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 a General Rate Increase for Electric Service	)))	Case No. ER-2012-0174

and

In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement General Rate Increase for Electric Service.	))))	Case No. ER-2012-0175

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

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COMES NOW Midwest Energy Consumers' Group ("MECG"), by and through the undersigned counsel, pursuant to Commission Rule 4 CSR 240-2.140(6), and submits its Proposed Findings of Fact and Conclusions of Law on the issues set forth below.

I. BURDEN OF PROOF

1. Section 393.150(2) provides that, in any rate increase proceeding, the burden of proof is on the party seeking the increased rate.

2. The Supreme Court has provided a great deal of insight regarding burden of proof. Specifically, as it applies to Commission proceedings, the Supreme Court has told us: (1) that burden of proof is a "substantial right" of the customers and (2) that burden of proof should be "rigidly enforced" by the Commission.

> The rules as to burden of proof are important and indispensable in the administration of justice, and constitutes a substantial right of the party of whose adversary the burden rests; they should be jealously guarded and rigidly enforced by the courts.[1]

3. The Supreme Court has also provided definition for the burden of proof.

> The burden of proof meaning the obligation to establish the truth of the claim by a preponderance of the evidence, rests throughout upon the party asserting the affirmative of the issue. The burden of proof never shifts during the course of the trial.[2]

As such, the burden of proof means that the proponent of higher rates in a Commission proceeding has the "obligation to establish the truth" of its need for the higher rates. In this regard, customers are given the benefit of the doubt that the utility only needs the lower rate and that the utility must "prove" that the higher rate is necessary. Therefore, if there is any question regarding the legitimacy of a cost or expense; if the Commission does not adequately understand an issue; or if the Company fails to adequately explain its need for the higher rate, then the utility has failed to meet its burden of proof.

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[1] *Highfill v. Brown*, 320 S.W.2d 493 (Mo. 1959).
[2] *Clapper v. Lakin*, 123 S.W.2d 27 (Mo. 1938).

4. Finally, the Supreme Court has provided insight as to the implications to a party that fails to meet its burden of proof: "the failure of the plaintiff to sustain such burden ***is fatal*** to his or her relief or recovery."[3]

[3] *Id.*

II. RETURN ON EQUITY

A. FINDINGS OF FACT

1. This issue concerns the rate of return that KCPL / GMO will be authorized to earn on its rate base. Rate base includes items like generating plants, electric meters, wires and poles, and the trucks driven by KCPL / GMO repair crews. In order to determine a rate of return, the Commission must determine KCPL / GMO's cost of obtaining the capital it needs.

2. Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return. The cost of long-term debt and the cost of preferred stock are relatively easy to determine because their rate of return is specified within the instruments that create them. In contrast, in determining a return on equity, the Commission must consider the expectations and requirements of investors when they choose to invest their money in KCPL / GMO rather than in some other investment opportunity. As a result, the Commission cannot simply find a rate of return that is unassailably scientifically, mathematically, or legally correct. Such a "correct" rate does not exist. Instead, the Commission must use its judgment to establish a rate of return on equity attractive enough to investors to allow the utility to fairly compete for the investors' dollar in the capital market, without permitting an excessive rate of return on equity that would drive up rates for KCPL / GMO's ratepayers. In order to obtain guidance about the appropriate return on equity, the Commission considers the testimony of expert witnesses.

3. Four financial analysts offered recommendations regarding an appropriate return on equity in this case. Dr. Samuel Hadaway testified on behalf of KCPL / GMO.

In his testimony,[4] Dr. Hadaway relies exclusively on three variations of the DCF analysis.[5] First, Dr. Hadaway conducted a constant growth DCF analysis relying on analysts' growth estimates which resulted in a return on equity of 9.80%.[6] Second, Dr. Hadaway conducted a constant growth DCF analysis that substituted his own subjective estimation of the long-term GDP growth rate. The result of this analysis is a return on equity of 10.10%.[7] Third, Dr. Hadaway combines the analysts' growth estimates and his own estimation of long-term GDP growth into a multi-stage DCF analysis. The result of his multi-stage DCF analysis is a return on equity of 9.90%.[8] Finally, Dr. Hadaway presents terminal value DCF analysis with a return of 10.30%.[9] Thus, Dr. Hadaway recommends a return on equity range of 9.80% - 10.30%. Given "current difficulties with interpreting financial model estimates and the forecasts for higher interest rates," KCPL requests a return at the high end of Dr. Hadaway's range [10]

4. Michael Gorman testified on behalf of the Office of the Public Counsel. In his testimony, Mr. Gorman conducts three versions of the DCF analysis, a risk premium analysis and a CAPM analysis. First, Mr. Gorman conducts a constant growth DCF analysis based upon analysts' growth rates resulting in a return on equity of 9.46%.[11] Second, Mr. Gorman conducts a sustainable growth DCF analysis which

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[4] Dr. Hadaway initially provided the results of his analysis in his direct testimony. In his rebuttal testimony, Dr. Hadaway "updated" his analysis "to take into account recent data and current conditions in the capital markets." (KCPL Exhibit 20, pages 29-31).

[5] While Dr. Hadaway conducted a risk premium analysis, he summarily rejected the results of that analysis (KCPL Exhibit 19, page 33). The results of that updated risk premium analysis indicate an ROE of 9.87% (KCPL Exhibit 20, page 31)

[6] KCPL Exhibit 20, Schedule SCH-12, page 1.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] KCPL Exhibit 20, page 31.

[11] OPC Exhibit 300, page 19.

resulted in a return on equity of 9.15%.[12] Third, Mr. Gorman conducts a multi-stage DCF analysis which results in a return on equity of 9.30%.[13] Next, Mr. Gorman undertook a risk premium analysis with a return on equity range of 9.00% to 9.20% with a midpoint of 9.10%.[14] Finally, Mr. Gorman conducts a CAPM analysis resulting in a return on equity of 8.40%.[15] Mr. Gorman rejected the results of his CAPM analysis and based his recommendation on the three DCF analyses and the risk premium approach. The ultimate result of Mr. Gorman's multiple analyses is a recommended return on equity of 9.10% to 9.50% with a midpoint of 9.30%.[16] The results of each of Mr. Gorman's studies are as follows:

MODEL		RESULT
DCF		
	Constant Growth (analyst's growth rates)	9.46%
	Constant Growth (GDP growth rate)	9.15%
	Multi-Stage	9.30%
Risk Premium		9.10%
Range		9.10% - 9.50%

7. A utility's cost of common equity is the return investors require on an investment in that company. Investors expect to achieve their return by receiving dividends and stock price appreciation. Financial analysts use variations on three generally accepted methods to estimate a company's fair rate of return on equity. The Discounted Cash Flow (DCF) method assumes the current market price of a firm's stock is equal to the discounted value of all expected future cash flows.[17] The Risk Premium

[12] *Id.* at page 21.
[13] *Id.* at page 28.
[14] *Id.* at page 33.
[15] *Id.* at page 39.
[16] *Id.*
[17] OPC Exhibit 300, page 16.

method assumes that all of 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 to compensate the investor for the risks of investing in equities compared to bonds.[18] The Capital Asset Pricing Method (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, and the expected risk premium on the market portfolio.[19] No one method is any more "correct" than any other method in all circumstances. Analysts balance their use of all three methods to reach a recommended return on equity.

8. In reviewing the various return on equity recommendations, it becomes apparent that the Commission's analysis boils down to: (1) the determination of the appropriate growth rates for use in the various DCF analyses and (2) whether the Commission wants to limit their return on equity analysis to solely DCF methods or whether it wishes to consider the results of the risk premium and CAPM analyses.

GROWTH RATES

9. As previously mentioned, all three experts rely upon analysts' growth rates for use in their initial constant growth DCF. As the Commission found in its recent AmerenUE decision, these analysts' growth rates are currently troublesome in that they are "based on an unsustainably high dividend yield and median growth rate."[20] While the DCF methodology is intended to be perpetual in nature, these underlying analyst growth estimates are only focused on the short-term.[21] Therefore, while the Commission is not willing to completely eliminate the results of the constant growth DCF based upon

[18] *Id.* at pages 29-30.
[19] *Id.* at page 34.
[20] *Report and Order*, Case No. ER-2010-0036, ("*AmerenUE*") page 21.
[21] OPC Exhibit 300, page 19.

analysts' growth estimates, it is mindful of the fact that, given current conditions in the electric industry, the results of that analysis are likely to be overstated.

10. In order to avoid the short-term nature of analysts' growth rates, Dr. Hadaway replaces the analysts' growth rates with an estimate of long-term GDP growth. While the use of a long-term GDP growth rate certainly appears more reasonable than the analysts' growth estimates, the GDP growth estimation provided by Dr. Hadaway is troublesome. As pointed out by Mr. Gorman, Dr. Hadaway rejects all recognized measures of GDP growth and instead provides his own estimate of GDP growth (5.8%)[22] based upon historical average GDP growth rates.[23] In this regard, Dr. Hadaway ignores numerous publicly available estimates of GDP growth.

The Commission is aware of its recent AmerenUE decision in which we stated an obvious preference for the use of publicly available assumptions as opposed to subjective assumptions. The Commission's rationale being that only such publicly available assumptions could be actually relied upon by the investment community in making its market decisions.

> Murray's reliance on analyst reports to support his recommendation is misplaced. ***Most investors do not have access to the specific analyst reports that Murray examined and thus they cannot rely on them in deciding where to invest their money.***[24]

As Mr. Gorman notes, if Dr. Hadaway's subjective estimate of GDP growth (5.8%) is replaced with publicly available estimate of GDP growth (Mr. Gorman uses the 4.90% estimate provided by *Blue Chip Economic Indicators*), the result of Dr.

[22] KCPL Exhibit 19, page 22.
[23] OPC Exhibit 300, pages 46-47.
[24] *AmerenUE* at page 20, paragraph 18 (emphasis added).

Hadaway's constant growth (GDP) DCF analyses drops from 10.3% to 9.4%.[25] The Commission notes that it has previously expressed concern with Dr. Hadaway's "transparent effort to inflate the company's proposed return on equity."[26] The use of such subjective growth estimates to the complete disregard of publicly available estimates of GDP growth appears to be such a "transparent effort to inflate" the recommended return on equity.

11. Ultimately, the Commission notes that, simply by replacing his subjective GDP growth estimate with a publicly available GDP growth estimate, Dr. Hadaway's DCF analysis leads to results that fall comfortably within the range recommended by Mr. Gorman (9.10% - 9.50%).

MODEL	HADAWAY RESULT	ADJUSTED HADAWAY RESULT
CONSTANT GROWTH DCF (Analysts' Growth Rates)	10.00%	9.50%
CONSTANT GROWTH DCF (Long-Term GDP Growth Rate)	10.30%	9.40%
TWO-STAGE GROWTH DCF	10.10%	9.30%
AVERAGE	10.10%	9.40%

Source: OPC Exhibit 300, page 49.

<u>OTHER RETURN ON EQUITY METHODOLOGIES</u>

12. As mentioned, KCPL's return on equity relies exclusively on various versions of the DCF analysis. In contrast, Mr. Gorman conducted and considered the results of his DCF analyses as well as the risk premium analysis in making his recommendation. Although not as egregious as the situation confronted in a recent

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[25] OPC Exhibit 300, page 48.
[26] *Report and Order*, Case No. ER-2007-0004 (issued May 17, 2007).

AmerenUE decision,[27] the Commission has, at least implicitly, stated a desire to consider the results of other methodologies. Interestingly, Dr. Hadaway initially conducted a risk premium analysis. Given its results of 9.87%, Dr. Hadaway based his recommendation entirely on his DCF analyses.

13. Just as the Commission believes it appropriate to consider the results of the constant growth DCF analysis even though based upon unsustainable analysts' growth estimates, it also believes that it should consider the results of the risk premium analyses. In this light, the Commission notes that Mr. Gorman's risk premium analysis results in a return on equity of 9.10%[28]. Given the foregoing analysis, the Commission again finds that the return on equity range recommended by Mr. Gorman (9.10% - 9.50%) to be the "balanced analysis that the Commission seeks."[29]

14. While the Commission believes that it fulfills the requirements of *Hope*[30] and *Bluefield*[31] through the comparable company analysis, it is also cognizant of the requirement that any awarded return on equity be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.[32] With this in mind, the Commission notes that the national average return for vertically integrated electric utilities in the second quarter of 2012 was 9.95%.[33] Demonstrating the

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[27] In that case, the Commission discussed the recommendation provided by AmerenUE that relied solely on the constant growth DCF analysis. Instead of relying simply on a constant growth analysis that relied upon "unsustainably" high growth rates, the Commission also considered the results of other DCF analyses. *AmerenUE* at page 22.
[28] OPC Exhibit 300, page 33.
[29] *Report and Order,* Case No. ER-2007-0004, issued May 17, 2007.
[30] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
[31] *Bluefield Waterworks & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 692 (U.S. 1923).
[32] *Id.* at 692 (emphasis added).
[33] KCPL Exhibit 20, page 5.

continuing decrease in the cost of capital, this represented a 35 basis point decrease from the national average return for the first quarter of 2012 of 10.30%.

15. While the Commission does not have figures for the national average return for the third or fourth quarter of 2012, it is aware that capital costs have continued to decrease. For instance, the Commission issued its Report and Order in the last KCPL rate case in April 2011. Since that time, bond yields for A rated (S&P rating) utility bonds have decreased by 148 basis points. Similarly, bond yields for Baa rates (Moody's rating) utility bonds have decreased by 110 basis points.[34] The decrease in capital costs is also reflected in Dr. Hadaway's recommendation. While the Commission believes his recommendation is inflated, his recommendation has decreased by 45 basis points.[35]

16. Based upon its consideration of the testimony of all the experts, and consistent with the findings expressed herein, the Commission finds that a reasonable range of return on equity is 9.10% to 9.50%. That is the range recommended by Mr. Gorman and the Commission finds that he is the most credible and reliable witness.

17. In its testimony, Staff raised significant concerns regarding the affordability of KCPL's rates. Specifically, Staff notes the following KCPL rate increases since January 1, 2007.

ER-2006-0314 (effective January 1, 2007):	10.46% increase
ER-2007-0291 (effective January 1, 2008):	6.50% increase
ER-2009-0089 (effective September 1, 2009):	16.16% increase
ER-2010-0355 (effective May 4, 2011):	5.23% increase[36]

[34] OPC Exhibit 300, page 4.
[35] KCPL Exhibit 20, page 31.
[36] See, Staff Exhibit 200, Cost of Service Report, at page 7.

Even ignoring any increase resulting from this case, KCPL rates have increased by 43.80%.

18. While KCPL's rates have increased by almost 44%, the national average residential rate has increased by only 13.56% since 2006.[37] More importantly to the economic well-being of Missouri, while the national average commercial and industrials rates has increased by 9.3% and 10.7% since 2006, KCPL's commercial and industrial rates has increased by 38.8% and 38.5% respectively.[38]

19. The affordability of KCPL's rates is also demonstrated through consideration of other economic data for the KCPL service area. Specifically, while KCPL rates will have increased by almost 44% in six years, the increase in average wages over that period has only been 11.45%.[39] While KCPL utility rates may be lower than the national average, the impact of lower wages in this service area means that "utility expenses constitute a higher percentage of a Missouri resident's living expenses than the average U.S. resident."[40] At the same time, counties served by KCPL are experiencing a higher mortgage delinquency rate and a higher unemployment rate than the rest of the state.[41]

20. In addition, Staff provides evidence which tends to show that KCPL rates have increased in large part due to its unwillingness or inability to control A&G costs. Without fail, among the Missouri and Kansas electric utilities, KCPL's

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[37] Staff Exhibit 200, Staff Cost of Service Report, at page 17.
[38] *Id.* at pages 18-19.
[39] *Id.* at page 6.
[40] *Id.* at page 7.
[41] *Id.* at pages 10-11.

A&G costs are significantly higher than any other utility. The following chart is indicative of this ongoing problem.[42]

	KCPL	GMO	Combined KCPL and GMO	Empire District Electric	Westar Energy	Ameren Missouri
A&G Costs per Customer	**$339.18**	$225.46	$296.07	$222.05	$255.06	$231.17
A&G Costs per Mwh	**$8.53**	$8.27	$8.45	$6.35	$5.38	$5.72
A&G Costs as % of Revenues	**11.15%**	9.28%	10.54%	7.06%	7.59%	8.53%

By all three metrics, KCPL's A&G costs are significantly higher than any other utility.

Disconcerting is the fact that KCPL has not made any inroads in its attempts to bring these costs under control. In the last case, the Commission noted that KCPL's A&G costs were higher than any other utility.[43] While comparably sized utilities (Westar and Ameren) have been able to reduce their level of A&G costs, KCPL's A&G costs have continued to grow.[44]

	KCPL	Ameren	Westar
A&G Costs as % of Revenues (change between 2009–2011)	**+3.34%**	-7.9%	-1.2%

Thus, not only are KCPL's A&G costs higher than other regional utilities, KCPL has apparently been unable to take any steps to control these costs.

[42] Staff Exhibit 200, Staff Cost of Service Report, at pages 250-251.
[43] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 154.
[44] Staff Exhibit 200, Staff Cost of Service Report, at page 252.

21. It is well established that the Commission can consider other factors in its determination of the appropriate return on equity within the reasonable range of return.[45] For instance, in the 2006 KCPL case, the Commission increased the KCPL return on equity by 25 basis points to account for risk associated with the KCPL Regulatory Plan.[46] Similarly, KCPL sought, but was denied, a 25 basis point increase in the last case to account for its alleged customer service excellence.[47]

22. In this case, the Commission finds that KCPL should be granted a return on equity of 9.10%. As previously indicated, Mr. Gorman asserts that this return is within his range of reasonableness. Furthermore, with this return on equity, the Commission is expressly considering concerns raised by the parties regarding the affordability of KCPL's rates. In addition, the Commission notes that it is important to remember that profit not only comes from the Commission's authorized return on equity, but also by the utility's ability to control costs. In this case, while the Commission is setting a return on equity of 9.10%, it is worth noting that KCPL can generate more profits simply by reducing its excessive A&G costs. Moreover, the Commission finds, consistent with the directives of the Hope and Bluefield cases, that this return will allow KCPL to maintain its "financial health."[48] Finally, the Commission notes that this return is consistent with the continuing decline in capital costs. As indicated, bond yields since

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[45] *State ex rel. Public Counsel v. Public Service Commission*, 274 S.W.3d 569, 576 (Mo.App. 2009); D.C. Transit System, Inc. v. Washington Metropolitan Area Transit Commission, 466 F.2d 394, 419-20 (D.C.Cir.1972).

[46] *Report and Order*, Case No. ER-2006-0314, issued December 21, 2006, at page 30.

[47] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at pages 119-120.

[48] In fact, the Commission expressly notes that Mr. Gorman determined, through financial metrics considered by rating agencies, that that "at my low-end recommended return on equity of 9.10% and the Company's actual capital structure, KCPL's financial credit metrics are supportive of an investment grade bond rating.[48]

the last case have dropped by 110 to 148 basis points. For all these reasons, the Commission finds that a return on equity of 9.10% is reasonable.

B. CONCLUSIONS OF LAW

A. In assessing the Commission's ability to use different methodologies to determine just and reasonable rates, the Missouri Court of Appeals has said:

> Because ratemaking is not an exact science, the utilization of different formulas is sometimes necessary. … The Supreme Court of Arkansas, in dealing with this issue, stated that there is no 'judicial mandate requiring the Commission to take the same approach to every rate application or even to consecutive applications by the same utility, when the commission in its expertise, determines that its previous methods are unsound or inappropriate to the particular application' (quoting *Southwestern Bell Telephone Company v. Arkansas Public Service Commission,* 593 S.W. 2d 434 (Ark 1980).[49]

Furthermore,

> Not only can the Commission select its methodology in determining rates and make pragmatic adjustments called for by particular circumstances, but it also may adopt or reject any or all of any witnesses' testimony.[50]

B. In another case, the Court of Appeals recognized that the establishment of an appropriate rate of return is not a "precise science":

> While rate of return is the result of a straight forward mathematic calculation, the inputs, particularly regarding the cost of common equity, are not a matter of 'precise science,' because inferences must be made about the cost of equity, which involves an estimation of investor expectations. In other words, some amount of speculation is inherent in any ratemaking decision to the extent that it is based on capital structure, because such decisions are forward-looking and rely, in part, on the accuracy of financial and market forecasts.[51]

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[49] *State ex rel. Assoc. Natural Gas Co. v. Public Service Commission*, 706 S.W.2d 870, 880 (Mo.App. W.D. 1985).
[50] *Id.*
[51] *State ex rel. Missouri Gas Energy v. Public Service Commission*, 186 S.W.3d 376, 383 (Mo.App. W.D. 2005).

DECISION:

Based on the evidence in the record, on its analysis of the expert testimony offered by the parties, and on its balancing of the interests of the company's ratepayers and shareholders, as fully explained in its findings of fact and conclusions of law, the Commission finds that 9.10 percent is a fair and reasonable return on equity for KCPL and GMO. The Commission finds that this rate of return will allow KCPL and GMO to compete in the capital market for the funds needed to maintain their financial health.

III. CAPITAL STRUCTURE

A. FINDINGS OF FACT

1. In its true-up testimony, KCPL recommends that the Commission utilize its true-up capital structure consisting of 52.56% common equity. This represents a sudden and large increase over the capital structure existing on March 31, 2012 which consisted of 45.51% common equity.[52]

2. Historically, a utility capital structure consists of both common equity and long-term debt. The difference in cost between equity and debt is significant.

> The portion of common equity in a company's capital structure is important for ratemaking purposes because common equity is the most expensive form of capital. The cost differential between common equity and debt is even greater when the income tax treatment of debt is considered. Interest expense or the cost of debt is tax-deductible, while dividends to shareholders are not.[53]

As the Commission has recognized, given this cost difference, "there is an optimum structure that will produce the minimum cost."[54] It is incumbent upon the utility, therefore, to manage its capital structure to this "optimum structure" and only include a reasonable amount of common equity.

3. In the past, the Commission has refused to recognize a utility's actual capital structure that deviated from this "optimum structure." In a *St. Joseph Light & Power* rate case, the Commission found that it was part of "its duty to protect the ratepayers" from rates that are based upon an equity-rich capital structure.

> The evidence clearly demonstrates that Staff, Public Counsel and AGP support the position that SJLPC's capital structure is too heavily weighted with common equity. The Commission agrees that SJLPC's capital structure is too heavily weighted with equity. In comparing SJLPC's own

[52] OPC Exhibit 300, page 13.
[53] *Report and Order*, ER-93-41 and EC-93-252, issued June 25, 1993, at page 252.
[54] *Id.* at page 252.

> assessment of its capital structure with that of its proxy group's average capital structure, the Commission cannot find that SJLPC's capital structure is even in line with its own proxy group. . . . The average common equity of the proxy group is 53.3%, which the Commission, unlike SJLPC, does not believe places SJLPC's common equity of 57.93% reasonably close to its proxy group's average. The Commission cannot support a capital structure for a company such as SJLPC that is so heavily weighted with common equity. The Commission, in its duty to protect the ratepayers, cannot establish rates based on this skewed capital structure. The Commission is of the opinion that if SJLPC chooses to continue with its current debt/equity ratio then its stockholders should bear the burden of its management's decision and not the ratepayers. ***Therefore, the Commission finds that the hypothetical capital structure as proposed by Public Counsel should be used in setting rates in this proceeding.***[55]

4. In its testimony, OPC alleges that the KCPL true-up capital structure: (1) includes significantly more common equity that KCPL's comparable company group; (2) provides no benefits to KCPL ratepayers; (3) is not reflective of ongoing operations; and (4) merely serves to inflate KCPL's revenue requirement. For these reasons, OPC argues that the Commission should utilize a capital structure consisting of 50% common equity and 50% long term debt. As OPC asserts, such a capital structure would be similar to the KCPL comparable company group and is reflective of KCPL's ongoing operations.

5. For these reasons expressed by OPC, and as set forth herein, the Commission agrees with OPC and will utilize a capital structure consisting of 50% common equity and 50% long term debt.

6. In its direct testimony, KCPL's return on equity witness utilized a comparable company group. That comparable company group was also adopted by OPC's witness Gorman.[56] In his testimony, Mr. Gorman demonstrated that the KCPL comparable company group only consisted of 49.6% common equity.[57] As compared to

[55] *Id.* at page 252.
[56] OPC Exhibit 300, page 15.
[57] OPC Exhibit 300, Schedule MPG-2.

the comparable company group then, KCPL's true-up capital structure of 52.56% is clearly equity rich.[58] In fact, KCPL's proposed capital structure contains more common equity than 17 of the 21 entities included in the comparable company group.[59]

7. KCPL's equity rich true-up capital structure provides no benefits to KCPL ratepayers. Sometimes, there is a reduction in debt cost resulting from the decreased risk associated with a higher equity ratio. In this case, however, the higher equity ratio does not provide this benefit. The current S&P debt credit rating is "BBB" with a "Stable" outlook.[60] This credit rating and outlook are based upon a higher ratio of debt in the capital structure.[61] Even with the higher equity ratio, the S&P credit rating and outlook remain the same.[62] As such, there is no decrease in the cost of debt associated with KCPL's equity rich capital structure. For this reason, the KCPL capital structure provides no benefit to KCPL ratepayers.

8. The KCPL capital structure is not reflective of ongoing KCPL operations. For 2011 and most of 2012, KCPL's capital structure consisted of approximately 45.5% common equity.[63] During the true-up period, KCPL utilized short-term debt to refinance a significant amount of long-term debt.[64] Consistent with some previous Commission decisions, KCPL excluded the entire amount of this short-term debt. As such, given the exclusion of this short-term debt, KCPL's equity ratio is artificially inflated. KCPL, however, admits that this level of short-term debt will be replaced immediately following

[58] Staff True-Up Accounting Schedules, Accounting Schedule 12.
[59] OPC Exhibit 300, Schedule MPG-2.
[60] OPC Exhibit 301, page 4.
[61] OPC Exhibit 301, page 2.
[62] *Id.* at page 5.
[63] OPC Exhibit 300, page 13.
[64] KCPL Exhibit 10, pages 6-11.

the true-up with another long-term debt offering.[65] With this planned long-term debt offering, KCPL's common equity ratio will immediately return to previously existing levels. As such, the Commission finds that KCPL's capital structure is not reflective of ongoing operations and its common equity ratio is illusionary simply because of the decision to exclude short-term debt.

9. Finally, the Commission agrees with Mr. Gorman that, given that there is no reduction in debt costs associated with KCPL's equity rich capital structure, there is no benefit to ratepayers associated with the KCPL's inflated equity ratio. While KCPL claims to have taken steps to minimize its revenue deficiency in response to the "difficult economic times" currently being experienced in its service area,[66] its common equity ratio is simply designed to inflate KCPL's revenue requirement. As Mr. Gorman notes:

> This increased common equity ratio does not appear to be necessary. As noted above, the credit rating agencies currently view KCPL's credit standing to be "Stable," with adequate utility cash flows. KCPL's current financial metrics, including its debt / equity ratio of approximately 54% [54% debt and 46% common equity], supports its investment grade bond rating. <u>***Hence, an increase in common equity ratio in this case seems to accomplish nothing more than increasing KCPL's cost of service and income.***</u>[67]

10. In this case, the Commission believes that the KCPL true-up capital structure departs from the "optimum structure" discussed in the *St. Joseph Light & Power* decision and sought by the Commission. As part of "its duty to protect the ratepayers" from rates that are based upon an equity-rich capital structure, the Commission will reject KCPL's proposed capital structure and utilize the 50% common equity / 50% long term debt capital structure recommended by OPC and Mr. Gorman.

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[65] Tr. 360-363.
[66] KCPL Exhibit 2, Bassham Direct, at pages 8-10.
[67] OPC Exhibit 300, Gorman Direct, page 11.

<u>IV. CLASS COST OF SERVICE / RATE DESIGN</u>

1. Any rate increase is necessarily divided into two distinct parts. First, how much of a revenue increase should the utility receive (revenue requirement)? Second, how should the revenue increase be allocated among the various customer classes (class cost of service)? In this portion of the Order, the Commission addresses the second issue

2. On October 29, 2012, a non-unanimous Stipulation and Agreement was executed and filed by Kansas City Power & Light Company, the Staff of the Public Service Commission, Midwest Energy Consumer's Group and the Missouri Industrial Energy Consumers. As provided by that settlement, the Signatories agree that the Commission should increase residential true-up revenues by 1.00% in addition to any other increase implemented by the Commission with a corresponding equal-percentage revenue neutral decrease in the true-up revenues for all other non-lighting rate classes. The Commission notes that this settlement exactly matches the revenue allocation recommended by the Staff.

3. On November 2, 2012, opposition to the Stipulation was filed by OPC as well as AARP and Consumers Council. Given the opposed nature of the Stipulation, the Commission cannot simply approve the Stipulation. Rather, as Commission Rule 4 CSR 240-2.115(2)(D) provides, the opposed non-unanimous stipulation "shall be considered to be merely a position of the signatory parties to the stipulated position." Consistent with *State ex rel. Fischer v. Public Service Commission*,[68] all of the opposed issues "shall remain for determination after hearing."

4. In this case, the Commission has been presented with several class cost of service studies designed to assess each classes' cost of service and whether that class is

[68] 645 S.W.2d 39 (Mo.App. 1983).

currently paying rates consistent with its cost of service. Specifically, class cost of service studies were prepared and filed by: (1) KCPL; (2) Staff; (3) Department of Energy; and (4) the Industrials. In fact, in the testimony of Maurice Brubaker, the various industrial groups presented three separate class cost of service studies. Noticeably, each of the parties that sponsored a class cost of service study supported the Non-Unanimous Stipulation as a reasonable resolution to this issue. In contrast, the two parties that opposed the Stipulation did not provide a class cost of service study. Instead, while refusing to endorse any of the allocators used by KCPL, OPC and AARP / CCM simply ask the Commission to adopt the results of KCPL's study.[69]

5. The results of the various class cost of service studies are as follows:[70]

INDEX OF RETURN

	Staff	**DOE**	**Industrials (A&E 4NCP)**	**Industrials (A&E 2NCP)**	**Industrials (4CP)**	**KCPL**
Residential	0.53	0.49	0.42	0.42	0.49	**0.98**
Small General	2.13	1.84	2.02	1.99	1.84	**1.98**
Medium General	1.55	1.31	1.42	1.41	1.31	**1.28**
Large General	1.29	1.34	1.42	1.45	1.34	**1.05**
Large Power	1.16	1.28	1.33	1.33	1.28	**0.54**

[69] See, *Public Counsel's Statement of Positions*, filed October 12, 2012, at page 3 ("Because of workload and resource issues, Public Counsel accepted the results of KCPL's CCOS for use in this case, but does not endorse any of KCPL's allocators."). See also, *Position Statement of AARP* and *Position Statement of Consumers Council of Missouri*, filed October 15, 2012, at page 2 ("Consumers Council [AARP] supports the Public Counsel's position.).

[70] Staff Exhibit 233, Scheperle Rebuttal, page 3 (referring to KCPL Study contained in Normand Direct; Staff Study contained in Staff Class Cost of Service Report; DOE Study contained in Goins Direct; and Industrials Study contained in Brubaker Direct).

6. Relevant to the interpretation of the previous table, Staff explains the meaning of Index of Return.

> An Index of Return above 1.0 indicates revenue from the customer class exceeds KCPL's cost of providing service to that class; therefore, to equalize revenues and cost of service, rate revenues should be reduced, i.e., the class has overpaid. An Index of Return below 1.0 indicates revenue from the class is less than KCPL's cost of providing service to that class; therefore, to equalize revenues, and cost of service, rate revenues should be increased, i.e., the class has underpaid.[71]

7. Given this understanding, there are two conclusions that are immediately apparent from the results of the class cost of service studies. First, six of seven studies (filed by Staff, DOE and Industrials) agree that the residential class rates are significantly below their actual cost of service. Only the KCPL study, relied upon by OPC and AARP / CCM, believes that residential rates are in line with cost of service. Second, six of seven studies indicate that the Large General / Large Power classes are currently paying rates that exceed their cost of service. Again, only the KCPL study, relied upon by OPC and AARP / CCM, fails to reach this same conclusion.

8. Given the virtual unanimity in the conclusions reached between the various class cost of service studies, Staff made a recommendation that would allocate more of the rate increase to residential and less to the non-residential classes.

> Staff recommends adjustments to class revenue responsibilities be made first on a company-wide revenue neutral basis to all classes of customers except the lighting class. The KCPL residential class should receive a positive 1% adjustment, the lighting class should receive the system average increase, and the remaining classes of customers (Small General Service group, Medium General Service group, Large General Service group, and the Large Power Service group) should all receive a negative adjustment of approximately 0.6%.[72]

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[71] *Id.* at page 4.
[72] Staff Exhibit 212, Scheperle Direct, at page 2.

10. The difference in the results of the KCPL study and those offered by Staff, DOE and the various Industrials appear to be based upon two issues: (1) the allocation between the classes of production plant and (2) the allocation between the classes of off-system sales margins.

Production Plant Allocation

11. In this case, KCPL's study, relied upon by OPC and AARP / CCM, utilized a methodology called Base / Intermediate / Peak for the allocation of production plant among the various customer classes. That production allocation methodology relies heavily on class energy usage. In contrast, each of the other class cost of service studies utilized a methodology that places more weight on class peak demand.

12. In a recent Ameren decision, the Commission expressly criticized production plant allocators that rely heavily on class energy usage and recognized the logic of the Average & Excess methodology.

> Some customer classes, such as large industrials may run factories at a constant rate, 24 hours a day, 7 days a week. Therefore, their usage of electricity does not vary significantly by hour or by season. Thus, while they use a lot of electricity, that usage does not cause demand on the system to hit peaks for which the utility must build or acquire additional capacity. Another customer class, for example, the residential class, will contribute to the average amount of electricity used on the system, but it will also contribute a great deal to the peaks on system usage, as residential usage will tend to vary a great deal from season to season, day to day, hour to hour. To recognize that pattern of usage, the Average and Excess method separately allocates energy cost based on the average usage of the system by the various customer classes. It then allocates the excess of the system peaks to the various customer classes by a measure of that class' contribution to the peak. In other words, the average and excess costs are each allocated to the customer classes once.[73]

[73] *Report and Order*, Case No. ER-2010-0036, issued May 28, 2010, at pages 84-85.

As such, the Commission found that production plant allocators need to rely heavily on the customer classes' relative peak demand.[74] Ultimately, the Commission adopted the use of the Average and Excess methodology in that case.

13. Contrary to the Commission's direction from that Ameren case, KCPL's study in this case, relies even more predominantly on class energy usage. In the Ameren case, approximately 55% of production plant was allocated on the basis of class energy usage.[75] In contrast, the KCPL BIP methodology, now relied upon by OPC and AARP / CCM, allocates approximately 80% of production plant based upon class energy.[76] The Commission finds that the KCPL BIP methodology overly relies on class energy in its allocation of production plant. Consistent with its findings from the Ameren case, the Commission finds that the Average and Excess methodology appropriately considers both class energy usage and, more importantly, class peak demand.

<u>Allocation of Off-System Sales Margins</u>

14. In both a recent KCPL and Ameren case, the Commission stated that off-system sales should be allocated based upon energy usage. As the Commission stated in that KCPL decision:

> The only costs assigned to non-firm off-system sales is the fuel and purchased power costs – the variable costs – hence the appropriateness of using the energy allocator. This is consistent with the way KCPL itself allocates the costs relating to the energy portion of firm capacity contracts – using the energy allocator. The reason is simple – the energy allocator is used to allocate variable costs of fuel and purchased power costs relating to retail sales. ***<u>Using the same rationale, the energy allocator is equally appropriate to use as the allocation factor for both energy of firm and non-firm off-system sales.</u>***[77]

[74] *Id.* at page 85.
[75] MECG Exhibit 407, Brubaker Rebuttal, page 6.
[76] *Id.*
[77] *Report and Order*, Case No. ER-2006-0314, issued December 21, 2006, at page 39.

While all the other studies allocated off-system sales margins consistent with this previous Commission decision, KCPL's study allocated on a different basis.[78]

15. The Commission finds that the KCPL study inappropriately allocates off-system sales margins. The Commission again adopts its finding that utility off-system sales margins should be allocated on the basis of class energy usage.

16. In addition to the allocation problems associated with the KCPL study relied upon by them, OPC and AARP / CCM's position is also undermined by the fact that KCPL has claimed that its study should not be relied upon for purposes of revenue allocation. KCPL has expressly indicated that its study is simply a snapshot and should not be relied upon for determining interclass revenue shifts. Several years ago, in preparing for a rate case, KCPL made a decision to switch to the BIP methodology. As KCPL acknowledges, the BIP methodology was not utilized because it was a superior methodology, but because it was perceived to allow consideration of seasonal class cost of service.[79] In subsequent meetings, KCPL indicated that the BIP method should not be used to as a basis for revenue allocation.[80] Certainly, if KCPL believes that the BIP class cost of service study is unsuitable for purposes of allocating a revenue increase, OPC and CCM's reliance on such a study is misplaced. Interestingly, even as the sponsor of the study, KCPL agreed that the revenue allocation in the non-unanimous stipulation was reasonable.

17. Finally, the Commission notes that, despite its longevity, the KCPL BIP methodology has fallen on disfavor among state utility commissions. As Mr. Brubaker relates, the BIP methodology first surfaced in 1980. In the 30 years since its

[78] MECG Exhibit 407, page 6.
[79] KCPL Exhibit 42, Rush Rebuttal, page 4.
[80] MEUA Exhibit 675, Johnstone Rebuttal, page 4.

development, the "BIP method never caught on and is only infrequently seen in regulatory proceedings."[81] KCPL made little effort to rebut this fact.

> What [KCPL] has not rebutted, and indeed cannot rebut, is that BIP is an obscure and arcane method that has not found support in the industry. . . In response to the request to identify rate proceedings he was aware of where the BIP method was adopted, all that Mr. Normand was able to provide was a reference to the November 2010 decision by the Kansas Corporation Commission in the KCPL Iatan 2 rate case. I would certainly think that if Mr. Normand had succeeded in selling the BIP method during the last 30 or so years that he has been promoting it, that he would be able to find at least one instance where it was adopted by a Commission prior to 2010.[82]

18. Recognizing that it is contrary to recent Commission decisions regarding allocation of production plant and off-system sales margins, given its disfavor in the regulatory arena, and in light of the fact that its sponsor has agreed to the interclass shifts called for in the non-unanimous stipulation, the Commission rejects the KCPL BIP methodology relied upon by OPC and AARP / CCM. Instead, as in the previous Ameren decision, the Commission again adopts the Average and Excess methodology. The Commission finds that this methodology appropriately considers both class energy and peak demand in its allocation of production plant. Furthermore, the Commission continues to find that off-system sales margins should be allocated on the basis of class energy usage. Given these findings, the Commission finds that the results provided by Mr. Brubaker are most credible.

19. Despite its acceptance of the Brubaker study, the Commission will not move rates entirely to the costs set forth in that study. Instead, like several parties, the Commission is cognizant of the notion of gradualism. The Commission finds that the 1.0% shift of costs to residential class and the corresponding decrease in costs for the

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[81] MECG Exhibit 407, Brubaker Rebuttal, pages 3-4.
[82] MECG Exhibit 408, Brubaker Surrebuttal, page 3.

non-lighting classes is consistent with the Brubaker results and the notion of gradualism. As such, the Commission finds that the position advanced by the non-unanimous stipulation is reasonable and will be adopted. Finally, the Commission notes that this result is identical to the one recommended by the Staff.

20. In the non-unanimous stipulation, the Signatories also addressed the rate design for the Large Power and Large General Service classes. That settlement provides for the following:

►For the Large Power ("LP") rate schedule, any increase to that rate class shall be implemented as follows:

a. No increase to the current energy charge tail block rate elements – the seasonal rate elements applicable to energy charge that exceeds 360 hours use per month;

b. 75% of the class average percentage increase shall be assigned to the middle block seasonal rate elements applicable to energy usage between 180 hours and 360 hours use per month; and

c. The remaining amount of the increase shall be assigned to all remaining rate elements on an equal percentage basis.

►For the Large General Service (“LGS”) rate schedule, any increase to that rate class shall be implemented as follows:

a. No increase to the over 360 hours use per month energy block;

b. The separately metered energy charges shall receive the LGS class average;

c. The second 180 hours use energy charge increase adjusted as needed to yield target class revenue increase, but not less than zero increase;

d. Remaining charges increase by Class average increase plus 4 percent, unless the second hours use block increase reaches zero, then the adder is reduced as needed to produce target class increase

21. While objecting to other aspects of that stipulation, OPC and AARP / CCM did not object to the Large Power / Large General Service rate design aspect of the stipulation. As such, the Commission may treat that provision as unopposed and unanimous. For this reason, the Commission approves the Large Power / Large General Service rate design settlement.

V. TRANSMISSION TRACKER

1. In this case, KCPL requests that the Commission implement a transmission tracker. KCPL envisions that a specific amount of transmission costs would be established in this rate proceeding and included in rates.[83] KCPL would then track its actual transmission costs against this amount included in rates. To the extent that actual transmission costs are greater than that included in rates, KCPL would treat the excess amount as a regulatory asset.[84] KCPL asserts that the regulatory asset would be amortized in the next rate proceeding and recovered in future rates.[85] As KCPL repeatedly points out in its testimony, the implementation of a tracker is designed to ensure the recovery of a certain cost item, "Use of a tracker ***ensures*** that in the years between rate cases the utility does not under-recover or over-recover its costs."[86]

2. The opposition to KCPL's proposal is unanimous. Every party that took a position on this issue opposed KCPL's proposal as bad regulatory policy. In addition, several parties alleged that KCPL's proposal is unlawful in that it violates the doctrine against retroactive ratemaking. For all the reasons contained herein, the Commission rejects KCPL's request for a transmission tracker.

Retroactive Ratemaking

3. In the case of *State ex rel. Utility Consumers Council v. Public Service Commission of Missouri*,[87] the Missouri Supreme Court considered the legality of the fuel adjustment clause. While holding that the Commission lacked statutory authority to

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[83] KCPL Exhibit 29, Ives Direct, page 15, lines 12-13.
[84] *Id.* at lines 13-15.
[85] *Id*. at page 16, lines 10-12.
[86] KCPL Exhibit 29, Ives Direct, page 14 (emphasis added). See also, "The Company requests that a transmission tracking mechanism be authorized in this case ***to ensure*** the appropriate recovery of transmission costs." (Id at page 13) (emphasis added).
[87] 585 S.W.2d 41 (Mo. banc 1979).

implement a fuel adjustment clause, the Court also provided the seminal discussion of the doctrine of retroactive ratemaking. There, the Supreme Court held that past expenses "cannot be used to set future rates." Such recovery would constitute retroactive ratemaking.

> **Past expenses** are used as a basis for determining what rate is reasonable to be charged in the future in order to avoid further excess profits or future losses, but under the prospective language of the statutes, *§§ 393.270(3)* and 393.140(5) they **cannot be used to set future rates to recover for past losses due to imperfect matching of rates with expenses.**[88]
>
> **To permit them to collect additional amounts simply because they had additional past expenses not covered by either clause is retroactive rate making**, i.e., the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match expenses plus rate-of-return with the rate actually established.[89]

4. In the case at hand, KCPL proposes a tracker mechanism that would use future rates to recover for past losses. Specifically, KCPL envisions that a specific amount of transmission costs would be established in this rate proceeding.[90] KCPL would then track its actual transmission costs against the amount included in rates. To the extent that actual transmission costs are greater than that included in rates, KCPL would treat the excess amount as a regulatory asset.[91] KCPL asserts that the regulatory asset would be amortized in the next rate proceeding and recovered in future rates.[92]

5. As such, KCPL's proposed transmission tracker would violate the doctrine against retroactive ratemaking due to the fact that KCPL has included future ratemaking in its proposed tracker. Despite the Supreme Court holding that "past expenses" "cannot

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[88] *Id.* at page 59. (emphasis added).
[89] *Id.* (emphasis added)
[90] KCPL Exhibit 29, Ives Direct, page 15, lines 12-13.
[91] *Id.* at lines 13-15.
[92] *Id*. at page 16, lines 10-12.

be used to set future rates to recover for past losses due to imperfect matching of rates with expenses," KCPL proposes the any loss associated with transmission costs would be recovered in future rates. For this reason, KCPL's transmission tracker is unlawful.

6. KCPL responds to this argument with two misplaced analogies. ***First***, KCPL argues that, since Accounting Authority Orders ("AAOs") are lawful, then its proposed tracker must also be lawful. While the Missouri Court of Appeals has found that AAOs are lawful, the Court has also held that this extraordinary treatment is limited solely to expenses and situations that are "unusual or extraordinary."[93] As the Court noted, "extraordinary items" are:

> Those items related to the effects of events and transactions which have occurred during the current period and which are ***not typical or customary business activities*** of the company. Accordingly, they will be events and transactions of significant effect which ***would not be expected to recur frequently*** and which ***would not be considered as recurring factors*** in any evaluation of the ordinary operating processes of business.[94]

Using this definition of extraordinary, the Commission has allowed deferral and recovery of power plant build costs, as well as ice storm and tornado damage costs. Each of these costs could be considered not typical and not recurring. On the other hand, transmission costs are typical, customary and recurring. As KCPL admits, these costs have been incurred every year and are expected to be incurred every year.

7. The reason for treating extraordinary costs differently than those costs that are typical, customary and recurring is made abundantly clear by the Court of Appeals.

> Deferral of costs just to support the current financial status distorts the balancing process utilized by the Commission to establish just and reasonable rates. Because rates are set to recover continuing operating expenses plus a reasonable return on investment, ***only an extraordinary***

[93] *State ex rel. Office of the Public Counsel v. Public Service Commission*, 858 S.W.2d 806, 810 (Mo.App. 1993).
[94] *Id.* (emphasis added).

event should be permitted to adjust the balance to permit costs to be deferred for consideration in a later period.[95]

Clearly, since KCPL's transmission costs are not "extraordinary," they should not "be permitted to adjust the balance" that rates will be excessive or inadequate.

8. ***Second***, KCPL attempts to argue the lawfulness of its proposed transmission tracker by bootstrapping it to the legislatively approved fuel adjustment clause. Again, KCPL's argument fails. As the Court held in its consideration of the fuel adjustment clause, the FAC has been expressly authorized by the General Assembly.[96] "By specifically stating that the legislature could authorize fuel adjustment clauses like the one adopted by KCP&L here, the Supreme Court in UCCM presumably contemplated that such clauses would not themselves violate the retroactive ratemaking doctrine."[97] In contrast, KCPL's proposed tracker mechanism and the deferral and recovery of past losses associated with transmission costs have not been authorized by the General Assembly. As such, any analogy to the Commission's fuel adjustment clause is necessarily misplaced. Absent legislative approval, the Commission finds that KCPL's tracker mechanism violates the doctrine against retroactive ratemaking.

Bad Regulatory Policy

9. In addition, the Commission finds that KCPL's transmission tracker constitutes poor regulatory policy because: (1) it replaces the opportunity for recovery with a guarantee of recovery; (2) it shifts the careful balancing of risk between rates being excessive or inadequate and (3) KCPL has not shown that the costs addressed by its

[95] *Id.* at page 811 (emphasis added).
[96] See, Section 386.266.
[97] *State ex rel. AG Processing, Inc. v. Public Service Commission*, 340 S.W.3d 146, 151 (Mo.App. 2011).

proposed tracker meet the criteria expressed by the Commission for such an extraordinary ratemaking tool.

10. It is well known doctrine of ratemaking that rates are established to provide the utility with an "opportunity" to recover its prudently incurred costs as well as a return on its invested capital.[98] Recognizing that rates merely provide for this "opportunity," there is no guarantee to the utility of earning any, or a stated level of, return on equity. Indeed, during questioning from the bench, KCPL acknowledged that it should only be provided an "opportunity" to recover its costs and profit.

Q So the IEC is a proposal that would make it easier for the company -- and I -- that's my characterization. That's not yours.

A Yes.

Q Would make it easier for the company to earn their authorized ROE?

A It would. Yes. And I don't -- when you say earn our authorized return, we -- what we're interested in is ***the opportunity to earn our authorized return***. [99]

11. Through its tracker proposal, however, KCPL seeks to disrupt this basic notion of ratemaking. Rather than an "opportunity" to recover this cost, KCPL, through the implementation of its tracker, would instead have a "guarantee" of its recovery. Certainly, every time that traditional ratemaking is replaced with an automatic adjustment mechanism, a tracker or deferral and amortization accounting, the utility moves closer to its desired goal of "guaranteed" cost recovery and a "guaranteed" return on equity.

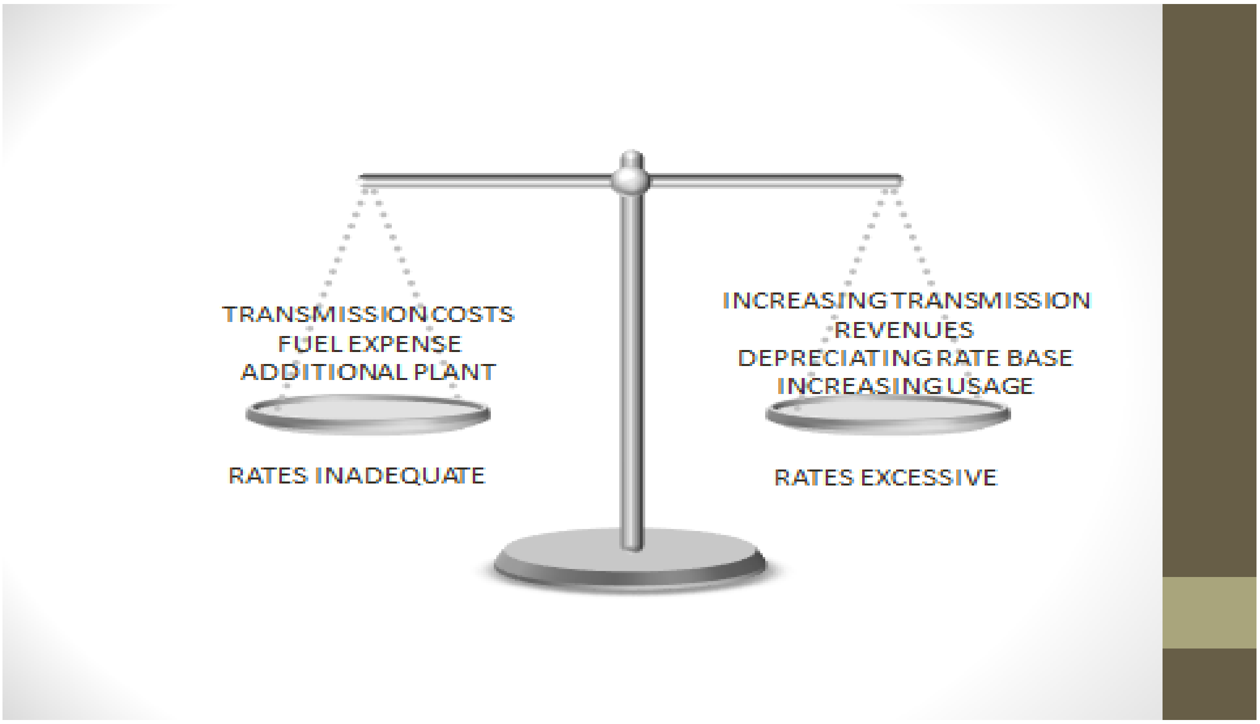
12. Given this, the Commission should be very careful in its implementation of extraordinary ratemaking mechanisms, like trackers. As the Commission has previously held, such mechanisms should be limited solely to those instances where they

[98] See, *State ex rel. Union Electric Company v. Public Service Commission*, 765 S.W.2d 618, 622 (Mo.App. 1989).
[99] Tr. 237-238.

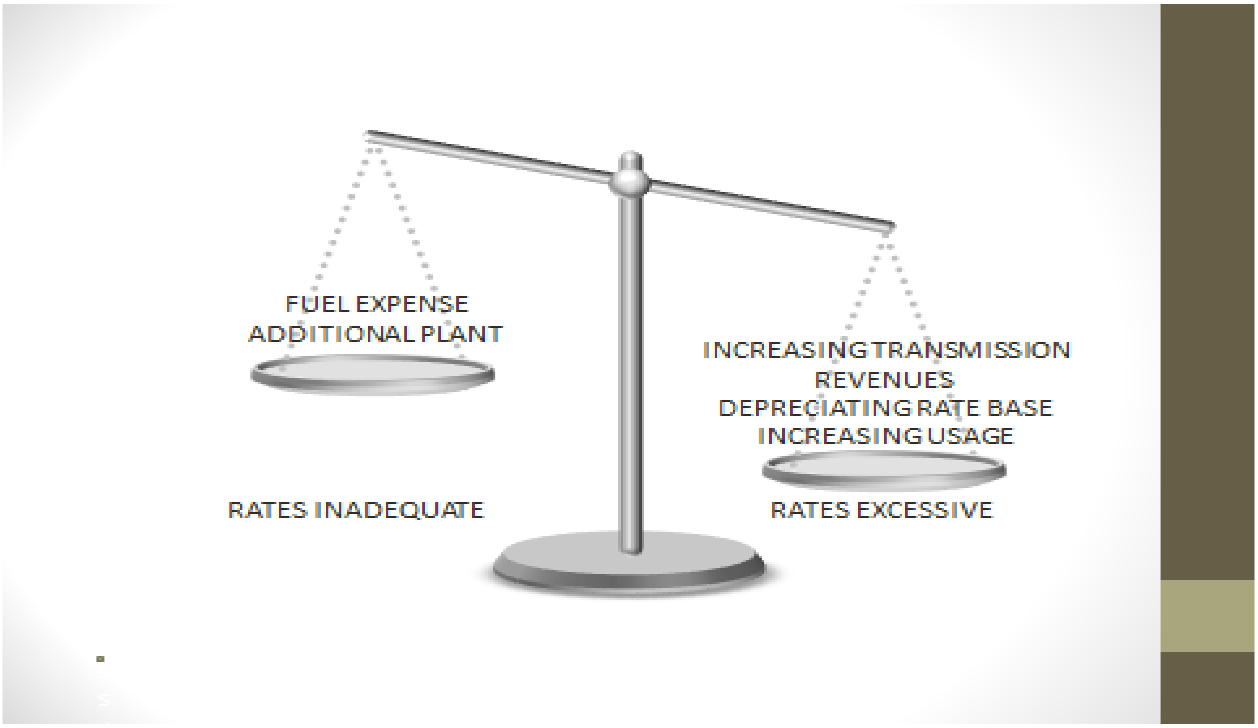
are necessary to protect the utility **and** ratepayers from volatile markets. With this in mind, the utility and consumers have agreed to the use of trackers for previous such instances. KCPL's proposal, however, is the first foray in their attempt to extend such mechanisms to an everyday expense that is not volatile, but instead simply projected to increase. In this case, KCPL's proposal has been opposed by every consumer group as well as the Commission's Staff. Clearly, it is not needed to protect ratepayers. Ultimately, KCPL's proposal represents poor regulatory policy.

13. KCPL's proposed tracker mechanism also represents a fundamental shift in the establishment of risk envisioned by the Missouri Supreme Court. In the previously discussed decision, the Supreme Court held that "[t]he utilities take the risk that rates filed by them will be inadequate, or excessive, each time they seek rate approval."[100] As envisioned by the Supreme Court, then, there are constantly pressures which may increase or decrease the possibility that rates will be inadequate or excessive. As reflected in the following slide, among the factors that may increase the possibility that rates will be inadequate are increased transmission costs. That said, however, there are many other factors that tend to heighten the possibility that rates will be excessive including increasing transmission revenues, increasing numbers of customers and usage and the utility's constantly depreciating rate base.

[100] *State ex rel. Utility Consumers Council v. Public Service Commission of Missouri*, 585 S.W.2d 41, 59 (Mo. banc 1979).



14. Under its transmission tracker proposal, KCPL wants to single out one cost item for special treatment without consideration of other offsetting items. The practical effect of this special treatment is to remove this item (transmission costs) from the risk balancing, thereby decreasing the chance that rates will be inadequate. The other side of this proposal, however, is that all of the items that tend to cause rates to be excessive still remain. Therefore, KCPL has shifted the careful balancing of risk envisioned by the Supreme Court.



15. As MECG witness Dauphinais points out, the KCPL transmission tracker proposal is flawed in that it fails to consider "whether the utility would simultaneously be receiving offsetting decreases in expenses or offsetting increases in revenues for those expenses and revenues that are not being tracked. To put it more simply, allowing a tracker can break the synchronism between revenues, expenses and rate base leading to a utility over-recovering its costs."[101]

16. The Commission itself has recognized this fundamental flaw in tracker mechanisms. When it first considered a tracker mechanism for Ameren's fuel costs, the Commission rejected the proposal and cited the same problems now found in KCPL's tracker proposal. Under a tracker mechanism, "the utility would be able to pass on increased costs in one area, in this case fuel and purchased power, without an examination of all the other areas in which its costs may have decreased or its revenues

[101] MECG Exhibit 404, Dauphinais Direct, page 7.

increased. As a result, ratepayers could be required to pay increased rates while the company enjoys increased profits."[102]

17. Finally, KCPL has not met the strict criteria previously expressed by the Commission for establishment of an extraordinary ratemaking mechanism like a tracker. In a previous Ameren decision, the Commission stated that such an extraordinary mechanism is only appropriate where the cost meets three criteria.

1. Substantial enough to have a material impact upon revenue requirements and the financial performance of the business between rate cases;

2. Beyond the control of management, where utility management has little influence over experienced revenue or cost levels; and

3. Volatile in amount, causing significant swings in income and cash flows if not tracked.[103]

The evidence in this case demonstrates that KCPL has not met the Commission order criteria.

18. Substantially Large: In its consideration of Ameren's fuel adjustment clause, the Commission noted that Ameren's fuel and purchased power expense is approximately 44% of the utility's operations and maintenance cost.[104] Similarly, KCPL fuel and purchased power expense of $264,312,622[105] represents 44.7% of KCPL's total O&M costs.[106] KCPL's transmission costs are dwarfed in contrast to the fuel and purchased power expenses previously deemed worthy of tracking. Currently, SPP Transmission Costs are approximately $20 million.[107] Current costs are expected to increase by $25

[102] *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 18.
[103] *Id.* at pages 20-21.
[104] *Id.* at page 21.
[105] Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 2).
[106] Total O&M cost = $590,839,365 Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 12).
[107] MECG Exhibit 404, Dauphinais Direct, page 8.

million.[108] Therefore, the incremental increase in transmission costs that KCPL seeks to track is only 4.2% of KCPL's total expenses. Certainly, transmission costs do not meet the Commission's first criteria for the use of an extraordinary ratemaking mechanism.

19. Beyond Management Control: In the Ameren case, the Commission not only considered management's control of costs, but extended its review to a consideration of the relative control of management versus ratepayers. In that case, while it found that Ameren "clearly cannot control the markets", the Commission also correctly decided that Ameren "has more ability to influence the prices it pays for fuel and purchased power costs than do its ratepayers who must simply pay the rates allowed by this Commission." Given their ability to influence such prices, the Commission held that "removing AmerenUE's financial incentive to control its fuel costs by allowing those costs to be passed through to ratepayers will not serve the interests of those ratepayers."

In the immediate case, the evidence indicates that transmission costs are subject to some influence by KCPL's management. For instance, the vast majority of costs in question concern SPP administration and transmission costs. Given its ability to participate in SPP and FERC, KCPL can certainly influence the magnitude and timing of these costs. "It can to a degree be managed by the Company by being active in the SPP stakeholder process and, as necessary, at FERC, to help ensure, working with other stakeholders, the SPP's costs are maintained within reasonable levels."[109]

Moreover, even to the extent that the transmission costs do change, given the forewarning provided through SPP projections, KCPL can effectively manage these costs through necessary rate increases. "[T]he increase is well forecasted by SPP and occurs in

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[108] *Id.*
[109] MECG Exhibit 404, Dauphinais Direct, page 8.

stairs steps much like the rate base of a utility increases as new major capital projects are brought into service."[110] Therefore, these costs can certainly be influenced by KCPL, but also management is certainly capable of timing rate cases to match when these costs are incurred. It is certainly not necessary to implement a tracker which would eliminate all incentive KCPL has to minimize these costs.[111]

20. Volatile: In a previous decision, the Commission held that volatility is more than simply an expectation that a cost will increase. Rather, volatility is characterized unpredictable increases and decreases in costs. As such, extraordinary mechanisms may be necessary to protect both the utility and the ratepayers from this volatility.

> Markets in which prices are volatile tend to go up and down in an unpredictable manner. When a utility's fuel and purchased power costs are swinging in that way, the time consuming ratemaking process cannot possibly keep up with the swings. As a result, in those circumstances, a fuel adjustment clause may be needed to protect both the utility and its ratepayers from inappropriately low or high rates.[112]

KCPL's transmission costs cannot be characterized as volatile. As the evidence indicates, "it cannot reasonably be said that the [SPP] administration charge is volatile like, for example, the market price of a commodity may be."[113] In fact, in its 18 pages of direct testimony supporting the implementation of a tracker mechanism, KCPL itself never characterizes transmission costs as "volatile."[114] Rather, like other aspects of KCPL's cost portfolio, transmission costs are simply projected to increase. Unlike other

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[110] *Id.*
[111] *Id.*
[112] *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 23.
[113] MECG Exhibit 404, Dauphinais Direct, page 8.
[114] See, KCPL Exhibit 29, Ives Direct, pages 13-17; KCPL Exhibit 12, Carlson Direct, pages 1-11 and Schedule JRC-1.

cost items, however, the increases in transmission costs are "well forecasted" and "occurs in stairs steps" which allows the Company to include the costs in a rate case.[115]

21. Ultimately, none of the Commission's criteria for the implementation of an extraordinary ratemaking tool like an adjustment mechanism or a tracker have been met by KCPL. Unlike fuel expenses that have previously been addressed by the Commission, KCPL's transmission costs are relatively small and are not large enough to have a material impact on KCPL's financial performance. Also, unlike costs for items purchased in a commodity market, KCPL's transmission costs can certainly be influenced and managed by KCPL. Specifically, this is done through its participation in both SPP and at the FERC. Finally, while the costs are projected to increase, they are not volatile. Rather, the stair step increases and the lead time provided by SPP for such increases make these costs perfect for timing and inclusion in a rate case.

22. Finally, it is important to point out that KCPL has foreclosed itself from the opportunity to request a transmission tracker. In 2005, KCPL executed its Regulatory Plan. That regulatory plan provided the regulatory support necessary for KCPL to implement its Comprehensive Energy Plan. One critical aspect of that Regulatory Plan was a commitment not to seek a fuel adjustment clause prior to June 1, 2015.[116]

On December 12, 2012, the Commission issued its decision in the pending Ameren rate case. In that order, the Commission held that it is appropriate for transmission costs to be considered within the context of Ameren's fuel adjustment

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[115] MECG Exhibit 404, Dauphinais Direct, page 8. See also the stair step projected increases in KCPL Exhibit 12, Carlson Direct, Schedule JRC-1.
[116] *Stipulation and Agreement*, Case No. EO-2005-0329, filed March 28, 2005, at page 7, approved by the Commission on July 28, 2005.

clause.[117] Given that the Commission has held that such costs should flow through the fuel adjustment clause, and recognizing that KCPL has voluntarily agreed not to seek such a clause, its current request for a transmission tracker is also prohibited.

This prohibition was recognized by KCPL in questioning from the bench.

> Q. Since you signed the stipulation and agreement that said that you wouldn't ask for a fuel adjustment clause, wasn't the signing of that stipulation and agreement an acceptance of some risk from the company that conditions could occur that would be alleviated by a fuel adjustment clause?
>
> A. Oh, absolutely.
>
> Q. And the company is saying, we're willing – in order to get -- in order to get this agreement, we're willing to take that risk of those conditions changing upon us rather than -- rather than somewhere else?
>
> A. That's correct. And one of the provisions in there accepting that risk was the ability to -- in -- rather than a fuel adjustment clause to ask for an IEC.[118]

23. In the case at hand, KCPL agreed not to seek a fuel adjustment clause until June 1, 2015. As KCPL acknowledged in response to questions from the bench, with this commitment, KCPL accepted the risk that conditions would change regarding the costs (including transmission costs) that would flow through that fuel adjustment clause. As such, KCPL's request for a transmission tracker is prohibited by its commitment in the Regulatory Plan. While KCPL was allowed to seek an interim energy charge, and may have been able to develop an interim energy charge that included such costs, it has voluntarily withdrawn its request for an IEC.[119] As such, the Commission will not grant what KCPL voluntarily provided as consideration for its Regulatory Plan.

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[117] See, Commission deliberations at November 28, 2012 public meeting.
[118] Tr. 241-242.
[119] *Second Non-Unanimous Stipulation and Agreement as to Certain Issues*, Case No. ER-2012-0174, filed on November 8, 2012, at page 4.

<u>VI. CROSSROADS</u>

1. This issue concerns the appropriate valuation to place on the Crossroads generating unit recently devoted by GMO to serving its ratepayers. The Supreme Court has held that the utility must be permitted to earn a return on the "fair value" of the property devoted to the public convenience.

> The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. . . . We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation . . . must be the <u>***fair value of the property being used by it for the convenience of the public***</u>. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be extracted from it than the services rendered by it are reasonably worth.[120]

The Commission's authority to establish the valuation of an electric corporation's plant has also been memorialized in Section 393.230.

> <u>***The commission shall have the power to ascertain the value of the property of every . . . electrical corporation . . . in this state and every fact which in its judgment may or does have any bearing on such value***</u>. The commission shall have power to make revaluations from time to time and to ascertain all new construction, extensions and additions to the property of every . . . electrical corporation. (emphasis added).

2. The Crossroads generating unit was originally designed and constructed for use by Aquila Merchant, a non-regulated affiliate operating in the wholesale market.[121] Despite the fact that the ratepayers are located in Missouri, the Crossroads unit is located in Clarksdale, Mississippi.[122] In August 2008, after the Great Plains Energy acquisition of Aquila, the Crossroads unit was transferred to the regulated books

[120] *Smyth v. Ames*, 169 U.S. 466, 546-547 (1898) (emphasis added).
[121] Ex. 216, page 4
[122] *Id.*

of GMO.[123] Recognizing, then, that Crossroads was transferred from a non-regulated affiliate to the Missouri regulated operations, the Commission's affiliate transaction rule is implicated.

3. The Commission has promulgated its affiliate transaction rule at 4 CSR 240-20.015. As it applies to the immediate issue, that rule provides that the purchase of "goods or services" from an affiliate shall be "the ***lesser*** of: (a) fair market price; or (b) the fully distributed cost."[124]

4. In the last case, the Commission found that the appropriate valuation for Crossroads was an interdependent package of three considerations: (1) Crossroads value; (2) reflection of all accumulated deferred taxes; and (3) disallowance of all transmission costs. Ultimately, in that case, the Commission used a surrogate sale of combustion turbines from Aquila to Ameren to establish the fair market value for Crossroads. In addition, the Commission included all accumulated deferred taxes as an offset to this rate base value. Finally, recognizing the apples to oranges nature of the surrogate sale valuation (i.e., the sale to Ameren involved facilities located in the same RTO as Ameren while Crossroads is located in a different RTO and over 500 miles from GMO customers), the Commission disallowed all transmission costs. As the Commission found, absent such a disallowance, the inclusion of Crossroads in GMO rate base would be imprudent.

> ***The decision to include Crossroads in the generation fleet at an appropriate value was prudent with the exception of the additional transmission expense***, when other low-cost options were available. Paying the additional transmission costs required to bring energy all

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[123] *Id.* at page 5.
[124] 4 CSR 240-20.015(2)(A) (emphasis added).

> the way from Crossroads and including Crossroads at net book value with no disallowances, is not just and reasonable.[125]

<u>VALUATION</u>

5. As in the last case, GMO again asks that the Commission include Crossroads in rate base at its net book value of $91.3 million.[126] In contrast, MECG claims that, given the mandate of the Commission's affiliate transaction rule, the fair market value of the Crossroads unit is established by certified filings made by Great Plains Energy shortly before the transfer of the Crossroads unit to the Missouri regulated operations. Staff presents evidence to support a continuation of the valuation methodology utilized by the Commission in the last case.

6. In February 2007, Great Plains Energy announced that it was seeking to acquire Aquila, Inc. Given several recent divestitures by Aquila, Great Plains acquisition amounted to simply the Missouri regulated electric operations as well as the Crossroads Energy Center. Over the next several months, Great Plains made three separate filings with the Securities Exchange Commission regarding the "fair value" of the Crossroads unit. As Great Plains indicated:

> ***<u>The preliminary internal analysis indicated a fair value estimate of Aquila's non-regulated Crossroads power generating facility of approximately $51.6 million.</u>*** This analysis is significantly affected by assumptions regarding the current market for sales of units of similar capacity. The $66.3 million adjustment reflects the difference between ***<u>the fair value of the combustion turbines at $51.6 million</u>*** and the $117.9 million book value of the facility at March 31, 2007. Great Plains Energy ***<u>management believes this to be an appropriate estimate of the fair value of the facility</u>***.[127]

[125] *Report and Order*, Case No. ER-2010-0356, issued May 4, 2001, at page 91 (emphasis added).
[126] Staff Exhibit 271, page 23.
[127] Staff Exhibit 258, pages 78-79 (citing to Great Plains Energy & Aquila Joint Proxy Statement / Prospectus, filed with the SEC on May 8, 2007, at page 175) (emphasis added).

Recognizing that the valuations disclosed by Great Plains to the Securities Exchange Commission were under oath and conducted shortly prior to the transfer of Crossroads to the Missouri regulated operations, MECG argues that the fair market value of Crossroads is $51.6 million.

7. Fairly closely aligned with the SEC valuation, Staff argues that the Crossroads valuation ought to be set based upon the sale of identical combustion turbines by Aquila to Ameren in 2006. The Crossroads Energy Center is a 300 MW natural gas combustion turbine generating site, consisting of four 75 MW General Electric model 7 EA combustion turbines.[128] Given its plans to enter the deregulated market in many locations throughout the nation, Aquila Merchant purchased a total of <u>eighteen</u> (18) of these General Electric combustion turbines.[129] Therefore, after the deregulated electric industry collapsed in late 2001, Aquila Merchant had significant experience selling the remaining <u>fourteen</u> (14) combustion turbines that were identical to those now located at Crossroads. That real market experience provides direct evidence that the "fair market value" for these General Electric turbines is significantly less than that now claimed by GMO, and is actually in line with the "fair value" previously noted by Great Plains.

8. For instance, of the 18 General Electric Turbines, six turbines were installed at the 510 MW Goose Creek Energy Center in Illinois.[130] An additional four turbines were installed at the nearby 340 MW Raccoon Creek facility.[131] Following the onset of the financial problems caused by the entry into the deregulated market, Aquila Merchant immediately began seeking third parties that were interested in purchasing

[128] Staff Exhibit 258, Cost of Service Report, at pages 74 and 77.
[129] *Id.* at page 77.
[130] *Id.*
[131] *Id.*

these units. As documented by Staff, the final sale price for both units (10 combustion turbines for a total capacity of 850 MWs) was $175 million.[132] As such, the final purchase price amounted to <u>**$205.88**</u> per installed kilowatt.[133] This sale was closed in 2006 and is, therefore, contemporaneous with the Great Plains acquisition in 2007.[134] Using this sale of identical combustion turbines between a willing buyer and willing seller, the value of Crossroads is $61.8 million.

9. In contrast, GMO claims that the fair market value of Crossroads is net book value. GMO argues that this is appropriate because: (1) it represents the cost at which Aquila Merchant built Crossroads and (2) Crossroads was found to be the least cost option provided in responses to a 2007 Request for Proposals. Furthermore, GMO argues that the Missouri Commission's has adopted the Uniform System of Accounts. Included in the USOA is a preference for "original cost" for the valuation of utility plant. As such, GMO argues that the cost to construct Crossroads represents "original cost."

10. GMO's argument is misplaced. Relevant to the immediate inquiry, the FERC USOA provides the following definition for original cost. "*Original cost,* as applied to electric plant, means the <u>***cost of such property to the person first devoting it to public service.***</u>"[135] The instructions to the FERC regulations specifically recognize a distinction between property <u>constructed</u> by the utility and property <u>acquired</u> by the utility. "The detailed electric plant accounts (301 to 399, inclusive) shall be stated on the

[132] *Id.*
[133] *Id.* (citing to Aquila's SEC Form 8K filing with the Securities Exchange Commission, filed December 16, 2006).
[134] *Id.*
[135] 18 CFR Part 101 §23 (emphasis added).

basis of cost to the utility of plant constructed by it and the original cost, estimated if not known, of plant acquired."[136]

11. In this case, contrary to the definition contained in USOA, GMO essentially argues that the Crossroads value should be based upon Aquila Merchant's cost of construction.[137] Contrary to GMO's assertions, however, the cost of construction for Aquila Merchant is **NOT** original cost. The cost of construction is not the original cost because as the FERC definition requires, Aquila Merchant did not devote Crossroads to the "public service." Instead, while GMO's IRP mandated a capacity addition in 2005 and a prudent utility would have fulfilled such a need at that time, Crossroads was not devoted to the "public interest" until it was actually transferred to GMO's regulated books in August of 2008.[138]

12. Similarly, fair market value is not established by responses to its RFP. As GMO admits, "fair market value is the price at which the property could be sold by a willing seller to a buyer who is under no compulsion to buy."[139] Responses to an RFP may show how Crossroads would compare to other resources options, but it doesn't demonstrate the fair market value of Crossroads. Furthermore, GMO fails to explain, given the alleged results of the RFP, why did it announce to the Securities Exchange Commission, mere months later, that "fair value" was only $51.6 million?

13. In the final analysis, the only evidence of "the price at which the property could be sold by a willing seller to a buyer under no compulsion to buy" is the proxy sale

[136] 18 CFR Part 101, Electric Plant Instructions.
[137] Staff Exhibit 271, Featherstone Rebuttal, page 27.
[138] *Id.* at page 22.
[139] *Shirley's Realty, Inc. v. Hunt*, 160 S.W.3d 804, 808 (Mo.App. 2005).

of identical turbines by Aquila to Ameren. These sales are contemporaneous with Great Plains' acquisition of Aquila and its deregulated Crossroads unit.

14. The Commission finds, given Great Plains' statements to the Securities Exchange Commission shortly before the transfer of the Crossroads unit to the Missouri regulated operations, as well as the arms-length sale of the Raccoon Creek / Goose Creek General Electric combustion turbines by Aquila, that the fair market value of Crossroads at the time of transfer (August 2008) was $61.8 million.

DEFERRED TAXES

15. As previously indicated, in the last case, the Commission found that entire balance of accumulated deferred taxes should be utilized as an offset to the rate base value for Crossroads. In this case, GMO asks that the Commission reconsider its previous decision. As an initial matter, the Commission notes that it has already addressed this matter twice, first in the context of its Report and Order and second within its Order of Clarification and Modification in which it rejected GMO's application for rehearing on this issue.

16. Essentially, GMO argues that deferred taxes should not be used as part of the Crossroads valuation, but instead should mathematically flow from the Commission's valuation. As with the last case, GMO's argument is misplaced. As MECG points out:

> GMO fails to recognize that the deferred taxes were not simply a mathematical calculated that flowed out of the Commission's adoption of the Raccoon Creek / Goose Creek valuations. In that case, deferred taxes were not designed to be simply "synchronized" with the Raccoon Creek / Goose Creek valuation. Rather, the deferred taxes were part and parcel of three unique aspects of the Commission's Crossroads valuation.[140]

[140] MECG Exhibit 426, Meyer Surrebuttal, pages 17-18.

The Commission's decision in the last case, to reflect the entirety of accumulated deferred taxes, was correct. ***First***, the accumulated deferred taxes in question arose out of the accelerated tax deduction provided by the income tax code. As with other deductions, the accelerated tax deduction is permitted only to the extent that the entity had income. Given the deterioration of the deregulated energy market as reflected by the significant decrease in fair market value reflected in the Great Plains SEC filings, it is apparent that this unit was not profitable. As such, on a stand-alone basis, Crossroads and Aquila Merchant would not have been able to recognize the accelerated depreciation deduction. Instead, the ability to take the accelerated depreciation deduction comes from the fact that Aquila Merchant was affiliated with the profitable regulated operations. For this reason, the existence of the regulated ratepayers and the profits derived from them provided the basis for the accelerated tax deduction and the deferred taxes that exist today.

Second, it is unquestioned that Great Plains Energy undertook significant due diligence as part of its acquisition of Aquila. One part of that due diligence would necessarily have been into the quantification of deferred taxes for all parts of the remaining Aquila operations including Crossroads. It is incomprehensible that Great Plains would not have considered this accumulated deferred tax balance as part of its final acquisition price for Aquila.

Third, as the Commission found, "[i]n all instances, KCPL and GMO use deferred income taxes relating to regulated investment assets as an offset (reduction) to rate base."[141] Given that this is now a regulated generating facility, the deferred income

[141] *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 96.

tax balance associated with this facility should also be reflected as "an offset (reduction) to rate base."

17. Clearly, the Commission carefully considered this issue in the last case. GMO has provided no new evidence to undermine the logic of the Commission's decision in that case. For this reason, the Commission reaffirms its previous decision and holds that the entire accumulated deferred tax balance should be used as an offset to Crossroads rate base.

TRANSMISSION COSTS

18. In its last decision, the Commission made numerous findings supporting its decision to disallow Crossroads transmission costs. Recognizing that, unlike the proxy sale valuation, Crossroads is located in a different RTO from its customers, the Commission found that GMO's decision to include Crossroads in rate base would be imprudent unless it disallowed all transmission costs.

> ***It is not just and reasonable to require ratepayers to pay for the added transmission costs of electricity generated so far away in a transmission constricted location***. Thus, the Commission will exclude the excessive transmission costs from recovery in rates.[142]
>
> ***The decision to include Crossroads in the generation fleet at an appropriate value was prudent with the exception of the additional transmission expense***, when other low-cost options were available. Paying the additional transmission costs required to bring energy all the way from Crossroads and including Crossroads at net book value with no disallowances, is not just and reasonable.[143]
>
> ***In addition to the valuation, the Commission concludes that but for the location of Crossroads customers would not have to pay the excessive cost of transmission.*** Therefore, transmission costs from the Crossroads facility, including any related to OSS shall be disallowed from expenses in

[142] *Report and Order*, Case No. ER-2010-0356, issued May 4, 2001, at page 87 (emphasis added).
[143] *Id.* at page 91 (emphasis added).

> rates and therefore also not recoverable through GMO's fuel adjustment clause.[144]
>
> The Commission further determines that it is ***not just and reasonable for GMO customers to pay the excessive cost of transmission from Mississippi*** and it shall be excluded.[145]

19. As the Commission recognized in its previous decision, Crossroads is located in Clarksdale, Mississippi.[146] While GMO has included Crossroads as a designated resource for its capacity requirements in SPP, it is not located within the contiguous footprint of SPP. Rather, Crossroads is entirely surrounded by Entergy service area. As such, GMO must incur transmission expenses across Entergy in order to get this energy to SPP and ultimately to its Missouri service area.[147]

20. Previously, Entergy did not belong to any Regional Transmission Organization ("RTO"). Instead, Entergy was a stand-alone transmission entity with FERC approved transmission rates. Therefore, in order to ensure the capacity and energy from Crossroads, GMO paid a firm transmission rate to Entergy.[148]

21. Recently, however, Entergy joined the Midwest Independent System Operator ("MISO").[149] In fact, the formal approval was announced on November 16, 2012[150] with Entergy formally joining in December, 2012.[151] As such, where GMO previously paid Entergy rates for transmission of energy from Crossroads to SPP, now GMO will pay MISO rates for the transmission of that energy.[152]

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144 *Id.* (emphasis added).
145 *Id.* at page 100 (emphasis added).
146 *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 78.
147 MECG Exhibit 426, Meyer Surrebuttal, page 16; Tr. 931.
148 GMO Exhibit 112, Crawford Surrebuttal, page 3.
149 Tr. 931-932.
150 *Entergy Gets Final Nod for MISO*. Published November 16, 2012. http://finance.yahoo.com/news/entergy-gets-final-nod-miso-160910712.html
151 *Id.*
152 Tr. 932.

22. As mentioned, GMO previously paid FERC approved rates for Entergy for the transmission of energy from Crossroads to SPP. Now, with the inclusion of Entergy in MISO, GMO will be paying the MISO transmission rates. During the hearing, evidence was garnered that the MISO rate for transmission would be "double" the Entergy approved transmission rate.[153]

23. Interestingly, Aquila was well aware of the problems with getting energy from Crossroads when it placed the facility in Clarksdale. Specifically, Aquila placed Crossroads in Clarksdale, a point of known transmission congestion, as an attempt to take advantage of the high market prices for energy in this congested area. The location of the generator in an area in which Aquila sought to take advantage of congestion is now requiring the payment of excessive transmission costs.

> What Mr. Crawford and GMO fail to understand is that Aquila made deliberate business decisions to locate these generators where there were known congestion issues on the transmission network. Aquila Network believed placing peaking units in areas of transmission constraints would allow the non-regulated operations to enjoy the benefits of high priced power when there were times of restrictions of the network. In other words, Crossroads was placed in a location where it would ultimately be costly to transport power out of the region. Of course, Aquila never intended to use the power generated from Crossroads for GMO customers, so the transmission costs and the ability to transport electricity from Mississippi never was a concern – that is until KCPL took over operating GMO.[154]

24. While GMO incurs these transmission costs associated with the energy from Crossroads, it does not incur these costs with regards to any of its other generating facilities. As the Commission previous held, "GMO does not incur any transmission costs for its other production facilities that are located in its MPS district that are used to

[153] Tr. 932.
[154] Staff Exhibit 272, Featherstone Rebuttal, page 37.

serve its native load customers in that district."[155] For this reason, all of the GMO generating facilities, except Crossroads, are located in the SPP footprint.[156] As Staff notes,

> All of KCPL's and GMO's generating facilities do not need firm transmission service because, as a member of the Southwest Power Pool (SPP) except for one power plant – Crossroads, all other generating units are able to transport power to their retail customers without incurring firm transmission costs. Since all other generating units in the KCPL and GMO fleets are within the SPP transmission territory there is no cost for transmission service when the electricity is used by retail customers. The single exception is Crossroads. Since this Mississippi generating plant is located 525 miles away from GMO's load centers, GMO has decided for the Crossroads facility to have firm transmission to get power back to its retail customers in Missouri.[157]

25. As previously indicated, the Commission utilizes a surrogate sale of identical combustion turbines (Raccoon Creek / Goose Creek) from Aquila to Ameren as a proxy valuation for the Crossroads unit. The price that Ameren paid for Raccoon Creek and Goose Creek reflected the location of those units in the same RTO. As such, Ameren did not incur transmission costs associated with bringing the energy from the units to its customers. Undoubtedly, if Raccoon Creek and Goose Creek were located in a different RTO and Ameren would have been required to incur ongoing transmission costs, the price for Raccoon Creek and Goose Creek would have been significantly lower. In an effort to reflect this significant difference between Crossroads and the Raccoon Creek / Goose Creek surrogate sale, the Commission believes that it must disallow all associated transmission costs. As the Commission previously held, it would be imprudent for GMO to include Crossroads in its rate base and incur these transmission costs.

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[155] *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 87.
[156] GMO Exhibit 110, Crawford Direct, Schedule BLC-7; Staff Exhibit 258, Staff Cost of Service Report, page 71.
[157] Staff Exhibit 272, pages 35-36.

> ***The decision to include Crossroads in the generation fleet at an appropriate value was prudent with the exception of the additional transmission expense***, when other low-cost options were available. Paying the additional transmission costs required to bring energy all the way from Crossroads and including Crossroads at net book value with no disallowances, is not just and reasonable.[158]

If required to include such transmission costs in GMO's rates, the fair market value for Crossroads must necessarily be reduced. In fact, the incurrence of such costs may lower the value of Crossroads to zero. This value is consistent with the fact that when offered to 79 different entities, no one even gave a bid for Crossroads.[159]

26. GMO attempts to minimalize the transmission costs associated with Crossroads. GMO falsely claims that, as a result of Crossroads proximity to the Gulf gas fields, the natural gas costs for Crossroads are cheaper than for its other units.[160] GMO then mistakenly concludes that this savings in natural gas costs more than offsets the cost of transmitting electricity from Mississippi to Missouri.[161] GMO's allegations are not only contradicted by Staff's abundant testimony, but also by GMO's own internal documents.

27. ***First***, in his testimony, Staff witness Featherstone points out that the reason for cheaper gas costs to GMO's Kansas City area facilities is the difference in cost between Midcontinent region gas and Henry Hub area gas.

> Historically, the Mississippi based Crossroads has experienced higher natural gas costs when compared to natural gas prices and costs in Kansas City, Missouri. GMO gets its natural gas in the area known as Midcontinent region of the United States – a location where natural gas prices tend to be lower than most of the other parts of the country and in the Gulf region, Mississippi in particular. The Midcontinent region includes portions of Texas, Oklahoma and Kansas. Historically, natural

[158] *Report and Order*, Case No. ER-2010-0356, issued May 4, 2001, at page 91 (emphasis added).
[159] Staff Exhibit 395, Appendix Project Spark, at page 2.
[160] GMO Initial Brief at paragraph 174.
[161] *Id.*

gas prices in the Midcontinent region have been significantly lower than at the Henry Hub area in Louisiana.[162]

28. ***Second***, Staff demonstrated through actual natural gas costs and transportation costs that GMO's Kansas City area facilities have cheaper costs.

29. ***Third***, GMO's internal documents demonstrate that the Kansas City area gas plants are much cheaper than Crossroads. Given GMO's argument that Crossroads natural gas costs make it cheaper to run, one would expect that Crossroads would be dispatched earlier than any other natural gas facility. GMO admits, however, that Crossroads is dispatched after South Harper, Ralph Green and the Greenwood units.[163] In addition, the heat rate for the Crossroads unit is worse than for these other natural gas units.[164]

30. ***Finally***, anecdotal evidence conclusively demonstrates that Crossroads natural gas costs cannot offset the high cost of transmitting energy from Mississippi to the Missouri service area. This is proven by the fact that KCPL and GMO have many natural gas units, but every other generating facility is located within the SPP footprint. More specifically, all twenty-one (21) natural gas generating units[165] are located within the KCPL and GMO service area.[166] According to GMO's logic, these other units should have been located in Mississippi to take advantage of the alleged low cost natural gas. Yet, KCPL and GMO never even studied a Mississippi location for these other natural gas facilities.

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[162] Staff Exhibit 293, Featherstone Surrebuttal, page 117.
[163] Staff Exhibit 394.
[164] Staff Exhibit 393.
[165] Staff Exhibit 258, Staff Cost of Service Report, pages 70-71.
[166] Tr. 894-895.

31. GMO then argues that the Commission is mandated, as a result of federal preemption regarding the rates for interstate transmission costs, to allow recovery of the transmission costs associated with Crossroads.[167] Making reference to previous federal and Commission decisions, GMO asserts that, by disallowing these costs, the Commission has displaced FERC's authority to establish appropriate transmission rates.

> At its most obvious, the filed rate doctrine means that a state commission cannot decide that the FERC-approved interstate transportation rate that the local distribution company (LDC), such as MGE, is paying is too high and refuse to allow the LDC to include those costs in its rates.[168]

GMO, however, fails to distinguish between ratemaking for interstate transmission rates, which is governed by FERC under the supremacy clause, and the authority to consider whether it was prudent for GMO to ever incur such costs, which is exclusively within this Commission's authority.

32. In <u>Nantahala Power and Light Company v. Thornburg</u>,[169] the United States Supreme Court held that the North Carolina Utility Commission unlawfully interfered with authority granted to FERC. Specifically, the North Carolina Commission acted unlawfully when it found that a power allocation agreement previously approved by FERC was unreasonable and instead calculated a new allocation methodology. Relying on the supremacy clause, the Court found that "under the filed rate doctrine, the [FERC] alone is empowered to make that judgment [of reasonableness], and until it has done so, no rate other than the one on file may be charged."[170] Given this, the Court held that,

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[167] GMO Initial Brief at paragraph 176.
[168] GMO Initial Brief at paragraph 176 (citing to *Order Consolidating Cases*, Case No. GR-2001-382, issued September 10, 2002.
[169] 476 U.S. 953 (1986).
[170] *Id.* at 964.

"***once FERC sets such a rate, a State may not conclude in setting retail rates that the FERC-approved wholesale rates are unreasonable***."[171]

33. In the case at hand, the Commission is not violating the supremacy clause by finding that GMO imprudently incurred the cost of transmitting power from Mississippi to Missouri. The Commission has not found that the FERC approved rate was "unreasonable." Rather, as it held in its previous decision, the Commission is finding that it was imprudent for GMO to include Crossroads, located in Mississippi, in its rate base for Missouri customers. Only by disallowing these costs could this decision be made prudent.

> ***The decision to include Crossroads in the generation fleet at an appropriate value was prudent with the exception of the additional transmission expense***, when other low-cost options were available. Paying the additional transmission costs required to bring energy all the way from Crossroads and including Crossroads at net book value with no disallowances, is not just and reasonable.[172]

Clearly, there is a distinction between finding that a FERC rate is unreasonable and finding that it was imprudent for a utility to ever incur those FERC approved costs. GMO fails to understand this distinction.

34. Moreover, the Supreme Court made it clear that it was limiting its decision solely to the strict holding previously expressed. By finding that state commission could not redetermine a FERC approved rate, the Supreme Court did not imply that the state commission was forced to implement an adjustment clause to allow automatic pass through, on a dollar for dollar basis, of any changes in the FERC rate. In fact, a change in FERC approved rates "need not lead to an increase in retail rates."[173]

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[171] *Id.* at 966.
[172] *Id.* at page 91 (emphasis added).
[173] *Id.* at page 967.

> The commission . . . may treat the proposed rate increase as it treats other filings . . . and investigate the overall financial structure of [the power company] to determine whether the company has experienced savings *in other areas which might* offset the increased price.[174]

35. As such, the Supreme Court was careful to limit its holding solely to the supremacy clause and made efforts to maintain the jurisdiction of the state utility commissions. As such, it is reasonable to believe that the *Nantahala* doctrine would not be extended to limit the state utility commission's ability to determine whether the utility prudently incurred the FERC approved charges.

36. Ultimately, the Commission's decision in this case is the same as its decision in the last case. Specifically, the Commission believes that the valuation of Crossroads is a three piece interdependent package. First, the Commission finds, using the surrogate sale of Raccoon Creek and Goose Creek, that the fair market value of Crossroads is $61.8 million. Second, the Commission finds that the entire balance of accumulated deferred taxes should be utilized as an offset to Crossroads rate base. Third, the Commission finds that it would be imprudent for GMO to include Crossroads in rate base given the transmission costs associated with bringing the energy from another RTO to its Missouri customers. For this reason, the Commission continues to disallow all transmission costs.

[174] *Id.* (citing to *Narragansett Electric Co. v. Burke,* 381 A.2d 1358, 1363 (1977). See also, *Public Service Co. of Colorado v. Public Utilities Commission*, 644 P.2d 933, 941 (Col. 1982) ("The commission may treat the [increase] as it treats other filings for proposed rate increases . . . and investigate whether [either of the gas companies] has experienced *savings in other areas which might offset the increased price* for natural gas to consumers.") (emphasis in original).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing pleading by email, facsimile or First Class United States Mail to all parties by their attorneys of record as provided by the Secretary of the Commission.

David L. Woodsmall

Dated: December 11, 2012