analysis also demonstrates that as Treasury yields have declined in recent years, the equity risk premium has increased.

4

5

Q. WHAT WERE THE RESULTING ESTIMATES OF COST OF EQUITY DERIVED USING THE RISK PREMIUM APPROACH?

6

1 A. As shown by Table 7, using the 314-day average ending November
 2 30, 2017, 10-year Treasury yield, produces an 10.31% return on
 3 equity and using the projected Q3 2018, 10-year Treasury yield
 4 produces a 10.27% return on equity.

Table 7

Risk Premium Results		
	314-day average	
	Current (11/30/2017)	Projected (Q3 2018)
10-year Treasury	2.26%	2.74%
Risk Premium	8.05%	7.53%
Return on Equity	10.31%	10.27%

5 G. *Issuance Cost Adjustment*

6 **Q. WHAT FURTHER ADJUSTMENT IS NEEDED TO DETERMINE**
 7 **THE APPROPRIATE AUTHORIZED ROE FOR WESTAR?**

8 A. The preliminary results must be adjusted to account for the costs
 9 incurred while issuing common stock, something neither the CAPM
 10 analysis or the DCF model considers. These costs are referred to
 11 as issuance or flotation costs. To the extent other state commissions
 12 recognize these legitimate equity costs, the risk premium analysis
 13 already takes these costs into account.

14 **Q. WHAT ARE FLOTATION COSTS?**

15 A. When a company issues common equity, just as it does with bonds
 16 and preferred equity, it incurs costs. The amount investors pay for
 17 the securities is greater than the net proceeds the issuing company

1 receives after taking transaction costs into account. Flotation costs
2 include costs such as underwriting, legal and printing fees, and, to
3 attract new buyers, the typical discount to the market that is required,
4 and market pressure; that is the effect of more supply of the shares
5 for a given demand.

6 **Q. HOW DO SUCH COSTS AFFECT THE UTILITY?**

7 A. A simple example illustrates this point. Assume that a new utility is
8 formed which requires \$10,000 of net capital to purchase the
9 necessary assets, or rate base, to serve customers. Stock can be
10 sold to investors to raise the money, but, in doing so, the company
11 incurs issuance costs of \$500. As a result, for the company to raise
12 \$10,000 of net proceeds it must sell \$10,500 of securities to
13 investors. Assume further that investors require a rate of return of
14 10.0%. If rates are set to earn 10.0% on the rate base of \$10,000,
15 investors receive income of just \$1,000, which is only a 9.5% return
16 on their total investment of \$10,500. Theoretically, this means the
17 price will fall, thereby driving up the return to 10.0%, the market cost
18 of capital in this example. For investors to earn their required return
19 of 10.0% on the amount they actually invested when they bought the
20 securities, utility rates must generate a 10.0% return on total cost of
21 the equity purchased by investors – \$10,500; a return that equates
22 to a 10.5% return on the lower net amount in this simplified example.

1 **Q. HAVE THE COMMISSION OR STAFF EXPERT WITNESSES**
2 **RECOGNIZED COMMON STOCK FLOTATION COSTS**
3 **PREVIOUSLY?**

4 A. Yes. Staff witness Mr. Gatewood has historically agreed that
5 common stock flotation costs should be recognized when estimating
6 the cost of equity capital. In his testimony in Docket No. 15-WSEE-
7 115-RTS, Mr. Gatewood even stated a range of 10 to 12 basis points
8 to recover flotation costs comports to Commission past practice.

9 **Q. WHY IS IT REASONABLE TO INCLUDE FLOTATION COSTS**
10 **WHEN SETTING AN ROE FOR WESTAR DESPITE THE FACT**
11 **THAT WESTAR HASN'T TRACKED THE ACTUAL AMOUNT OF**
12 **FLOTATION COSTS IT HAS INCURRED?**

13 A. Westar has been an incorporated entity for nearly 100 years. In that
14 time, there has never been an accounting mechanism to recover or
15 track costs associated with equity issuances. Because there has
16 been no accounting rule or regulatory mechanism to track equity
17 issuance costs from the past 100 years, tracking and quantifying
18 issuance cost recovery of past costs would not be possible. Because
19 of the lack of such historic information and in the interest of inter-
20 generational fairness, a flotation cost adjustment is required on an
21 ongoing basis.

22 **Q. HOW DOES USE OF A FLOTATION COST ADJUSTMENT**
23 **ADVANCE INTER-GENERATIONAL FAIRNESS?**

1 A. As with all costs, issuance costs should be borne by those customers
2 receiving the associated benefit. If common stock issuance costs
3 were expensed as incurred, only customers who are served under
4 rates which recover the expense of a particular issuance would bear
5 the entire cost associated with it. However, because common equity
6 has an indefinite life, issuance of stock benefits both current and
7 future customers. Consequently, it is appropriate to include flotation
8 costs in the cost of equity because they represent costs associated
9 with permanent investment in the business. Consistent with this
10 concept, accounting rules do not allow for the expensing of these
11 costs as they are incurred.

12 **Q. WHY ARE COMMON STOCK ISSUANCE COSTS NOT**
13 **AMORTIZED OVER TIME, AS THEY ARE WITH BONDS?**

14 A. In the case of bond financing, issuance costs are amortized over the
15 life of the bonds, with the unamortized portion reflected in the net
16 interest rate calculation. This ensures that those customers
17 benefiting from the bond issue bear their share of the corresponding
18 issuance costs but, unlike bonds, common stock has an indefinite life
19 and any such amortization period would be arbitrary. An appropriate
20 means of recognizing these costs is to adjust the DCF estimate of
21 ROE upward slightly to capture the effect of issuance costs.

22 **Q. HOW DID YOU RECOGNIZE FLOTATION COSTS IN YOUR**
23 **ANALYSIS?**

1 A. I applied an adjustment to the unadjusted DCF result to ensure that
2 the costs of raising capital are recovered in the ratemaking process.

3 **Q. WHAT IS THE MAGNITUDE OF THE ADJUSTMENT AND HOW**
4 **SHOULD IT BE APPLIED?**

5 A. The relevant financial literature suggests that issuance costs
6 average about 4.0% to 5.5% of gross proceeds. As stated by Roger

7 A. Morin, Ph.D. in *New Regulatory Finance (2006)*:

8 . . . empirical studies by Lee et al. (1996), Borum and
9 Malley (1986), Logue and Jarrow (1978), Pettway
10 (1984), Pettway and Radcliffe (1985), Excbo and
11 Masulis (1987), Bhagat and Frost (1986), Mikkelson
12 and Partch (1986) and Smith (1977, 1986),
13 underwriting costs and expenses average 4.0%-5.5%
14 of gross proceeds from utility stock offerings. The more
15 recent study by Lee et al. (1996) finds an average
16 flotation cost of 4.92% for utility common stock
17 offerings³

18 Morin goes on to summarize that, for utility stocks, the costs
19 associated with market pressure range from 0.6% up to 3.0% based
20 on relevant studies.

21 With the direct costs and market pressure related to issuing
22 equity, flotation costs average **above** 5.0%.

23 In my analysis, I made the adjustment by reducing the stock
24 price used in the DCF formula by 5.0%. This is a reasonable
25 approach that is toward the lower end of issuance and market
26 pressure cost estimates that is accepted in financial literature.

³ Morin, Roger A., *New Regulatory Finance*, Public Utility Reports, at 323 (2006).

1 **Q. TO WHAT PORTION OF COMMON EQUITY IS THE**
2 **ADJUSTMENT APPLIED?**

3 A. That is a somewhat contentious point. There is disagreement as to
4 whether an adjustment should be applied to the entire equity
5 component or just the part that is raised directly from investors (*i.e.*,
6 excluding the portion attributable to retained earnings).

7 There are arguments that the adjustment needs to be applied
8 to the entire common equity component, *i.e.*, both paid-in capital and
9 retained earnings. The argument for this position is that it is a
10 common but mistaken belief that because retained earnings are not
11 raised directly from investors, no issuance costs are attributable to
12 these funds. However, because retained earnings are sourced in the
13 original stock investment and because this investment included
14 flotation costs, mathematical properties cause the effects to flow
15 through retained earnings as well. This argument holds that, without
16 an adjustment to the entire common equity balance (*i.e.*, both paid-
17 in-capital and retained earnings), shareholders will not receive an
18 adequate return.

19 Others suggest that the adjustment should be applied only to
20 the portion of equity that is raised directly from investors (*i.e.*,
21 excluding retained earnings). Rather than ask the Commission to
22 engage in that academic controversy, I have taken the more

1 conservative approach by not applying the adjustment to the retained
 2 earnings portion of equity.

3 **Q. WHAT IS THE IMPACT OF THE FLOTATION COST**
 4 **ADJUSTMENT ON YOUR DCF ESTIMATES?**

5 A. The flotation cost adjustment increased the average and median
 6 DCF model results by 15 and 16 basis points, respectively (see Table
 7 8).

Table 8

Company	Unadjusted ROE	Adjusted ROE	Flotation Costs
Ameren Corp	8.08%	8.16%	0.08%
Allete Inc	9.00%	9.16%	0.16%
Avista Corp	10.22%	10.38%	0.16%
Great Plains Energy Inc	7.62%	7.76%	0.13%
IdaCorp Inc	2.38%	2.61%	0.22% (excluded)
Alliant Energy Corp	5.78%	5.91%	0.13%
NorthWestern Corp	6.62%	6.81%	0.19%
OGE Energy Corp	8.67%	8.89%	0.21%
PNM Resources Inc	8.70%	8.87%	0.17%
Pinnacle West Capital	8.85%	8.98%	0.13%
Portland General Electric Co	7.46%	7.61%	0.16%
Peer Group Average	8.10%	8.25%	0.15%
Peer Group Median	8.38%	8.52%	0.16%

8 As Table 9 shows, the proxy group's average and median
 9 retained earnings to common equity ratio is around 50%, with
 10 Westar's being 30%. Based on the peer group's retained earnings to
 11 common equity ratio, at minimum, an 8-basis point adjustment for
 12 issuance costs is reasonable.

Table 9

<i>dollars in millions</i>				
<i>Balances as of 9/30/2017</i>				
	Retained	Total		
	Earnings	Common	Equity	Ratio
Alliant Energy Corporation	\$ 2,325	\$ 4,154		56.0%
Ameren Corporation	1,830	7,345		24.9%
CMS Energy Corporation	(434)	4,535		-9.6%
El Paso Electric Company	1,167	1,136		102.7%
Entergy Corporation (exclude)	8,618	8,690		99.2%
IDACORP, Inc.	1,413	2,248		62.9%
NorthWestern Corporation	436	1,726		25.3%
OGE Energy Corp.	2,527	3,617		69.9%
Pinnacle West Capital Corporation	2,576	5,142		50.1%
PNM Resources, Inc.	691	1,766		39.2%
Portland General Electric Company	1,205	2,402		50.2%
Peer Group Average				47.1%
Peer Group Median				50.1%
Westar Energy Inc	\$ 1,196	\$ 3,929		30.4%

Source: Bloomberg; accessed 12/04/2017

- 1 H. *Summary of ROE Estimation Results and Recommendation*
- 2 **Q. PLEASE SUMMARIZE THE ROE YOU ARE RECOMMENDING?**
- 3 A. Table 10 summarizes the ROE results of three estimates of ROE,
- 4 adjustments for flotation costs, and recently authorized ROEs by
- 5 other state commissions.

Table 10

Adjusted ROE Recommendation				
Flotation Costs	0.08%			
<i>Issuance costs only applied to DCF and CAPM results</i>				
	<u>Unadjusted Range</u>		<u>Range with Flotation Costs</u>	
DCF Results	8.10%	8.38%	8.18%	8.46%
Forward CAPM Results	9.46%	9.99%	9.54%	10.07%
Risk Premium Results	10.27%	10.31%	10.27%	10.31%
Recently Authorized ROEs	9.75%	9.85%	9.75%	9.85%

1 A 9.85% ROE is well within the range of reasonableness and
2 is what is supported in this rate application. A 9.85% ROE will
3 continue to give Westar the opportunity to earn returns
4 commensurate with our peers and allow us to compete effectively for
5 capital. A 9.85% ROE is also near the average of recently authorized
6 ROE's for vertically-integrated electric utilities.

7 **Q. THANK YOU.**