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Refund; R&D Tax Credits; Off-
System Sales; DSM
Witness: Chris B. Giles
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Case No.: ER-2007-0291
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2007-0291

REBUTTAL TESTIMONY

OF

CHRIS B. GILES

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

**Kansas City, Missouri
August 2007**

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REBUTTAL TESTIMONY

OF

CHRIS B. GILES

Case No. ER-2007-0291

1 **Q: Are you the same Chris B. Giles who submitted Direct Testimony in this**
2 **proceeding?**

3 **A: Yes, I am.**

4 **Q: What is the purpose of your Rebuttal Testimony?**

5 **A: The purpose of my testimony is to rebut certain positions taken by Missouri Public**
6 **Service Commission (“Commission”) Staff, the Office of the Public Counsel (“OPC”),**
7 **and the Department of Energy—National Nuclear Security Administration (“DOE”) in**
8 **their Direct Testimony in this proceeding. Specifically, I address (i) treatment of**
9 **Hawthorn 5 (“H5”) subrogation proceeds; (ii) treatment of the Wolf Creek DOE refund;**
10 **(iii) treatment of Research and Development (“R&D”) tax credits; (iv) level of Off-**
11 **System Sales (“OSS”) margins; and (v) treatment of Demand-Side Management**
12 **(“DSM”) related costs.**

13 **H5 SUBROGATION PROCEEDS**

14 **Q: What is the issue regarding H5 subrogation proceeds you are addressing?**

15 **A: I address the position taken by Commission Staff witness Charles Hyneman and DOE**
16 **witness James Dittmer in their Direct Testimonies in this case. Mr. Hyneman and Mr.**
17 **Dittmer both advocate Kansas City Power & Light Company (“KCPL” or the**

1 "Company") amortize as a reduction to cost of service over 5 years the subrogation
2 proceeds recorded by KCPL in 2006 related to the H5 outage that occurred in 1999.

3 **Q: What reasoning did Mr. Hyneman give to support his position?**

4 **A:** Mr. Hyneman, in his Direct Testimony, page 4, states

5 "KCPL received the proceeds as a direct result of KCPL's regulated
6 activities. Without substantive reasons to the contrary, revenues and
7 expenses directly related to regulated operations should be accounted for
8 as regulated revenues and expenses."
9

10 Staff's Cost of Service Report, page 41, further states

11 "The Staff is not aware of any prior adjustments it made to KCPL's cost of
12 service to disallow the payroll and benefits expenses of KCPL's
13 employees who worked on the lawsuit that resulted in the proceeds. Nor
14 is the Staff aware of any adjustments to KCPL's legal expenses for legal
15 costs incurred in prosecuting the lawsuit that resulted in KCPL receiving
16 proceeds.
17

18 **Q: Do you agree with Mr. Hyneman?**

19 **A:** No, I do not, as I explain below. However, some background is appropriate to establish
20 the context of these proceeds. KCPL received these proceeds in 2006. The proceeds
21 were related to damages awarded to KCPL as a result of the approximate two year outage
22 of H5 from 1999 through mid 2001. This explosion and subsequent costs of replacement
23 power and property damage were received by KCPL through subrogation litigation and
24 insurance proceeds. The proceeds of this litigation have absolutely nothing to do with the
25 test year in this case. In addition, the cost of replacement power and property damages
26 that resulted from the explosion were never paid by customers during the outage or at any
27 time subsequent to the outage. In addition, the proceeds are recorded net of litigation
28 costs. KCPL did not need to make any adjustments to legal expenses incurred in

1 prosecuting this lawsuit that resulted in KCPL receiving these proceeds. KCPL never
2 recorded them. There was nothing to adjust.

3 **Q: Why were customers not charged for property damage or the costs of replacement**
4 **power related to the H5 outage during 1999-2001?**

5 A: Insurance proceeds related to property damage were almost entirely reflected as salvage
6 in the reserve for depreciation related to H5, thus customers will fully receive the benefit
7 of insurance proceeds on an ongoing basis. Rate base is reduced by the amount of
8 insurance proceeds related to property damage. During the period of the Hawthorn
9 outage, KCPL did not have a fuel adjustment clause that would have recovered
10 replacement power costs. KCPL did not request a rate increase at any time during the
11 outage or subsequent to the outage that resulted in recovery of the replacement power
12 costs. Thus, customers have never paid these costs.

13 **Q: What is the purpose of using a normalized test year to set rates?**

14 A: Rates are set for a future period. In this case, rates will become effective in 2008 based
15 on a normalized test year of 2006 trued up for certain items through September 30, 2007.
16 Unusual non-recurring events are excluded from test year data because they do not reflect
17 the ongoing operating characteristics or cost of service of the Company. Clearly, the
18 proceeds from subrogation litigation related to an explosion in 1999, the results of such
19 explosion never having been included in rates at any time, has nothing to do with setting
20 rates in this case. The only means to truly deal with this issue had customers been
21 charged for it in the first place would be to refund the proceeds directly to customers
22 through a fuel adjustment or a one time credit.

1 Q: Why would a refund be appropriate when customers have never paid for the
2 replacement power in the first place?

3 A: It wouldn't. I simply raise this point to illustrate that one would not refund money that
4 had never been collected in the first place.

5 Q: Did the Company include payroll and benefits expenses of KCPL's employees who
6 worked on the lawsuit?

7 A: An immaterial amount may have been related to the litigation, *i.e.*, less than \$50,000. If
8 so, KCPL will adjust this amount out of its cost of service in this case.

9 Q: Mr. Dittmer states that the amortization of the subrogation proceeds is similar to
10 amortizing an expense that is non-recurring and thus should be similarly amortized
11 for setting rates. Do you agree with Mr. Dittmer?

12 A: No, Mr. Dittmer's analogy is incorrect and misleading. The purpose of amortization of
13 non-recurring or unusual expenses is to provide recovery of prudently incurred costs over
14 time. His own argument points out the fallacy of his position. Had the Company
15 requested and the Commission grant amortization of the costs of replacement power
16 during the H5 outage and those costs had been reflected in rates at any period of time
17 subsequent to the outage, I would agree the Company would now need to amortize the
18 subrogation proceeds for purposes of setting rates. As I stated previously, however, the
19 Company did not amortize these costs and did not collect these costs at any time in rates.

20 Q: Mr. Dittmer states on page 19 of his testimony that "Finally, I note that KCPL's
21 earnings during the years 2000 through 2005 were adequate, if not robust, in
22 relation to returns being authorized by this as well as other state regulatory
23 commissions during the noted years. Thus, I do not believe that KCPL can credibly

1 argue that its shareholders are entitled to these credits relating to prior years when
2 it was already earning adequate if not excessive rates of return during the relevant
3 period." Does Mr. Dittmer provide any evidence or support for this statement?

4 A: No, he does not. He provides no evidence or support and it is not clear to me that he
5 could. KCPL did not file any rate cases between 1999 and 2005. Although, some parties
6 may believe information can be gleaned from annual surveillance reports to determine
7 whether KCPL was earning at an appropriate level, the surveillance reports are not
8 reflective of test year cost of service analysis as is required in rate cases. In fact,
9 surveillance reports are utilized by the Staff to determine whether an audit is needed in
10 anticipation of a complaint case. During this time period 1999 through 2005, Staff
11 conducted audits in various years and in some years did not. However, Staff never filed a
12 complaint case stating KCPL should adjust rates.

13 **Q: What is the significance of Mr. Dittmer's statement?**

14 A: I can only conclude that Mr. Dittmer believes retroactive ratemaking is appropriate
15 because the Company in his view, without any evidence, was earning in excess of other
16 utilities.

17 **Q: Is retroactive ratemaking ever appropriate?**

18 A: No, it is not, whether for the Company's benefit or an intervener's. I do not think Mr.
19 Dittmer would support the Company if it were to propose to reach back to 1999 and 2000
20 and charge customers now for the cost of replacement power during this period. The cost
21 of that replacement power (in excess of \$150 million) far exceeds the subrogation
22 proceeds Mr. Dittmer proposes to now amortize back to customers even though they
23 never paid the costs to begin with.

1 WOLF CREEK DOE REFUND

2 Q: Staff recommended a five-year amortization for the Wolf Creek DOE settlement.
3 Do you believe this is appropriate?

4 A: No, I do not. This issue is essentially the same as the H5 subrogation issue I just
5 discussed. The DOE refund at issue was the result of a lawsuit filed by KCPL against
6 DOE. The Company was overcharged for uranium enrichment services purchased from
7 the government during fiscal years 1986-1993. The lawsuit settled, and in December
8 2006, KCPL accrued \$427,150 for the settlement. Staff, in its *Cost of Service Report*
9 describes its adjustment (S-20.1) to remove the settlement proceeds from test year
10 expense. KCPL made the same adjustment, as KCPL considers this an unusual event,
11 related to a period outside the test period in this case. However, Staff also deferred the
12 amount of these proceeds as a regulatory liability to be flowed back over five years as a
13 reduction to KCPL's cost of service.

14 Q: Did Staff give a reason for the deferral adjustment?

15 A: No, it did not. It merely stated it had made the adjustment.

16 Q: You said this was essentially the same issue as the H5 subrogation proceeds issue?
17 Can you explain?

18 A: Yes, I can. This issue, like the H5 proceeds issue is a violation of the "matching"
19 principle and represents retroactive ratemaking. These proceeds were received as a
20 result of activities that happened in a prior period. The corresponding costs are not in this
21 test year. There is no "match." Not only is there no match, the Commission would need
22 to go back as much as 20 years to get the costs. Customers never paid these costs. KCPL
23 did not have a rate case or a fuel adjustment clause during the time these costs were

1 incurred. It is no more appropriate to reach back beyond the test year as Staff proposes,
2 than it is for the Company to reach back for rate increases foregone during this period.

3 **R&D TAX CREDITS**

4 **Q: Are there any other recommendations in this case that you believe fall into the**
5 **category of retroactive ratemaking?**

6 A: Yes, there is another recommendation made by both Staff in its *Cost of Service Report*,
7 and DOE witness James Dittmer that constitutes retroactive ratemaking.

8 **Q: What is this recommendation?**

9 A: Mr. Dittmer on page 16 of his Direct Testimony states, "I am proposing tax credits
10 anticipated to be received by KCPL related to filing amended federal tax returns for
11 calendar years 2000 through 2005 be deferred and amortized as a credit to the cost of
12 service over a five-year period."

13 **Q: Did Staff take the same position?**

14 A: Essentially, it did. Staff in its *Cost of Service Report*, pages 51 and 52, states,

15 "In response to U.S. Department of Energy (DOE) Data Request No. 55, KCPL
16 indicated it intends to file amended tax returns for years 2001-2005 for the
17 purpose of reflecting allowable tax credits and current year tax deductions for
18 research and experimental expenditures under Internal Revenue Code (IRC)
19 Sections 41 and 174. It is the Staff's position that the additional cash flow from a
20 tax reduction from an amended tax return should be deferred and amortized for
21 ratemaking purposes. This increase in cash flow to KCPL should be used to
22 mitigate the Regulatory Plan Amortization that KCPL's ratepayers are paying in
23 current rates and will continue to pay until rates become effective in 2010 to
24 recognize the in-service date for KCPL's new coal burning generating facility,
25 Iatan 2.

26 The occurrence of an extraordinary income event should be viewed in the
27 same manner as an extraordinary cost event like KCPL's 2002 ice storm.
28 Deferred accounting and amortization for ratemaking purposes should apply
29 equally to both extraordinary costs and extraordinary income."
30

1 Q: There seems to be a discrepancy with the years in question between Mr. Dittmer
2 and Staff. Can you clarify the time frame in question?

3 A: Yes, I can. The response to DOE Data Request No. 55, correctly indicated Ernst &
4 Young is providing services to assist the Company in filing and sustaining tax refunds for
5 the "tax years ended December 31, 2000 through December 31, 2004."

6 Q: Did the Company reflect the R&D tax credit associated with the 2006 tax year in its
7 case?

8 A: Yes, it did.

9 Q: So, the Company is not disputing the R&D tax credit?

10 A: No, the Company is not disputing the R&D tax credit. It is the deferral and amortization
11 of tax credits for prior periods that the Company is disputing.

12 Q: Has the Company received these prior year tax credits?

13 A: No, it has not. The Company believes those prior period tax credits will be received
14 sometime in 2008.

15 Q: If the Company had received the prior period tax credits during the test year tried
16 up through September, would you agree with the recommendation to defer and
17 amortize them over 5 years?

18 A: No, I would not. It is not appropriate to reach back to events that occurred in prior years
19 outside the test period to set rates for future periods. Once again, this is a violation of the
20 matching principle used in setting rates, and is nothing more than retroactive ratemaking.

21 Q: Staff and DOE support their position by characterizing these events as
22 extraordinary income events and comparing them to extraordinary cost events
23 which the Company defers and amortizes. Is that the case?

1 A: No, it is not. Extraordinary cost events are amortized when they occur in a test year or
2 when the Commission has approved an accounting authority order to defer and amortize
3 for recovery purposes an unusual but prudently incurred expense over time. In those
4 instances where accounting authority orders are granted the Company does not recover
5 any of the amortized costs unless it files a rate case. Similarly, if no rate cases reflect the
6 costs associated with a future credit, then no credit is owed. In addition, the Company
7 must operate within the bounds of the revenue generated. For example, if the Company
8 experiences an abnormally higher number of small to medium storms, as it did in 2006,
9 then it is not able to recover those additional costs retroactively. Consistent with
10 ratemaking principles, the Company cannot go back in time and ask to have those costs
11 reimbursed going forward. They would be outside the test period. The matching
12 principle would be violated. Likewise, going back in time to ask for prior period
13 revenues, as the Staff and DOE recommend is contrary to ratemaking principles and
14 should not be allowed.

15 **OSS MARGINS**

16 **Q: Did KCPL prepare its case consistent with the order of the Commission in ER-2006-**
17 **0314 as it pertains to OSS margins?**

18 A: Yes, it did. Consistent with that order, KCPL used OSS margins at the 25th percentile as
19 projected in the analysis prepared and presented in the Direct Testimony of Company
20 witness Michael Schnitzer.

21 **Q: How did Staff treat OSS margins in this case?**

22 A: Their treatment was consistent with the order in ER-2006-0314 as well, setting OSS
23 margins at the 25th percentile.

1 Q: Did Staff make any recommendations regarding the tracking mechanism ordered in
2 ER-2006-0314 that requires KCPL to track its actual annual results, and account
3 for the Missouri jurisdictional amount exceeding the 25th percentile as a regulatory
4 liability to be reflected as a reduction to cost of service in KCPL's next rate case?

5 A: Yes, it did. Staff recommended the continuation of this tracking mechanism.

6 Q: Does KCPL object to such a tracking mechanism?

7 A: No, KCPL does not object to tracking Missouri jurisdictional OSS margins exceeding the
8 25th percentile as updated by Company witness Michael Schnitzer, and reflecting those
9 margins as a reduction to cost of service in KCPL's next rate case.

10 Q: Has any party in this case proposed a different treatment of OSS margins, contrary
11 to the Commission order in ER-2006-0314?

12 A: Yes, in the Direct Testimony of OPC witness Ted Robertson, Mr. Robertson recommends
13 OSS margins be set at the 40th percentile rather than the 25th percentile. He goes on to
14 recommend customers be paid interest on margins exceeding the 40th percentile.

15 Q: Have the conditions that prompted the Commission to establish a tracking
16 mechanism, and set OSS margins at the 25th percentile changed?

17 A: No, they have not. Mr. Robertson, at page 7 of his Direct Testimony, points out that the
18 language in the Report and Order in ER-2006-0314, "goes on to state that the
19 Commission authorized the 25th percentile baseline because it believed ratepayers, in the
20 short term, are not harmed due to the fact any sales over the baseline will be flowed back
21 to them and that the damage to KCPL, in the event it did not achieve the baseline, could
22 be more disastrous than any benefit the [sic] might accrue to ratepayers by authorizing a
23 higher baseline."

1 Q: **Are the Commission's concerns stated in the last rate case still valid?**

2 A: Yes, they are. As KCPL witness Michael Schnitzer described in his Direct Testimony,
3 there is significant risk associated with margins in the OSS market. The risk of the OSS
4 market consists of several components, including market price, volumetric risk associated
5 with generation variable cost, generation unit outages, coal supply availability, weather,
6 and uncertainty of retail sales growth. A detailed risk analysis of the OSS market has
7 been prepared by Mr. Schnitzer and is included in his Direct Testimony.

8 As discussed in the 2006 Rate Case, the significant construction program, which
9 KCPL is currently implementing in compliance with the Regulatory Plan, requires that
10 KCPL maintain sufficient cash flow to maintain its credit ratings. If, because of a change
11 in the OSS market, KCPL's actual OSS margins for 2007 were less than what is built into
12 the revenue requirement, then the Company's cash flow and credit metrics would be
13 negatively affected resulting in higher costs for the construction program and ultimately
14 for customers. Significant changes have occurred in the OSS market since the Company
15 filed the 2006 Rate Case. These changes in the market confirm that the Company's cash
16 flow requirements in 2007 are at risk, and highlight the risk of including the 40th
17 percentile of projected OSS margins in the revenue requirement determination.

18 Q: **Please describe the changes in the market since the 2006 Rate Case process?**

19 A: When KCPL filed its original 2006 application, natural gas prices and the wholesale
20 energy market were at a relatively high level. Natural gas prices were around \$10 per
21 mcf, considerably higher than the \$2-\$5 range during years prior to that case. In the 2006
22 Rate Case, I testified that the Commission should look forward and take into account the
23 risk of the OSS market in determining the amount of OSS margin to include in KCPL's

1 revenue requirement. I noted that historical data should not be used as indicative of
2 potential future margins in this volatile market. By September 2006, natural gas prices
3 had sharply declined. This resulted in a much lower expectation of OSS margins for
4 2007.

5 **Q: What is the current expectation for off-system sales margins for 2007?**

6 A: Prices in the market have continued to decline. The Company's current 50th percentile
7 projection for 2007 is ** [REDACTED] **, compared to the 25th percentile of ** [REDACTED]
8 [REDACTED] ** of one year ago. However, it will be a significant challenge to reach ** [REDACTED]
9 [REDACTED] ** or even ** [REDACTED] ** in 2007 given that total OSS margins for the seven
10 month period January through July 2007 were ** [REDACTED] **. Had the Commission set
11 the OSS margins at the 50th percentile of one year ago, ** [REDACTED] **, and the
12 Company actually achieves the current projection of ** [REDACTED] ** (50th percentile),
13 cash would be short by over ** [REDACTED] ** on a total Company basis.

14 **Q: By setting the projected OSS margin at the 25th percentile, do Missouri customers
15 still receive the benefit of all (100%) of the Missouri OSS?**

16 A: Yes, given the tracking mechanism, all Missouri OSS margins (100%) realized by the
17 Company will be credited back to Missouri customers in a future rate case.

18 **Q: Why is it so important to set OSS margins at the 25th percentile?**

19 A: Additional amortizations are impacted as well as cash flow. Setting margins at the 40th or
20 50th percentile provides the Company less chance to remain investment grade. As the
21 past year has proven, had the OSS been set at the 50th percentile, or the 40th percentile,
22 KCPL would be below investment grade today.

1 Q: Mr. Robertson, at page 11 of his Direct Testimony states, "...it is our belief that a
2 baseline net margin set at the 25th percentile is unreasonably low in light of the
3 extensive risk-sharing between ratepayers and shareholders that has already been
4 effectuated in the KCPL regulatory plan." What is this "extensive risk-sharing"
5 effectuated in the KCPL regulatory plan?

6 A: I presume Mr. Robertson is referring to the additional amortizations mechanism agreed to
7 in the regulatory plan Case No. EO-2005-0329.

8 Q: Does the provision for additional amortizations reduce risk of the OSS market?

9 A: No, it does not. It is important to recognize that the amount of additional amortizations is
10 dependent on the revenue received by the Company. OSS margins are a credit to revenue
11 requirement. Thus, setting the OSS margins equal to the 25th percentile helps to mitigate
12 the impact the risky OSS market has on determining the amount of additional
13 amortizations. As covered extensively in the Company's rate case one year ago, OSS
14 margins are not the same as retail revenue and should not be treated the same when
15 calculating the amortization amount.

16 Q: Mr. Robertson advocates interest payments on the amount of OSS margins returned
17 through the tracking mechanism established in the 2006 Rate Case. Do you agree
18 with this position?

19 A: No, I do not. If the Company paid interest on OSS margins in excess of the amount set
20 out to be tracked, then the same amount of interest expense would be included in the
21 Company's cost of service calculation, thereby increasing the revenue requirement.
22 Recovery of this interest expense in rates would exactly offset the amount paid out.

1 Customers would not benefit, nor would they be harmed. It would be as though no
2 interest was paid.

3 Additionally, the current tracking mechanism is not symmetrical. The Company
4 is at risk if it does not meet the level of OSS margins projected. The Company must bear
5 that risk, not the customers. Customers should not be entitled to interest payments when
6 the Company would not be kept whole should OSS margins fail to meet the projection.

7 **DSM RELATED COSTS**

8 **Q: Was the treatment of costs associated with DSM as rate base ever an issue in ER-**
9 **2006-0314, the Company's 2006 rate case?**

10 **A:** No, it was not. At the end of the case, Staff provided and the Company accepted, a final
11 reconciliation based on the Commission's order. This reconciliation indicated DSM costs
12 as rate base items, consistent with every prior reconciliation prepared in the case.

13 **Q: Is it an issue in the case?**

14 **A:** Yes, Staff has recommended construction accounting treatment of DSM costs rather than
15 rate base treatment. The return component would be based on KCPL's existing
16 Allowance for Funds During Construction ("AFUDC"), consistent with what is done for
17 capital projects until they go into service.

18 **Q: Why is this of concern to you?**

19 **A:** The Regulatory Plan provides rate base treatment of DSM. DSM is a cornerstone of
20 KCPL's Regulatory Plan developed with the input of many parties. I believe Staff's
21 recommendation as stated violates the Regulatory Plan agreed to and signed by the Staff.
22 If the Staff believes the return earned on these investments should be no greater than the
23 Company's AFUDC rate, then the AFUDC rate should be applied to the DSM costs.

1 Excluding DSM-related investments from earning a cash return is not consistent with the
2 Regulatory Plan.

3 **Q: Has Staff or the Commission addressed this issue for any other electric utility?**

4 A: Yes, it has. In Aquila's last rate case, Case No. EO-2007-0004, the Commission
5 determined the treatment of DSM program costs in its approval of the "Stipulation and
6 Agreement as to Certain Costs."

7 **Q: What was the approved treatment?**

8 A: Quoting from the agreement, page 7, numbered paragraph 11,

9 11. **Demand Side Management ("DSM") Program Costs.** The
10 Signatories agree that for ratemaking purposes Aquila will defer the costs
11 of DSM programs in Account 186 and calculate allowance for funds used
12 during construction (AFUDC) annually. DSM programs are defined as
13 demand response and energy efficiency programs. The prudently-incurred
14 costs included in the Account 186 balance will be amortized over a ten
15 (10) year period. When new rates go into effect reflecting amortization
16 recovery as a result of future general rate proceedings, the prudently-
17 incurred costs included in the Account 186 balance will be added to rate
18 base. Aquila will stop accruing AFUDC on the amount included in rate
19 base, and Aquila will begin amortizing the balance. Additional DSM
20 program costs incurred after the effective date of a final Report and Order
21 in the initial general rate proceeding following Case No ER-2007-004 will
22 be treated in the same manner, but will be deferred in a different sub-
23 account by vintage. (emphasis added)

24
25 **Q: Was Staff a signatory to the agreement?**

26 A: Yes, it was.

27 **Q: Did the Commission approve the agreement?**

28 A: Yes, it did.

29 **Q: Is there any reason why Staff or the Commission would consider DSM costs for one
30 utility as rate base costs, but deny the same treatment for another utility?**

31 A: There is no reason that I am aware of.

1 Q: In its Report and Order in the 2006 Rate Case did the Commission provide
2 guidance on the types of assets that rise to the level of rate base?

3 A: Yes, the Commission stated that the asset must entail probable future economic benefits
4 obtained or controlled by a particular entity as a result of past transactions or events.

5 Q: Do DSM related initiatives meet this definition?

6 A: Yes, they do. KCPL's investments in these initiatives will provide future economic
7 benefits for years to come. They have the potential to provide environmental benefits,
8 and delay construction of new generation. Rates paid by customers should be lower with
9 these cost-effective programs than without them.

10 Q: Does that conclude your testimony?

11 A: Yes, it does.

