BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Service to Implement its Regulatory Plan.	))))	Case No. ER-2007-0291

STAFF'S POST-HEARING BRIEF

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<u>STAFF'S POSTHEARING BRIEF</u>

On February 1, 2007, Kansas City Power & Light Company (KCPL) filed with the Commission tariff sheets designed to implement a general electric rate increase for service it provides to its Missouri customers in and about Kansas City, Missouri. The Commission suspended the effective date of the tariff sheets and opened Case No. ER-2007-0291 to address that filing.

On October 3, 2007, KCPL and the Staff of the Commission (Staff) filed a *Stipulation and Agreement as to Certain Issues*. No party objected to that agreement; however, the Commission has taken no action on it. The *Stipulation and Agreement as to Certain Issues* resolves a number of the issues in the case between KCPL and the Staff. Those issues were listed as Issues Nos. 8 (Cost of Removal Income Tax), 9 (Organization Membership Dues), 11 (Washington Employee Costs), 12 (KCPL Supplemental Executive Retirement Pension (SERP) costs), 13 (Meal Expenses), 16 (Research and Development Tax Credits), 17 (Bad Debt Expense), 18 (Wolf Creek Refueling Outage Costs), 19 (Rate Case Expense) and 20 (Surface Transportation Board Litigation Expenses) in the List of Issues section of the pleading titled, "*List of Issues, Order of Witnesses and Order of Cross-examination*," the Staff filed in this case on September 21, 2007.

On October 2, 2007, during the second day of the main evidentiary hearing in this case, KCPL represented that Issue no. 10 (Advertising Costs) was no longer a contested matter, and the Staff agreed. KCPL, as stated in its position statement on the issue filed September 25, 2007, agreed to the resolution of the issue as stated and proposed in the prefiled rebuttal testimony of KCPL witness Mr. Spielberger and the prefiled surrebuttal testimony of Staff witness Mr. Vesely, and the Staff agreed. (Vol. 6 Tr. 320-21; KCPL Statement of Positions, statement to

Issue No. 10, pp. 13-14; Vesely Surrebuttal, Ex. 115; Ex. 24, Spielberger Rebuttal). Therefore, that issue is not argued by the Staff in this brief.

While the Commission has not approved the *Stipulation and Agreement as to Certain Issues*, argument in this brief is limited to the contested issues not resolved by that agreement. The Staff has organized this brief to follow the listing of issues filed September 21, 2007, omitting both the listed advertising issue and the above listed issues addressed in the *Stipulation and Agreement as to Certain Issues*. The Staff believes that, from a cost of service perspective, the most significant contested issues remaining are those pertaining to KCPL's rate of return (Issues 1 & 2), Hawthorn 5 Subrogation Proceeds (Issue 3), Long-term Incentive Compensation (Issue 4), Short-term Executive Compensation (Issue 5) and Talent Assessment Program Severance Cost (Issue 6).

Further, there is no issue between KCPL and the Staff on Issue No. 24 (KCPL Experimental Regulatory Plan Additional Amortization); therefore, no argument is presented in this brief on that issue.

INTRODUCTION

From the perspective of the greatest impact on KCPL's revenue requirement without any additional amortization for credit metrics under the *KCPL Experimental Regulatory Plan* the Commission approved in Case No. EO-2005-0329, the Staff believes the most significant disputed issue is the appropriate return on common equity (Issue 1).

From that same perspective, the next most significant disputed issues are those which raise the question of whether the Commission should require the sharing of the financial benefits of the Hawthorn 5 subrogation payments (Issue 3) and the nuclear fuel overcharge refund (Issue 15) that KCPL received during the test year similarly to how it typically requires the sharing of the burden of extraordinary expenses booked under an accounting authority order (AAO) (such as KCPL's recent ice storm AAO), when it allows those expenses to be included in cost of service. When allowed by the Commission, extraordinary expenses are typically straight-line amortized over a period of years and the resulting annual amount is included in the utility's cost of service. Therefore, the overarching question these issues present is whether the Commission should treat these atypical financial benefits in the same way, by straight-line amortizing them to cost of service.

REVENUE REQUIREMENT

Rate of Return

1. Return on Common Equity: What return on common equity should be used for determining KCPL's rate of return?

    a. Is KCPL's decreased risk due to the Kansas City Power & Light Company Experimental Regulatory Plan the Commission approved in Case No. EO-2005-0329 a factor that reduces the return on common equity otherwise appropriate for KCPL?

    b. Is KCPL's increased risk due to its large construction undertakings a factor that increases the return on common equity otherwise appropriate for KCPL?

    c. If so, what is the impact of these factors?

The primary issue driving this case is the financing of the construction of Iatan II. As the Commission is well-aware, last year KCPL pursued its first rate case in some twenty years. KCPL did so only because it had no choice. Desiring to build a new baseload coal plant – Iatan II – KCPL obtained from the Commission the approval of an Experimental Regulatory Plan[1] calling for a series of four annual rate cases.[2] Tr. 6:341. Last year, in the first of those cases, this

[1] Case No. EO-2005-0329.
[2] The middle two of which are optional.

Commission gave KCPL the highest return on common equity in the nation. Appropriately, that award was announced in the Christmas season. Today, KCPL is asking that the Commission set its return on common equity at the same level as last year, 11.25 percent. Coincidentally, an award at that level will again be the highest return on equity ("ROE") award yet reported for 2007.[3]

Staff suggests that the goal of the regulatory plan can be met with a lower ROE award.

The Commission's Duty:

The Commission's duty with respect to ROE is to award a "fair and reasonable" return to investors on the value of the utility property committed to the public service. *St. ex rel. Missouri Public Service Co. v. Fraas,* 627 S.W.2d 882, 886 (Mo. App., W.D. 1981). Too little is an unconstitutional taking; *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 690, 43 S.Ct. 675, 678, 67 L.Ed. 1176, 1181 (1923), too much is an unconscionable windfall. The right amount – the "just and reasonable" amount -- is a return "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[.]" *Id.,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183. The right amount is one that is fair to both the utility's investors and the utility's customers. *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n.,*515 S.W.2d 845 (Mo. App., K.C.D. 1974).

What is Return on Equity?

Utility rates are designed to produce a certain amount of revenue on an annual basis, the "revenue requirement." *In the Matter of The Empire District Electric Company,* 13 MoPSC3d 350, 368-69 (*Report & Order,* March 10, 2005) ("*Empire*"). This revenue requirement has three

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[3] Eighteen awards have been reported for the first two quarters of 2007. *Ex. 121.* The mean is 10.27%; the extremes are 9.67% and 10.90%. *Id.* Note that all 18 awards fall within the Commission's Zone of Reasonableness, which extends from 9.27% to 11.27%. Tr. 6:237.

components: First, an amount equal to the utility's prudently-incurred operating and maintenance expenses on a going-forward basis. Second, an amount sufficient to pay the utility's annual tax obligations. Third, an amount sufficient to service the capital used by the utility. Part of that capital is debt and debt, as we are all well-aware, is serviced by making regular payments to creditors. The other part of that capital is equity. Equity is serviced by paying dividends to the equity investors. It is this very last part of the revenue requirement that is the ROE, another word for which is "profit." After all, all of the rest of the utility's annual revenue will be spent on operating expenses, taxes and debt payments. Only the fraction that is left after these obligations are met will flow to the utility's owners as a return on their investment.

Calculating the Cost of Capital:

The determination of ROE is a difficult task, as academic commentators and reviewing courts have noted, and is inevitably a matter of dueling expert witnesses. As this Commission recently put it, "Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return." *In the Matter of AmerenUE,* Case No. ER-2007-0002 (*Report & Order,* issued May 22, 2007) at p. 36 ("*AmerenUE*"). The Commission went on to say:

> [T]he Commission cannot simply find a rate of return on equity 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 AmerenUE's ratepayers.

AmerenUE, at p. 37.

Capital consists of debt and equity; and equity is subordinate to debt because the equity investors do not get paid unless and until the debt investors – a/k/a creditors -- have been paid. Therefore, equity is necessarily more risky than debt. As all of the experts that testified in this case have explained, the greater the risk associated with an investment, the greater the potential return that is required to attract investors. Because equity is more risky than debt, it follows that the return on equity must be greater than the return on debt. Put another way, the cost of a utility's debt is an absolute floor for the cost of equity, because equity necessarily costs more than debt. The embedded cost of KCPL's debt is 5.93 percent. *Barnes, True-up Direct, Sch. 1 and 3; Cline, True-up Direct, p. 1.*

Fortunately, the Commission can find additional guidance in the process of determining KCPL's ROE in two decisions of the United States Supreme Court. In the earlier of these cases, *Bluefield Water Works & Improvement Co, supra,* the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public 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; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Bluefield, supra, 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-83. Similarly, in the later of the two cases, *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943), the Court stated:

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns

> on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Hope Natural Gas, supra, 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

From these two decisions, three guiding principles are derived:[4]

(1) An adequate return is commensurate to the returns realized from other businesses with similar risks;

(2) An adequate return is sufficient to maintain the utility's credit and to enable it to obtain necessary capital; and

(3) An adequate return is sufficient to assure confidence in the financial integrity of the utility.

The first of these principles unmistakably requires a comparative process; it is only by comparison that a "commensurate return" may be determined. Comparison to what? To other businesses that face similar risks as the regulated electric utility under consideration; that is, comparison to other regulated electric utilities. The cost of common equity set by the Commission, therefore, must be about as much as other, similar utilities are earning. The word "similar" here refers to "corresponding risks." The second principle, simply stated, refers to the effect of the Commission's decision on the utility's credit rating. If the Commission's decision will not cause it to drop, then the utility's credit is maintained and its ability to attract capital is unimpaired. The third principle is a function of the other two: if the utility is earning about as much as other, similar utilities and its credit rating isn't damaged, then one may presume that confidence in its financial integrity is undiminished.[5]

All businesses use a mixture of debt capital and equity capital; the particular percentage

[4] *See* Ex. 201 (Gorman Direct) at 8-9.
[5] The third principle may well have more application in the case of a troubled utility. KCPL is not a troubled utility.

of each type for any given business is referred to as its "capital structure." *See Empire,* at 369-70. KCPL's capital structure includes 41% debt and 58% equity.[6] *Barnes, True-up Direct: Sch. 1.* The cost of debt capital can be readily determined from the instruments in question. These costs are thus historical or "embedded." The cost of equity capital or ROE, on the other hand, cannot be so easily determined. Instead, it is a matter of expert opinion.

Staff's expert, Matt Barnes, has suggested a range from 9.14 percent to 10.3 percent, with a midpoint of 9.72 percent. Ex. 105 (Barnes Direct) at p. 20. His recommendation is the lowest recommended common equity figure offered in this case. Michael Gorman, testifying for the Public Counsel, was higher at 9.50 percent to 10.70 percent, midpoint 10.10 percent. Ex. 201 (Gorman Direct) at 30. Dr. Samuel Hadaway, testifying for KCPL, proposed an ROE of 11.25 percent, the same figure that this Commission awarded to KCPL in its previous rate case last year.[7] Ex. 11 (Hadaway Direct) at 39.

ROE Recommendations	
Analyst	**ROE**
Hadaway (KCPL)	11.25
Gorman (OPC)	10.10
Barnes (Staff)	9.72
Exhibits 11, 105 and 201.	

The Commission has the onerous task of finding its way through the "thicket of conflicting opinions" of the various expert witnesses who have testified in this case. *AmerenUE,* at p. 39; *and see Empire* at 370 and 372. The chart above sets out the several ROE recommendations offered in this case by the three different experts. The several recommendations extend from a low of 9.72 percent to a high of 11.25 percent; a range of 153

[6] *Barnes, True-up Direct: Sch. 1 & 2; Cline, True-up Direct.*
[7] Dr. Hadaway strenuously asserted that this result was coincidental. Tr. 6:250-251.

basis points, worth some \$ 129,800 each.[8] The entire range, therefore, is worth \$19,859,400 (153 x \$129,800).[9]

Each of the three experts is eminently qualified in this field. They have used similar data and similar methods. Matt Barnes applied a traditional, constant-growth Discounted Cash Flow ("DCF") model as his primary analytical tool to a group of sixteen comparable electric utilities. Ex. 105 (Barnes Direct), p. 14 ff.; Tr. 6:307. Barnes used two versions of the Capital Asset Pricing Model ("CAPM") and a company-specific DCF as checks on the reasonableness of the results of his principal analytical tool. Ex. 105 (Barnes Direct), 19 ff. Michael Gorman averaged the results obtained by applying a constant growth DCF, a two stage DCF, a CAPM, and a Risk Premium analysis to two comparable groups: Hadaway's group of twenty-four companies and his own group of seventeen. Ex. 201 (Gorman Direct) at 9 ff. Dr. Hadaway used three different DCF models, checked with three Risk Premium models, applied to his group of twenty-six proxy companies. Ex. 11 (Hadaway Direct), 32 ff.; Tr. 6:307. Predictably, Dr. Hadaway -- the Company's expert -- offered the highest ROE recommendation, which, at 11.25 percent, is fully 115 basis points higher than the next highest recommendation at 10.10 percent.[10] The other experts' recommendations are lower, ranging from 9.72 percent to 10.10 percent, a range of only 38 basis points, and are clustered closely together in comparison to Hadaway's outlying recommendation of 11.25 percent.

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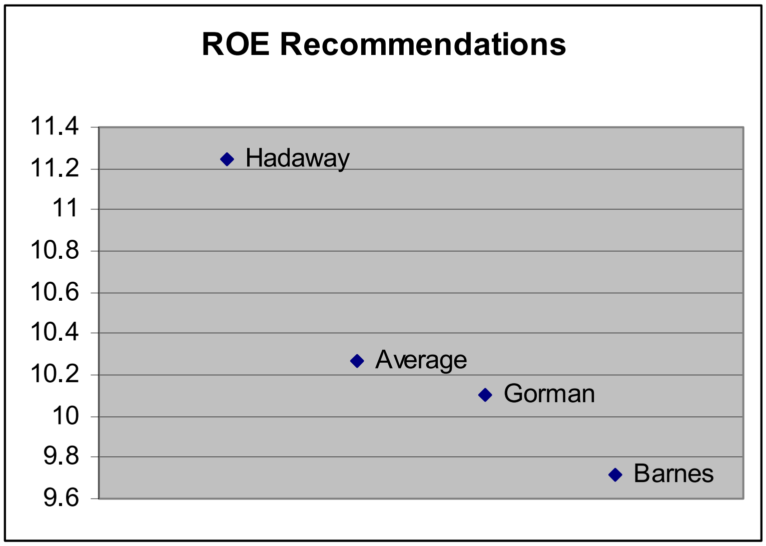
[8] KCPL's net original cost rate base is approximately \$1,298 million dollars, which, when multiplied by one basis point – one hundredth of a percentage point, 0.0001 – yields \$129,800 dollars. *See Staff Accounting Schedules, Sch. 1*.

[9] In other words, if the Commission selects Dr. Hadaway's recommendation rather than Matt Barnes', the ratepayers will be required to provide \$20 million more to KCPL on an annual basis.

[10] 115 basis points are worth \$ 14,927,000.



It is noteworthy that these experts have reached such widely differing conclusions, although their training, data and methods are much the same. However, as the Commission has pointed out, "it is not the method employed, but the result reached, that is important." *See Empire* at 372 n. 52.

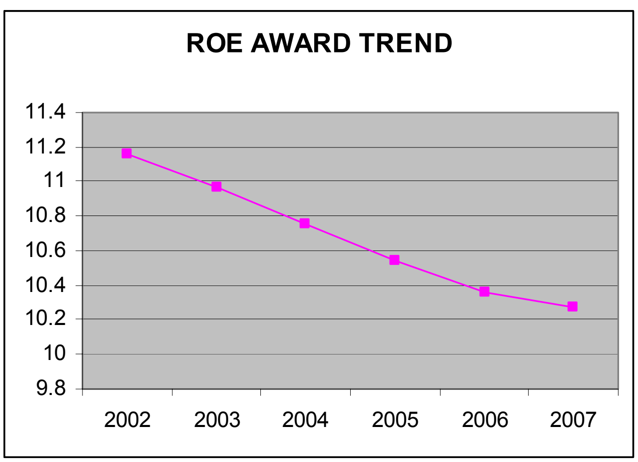
The Zone of Reasonableness:

The Commission has devised an objective, analytical tool to assist it in parsing the recommendations of the experts and reaching a fair and reasonable result, the so-called "Zone of Reasonableness." The Zone of Reasonableness is defined as extending one hundred basis points – one percentage point – above and one hundred basis points below the recent national average of ROE awards in the appropriate regulated industry. *See Empire* at 375; *In the Matter of Missouri Gas Energy,* 12 MoPSC3d 581, 593 (*Report & Order,* September 21, 2004); *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Report & Order,* issued December 21, 2005); *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314 (*Report & Order,* issued December 21, 2006). The national average ROE award for electric utilities for the first two quarters this year was 10.27 percent,[11] so the Zone of Reasonableness extends from 9.27 percent to 11.27 percent.

The Zone of Reasonableness analysis is a type of benchmarking analysis. The recommendations of the experts are compared to the average of the ROEs awarded by other commissions during a recent period of time. However, benchmarking is not especially helpful in the present case because all three recommendations are within the Zone of Reasonableness.

ROE AWARDS, 2002-2007						
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
1st Q	10.87	11.47	11.00	10.51	10.38	10.27
2nd Q	11.41	11.16	10.54	10.05	10.69	10.27
3rd Q	11.06	9.95	10.33	10.84	10.06	--
4th Q	11.20	11.09	10.91	10.75	10.39	--
Full Year	**11.16**	**10.97**	**10.75**	**10.54**	**10.36**	**10.27**
Hadaway Direct, p. 31 & Rebuttal, p. 5.						

However, while the Zone of Reasonableness is not helpful in this case in identifying



unreasonable recommendations, it is helpful to array the annual average of electric industry ROE awards for 2002 to 2007 on a chart in order to highlight an undeniable downward trend. As the chart above shows, average ROEs have trended downward precipitously and there is no evidence

[11] Ex. 121.

that this trend has yet hit bottom. The Commission should keep this trend in mind as it considers KCPL's request for an ROE of 11.25 percent, same as last year.

"Adders," "Subtracters" and the Concept of Similar Risk:

As he did in last year's KCPL rate case, Dr. Hadaway proposed an upward adjustment of 50 basis points to KCPL's ROE to reflect the Company's unusual construction risk, a risk which Dr. Hadaway admitted was already addressed by the regulatory plan mechanism of additional amortizations. Tr. 6:271-272. Moreover, it is frankly difficult to take Dr. Hadaway's adder seriously[12] since he admitted that he did not arrive at the figure of 50 basis points using any recognized analytical tool:

> MR. THOMPSON: I want to follow up on the question that Commissioner Jarrett asked you about the adder. What I want to know is how did you come up with the 50 basis points? I mean, why not 32 or 81? How come 50?
>
> DR. HADAWAY: I think the standard RTO FERC adder, a minimum of 50 basis points was probably the thing that stuck in my mind more than anything from my review. Nothing more elaborate than that.

Tr. 6:266. The ratepayers are doubtless relieved that it was not the current population of China that happened to stick in the good doctor's mind.

This game of finding reasons to add an upward adjustment to the results of the comparative company analysis is one that the Commission has seen repeatedly. Dr. Hadaway testified that adders "are becoming more common." Tr. 6:268. He also noted that "subtracters" or "deflators" are sometimes recommended. Tr. 6:270. In the previous KCPL rate case, upward adjustments were urged to reflect (1) unusual construction risk (50 basis points – Dr. Hadaway), (2) off-system sales risk (526.35 basis points), and (3) just plain management excellence (50 to 100 basis points). *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314

[12] The adder is worth $6,490,000 (50 x $129,800) which is a serious matter indeed for the ratepayers who are expected to come up with the money.

(*Staff's Post-hearing Reply Brief and True-up Brief,* Docket Item No. 520, filed November 27, 2006), pp. 44-46. Likewise, in last year's Empire District Electric Company rate case, Empire's witness proposed an "adder" of 40 basis points to account "for the difference in the perceived financial risk of [the] proxy companies in the marketplace and the financial risk implied by [his] recommended capital structure for Empire." *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Pre-hearing Brief of Staff of Public Service Commission,* Docket Item No. 191, filed September 6, 2006), p. 37 (*quoting* Vander Weide's Direct Testimony filed in that case, pp. 4 and 6). The same witness later proposed an "adder" for AmerenUE based on the same consideration, *AmerenUE* at 40; AmerenUE's second expert also proposed an adder. The Commission, however, was not fooled:

> In addition to the obvious incongruity of a large risk adjustment for a company with an average level of risk, the opposing experts convincingly explained that the proposed upward adjustment for financial risk was inappropriate for more technical reasons as well. In particular, the Commission accepts as credible the testimony of MIEC's witness, Michael Gorman, who explains that AmerenUE's proposed adjustment for financial risk is an incomplete assessment of AmerenUE's overall risk because it ignores the difference in operating risk between AmerenUE and comparable companies,69 because it does not properly evaluate the financial risk differential between the proxy groups and AmerenUE, and because it fails to recognize that a company's book value financial risk is already captured in a company's stock price.
>
> In sum, the financial risk upward adjustment proposed by AmerenUE's witnesses appears to be a transparent effort to inflate the company's proposed return on equity to obtain a better bargaining position in the hope the Commission would simply split the difference between the extreme positions. Such efforts call into question the credibility of these witnesses. Indeed, Vander Weide came close to acknowledging that his proposed return on equity was extreme when at the hearing he indicated an eleven percent return on equity, in line with the amounts that the Commission has allowed Kansas City Power & Light and The Empire District Electric Company in recent rate cases, "would be a benchmark that the financial community would look at."

AmerenUE at 40-41.

The Commission was right to reject these dubious adders. The concept of risk is particularly subject to manipulation by analysts. First, all of the classic financial analysis methodologies take the risk of the investment into account; thus, no "adder" or "subtracter" is necessary. The proxy groups, for example, if properly constructed, consist of companies subject to corresponding risks.[13] Second, the use of an adder is an egregious violation of the comparative company ROE analysis required by the United States Supreme Court in *Hope* and *Bluefield.* It is important to remember that those cases were written to explain why utility investors could not expect bloated and exorbitant returns. The use of an "adder" to evade the results of the required comparative analysis is contrary to both the letter and the spirit of the controlling cases and may expose the Commission's decision to a heightened risk of reversal on appeal. Third, Hadaway's adder is not supported by the record, Ex. 106 (Barnes Rebuttal) at 4, takes no account of the regulatory plan amortizations, *id.,* and frankly appears to have been proposed merely to inflate KCPL's ROE. OPC witness Gorman testified:

> Dr. Hadway's proposed 50 basis point return on equity add-on is unreasonable for KCPL in this proceeding for several reasons. First, KCPL is not unique in that it is involved in a major construction program. Indeed, most utilities in the electric industry today are involved in major construction programs, and the companies in the proxy group used to estimate KCPL's return on equity are also involved in major construction activity. Second, KCPL has a regulatory plan to help support and mitigate the risk of its major construction program . KCPL currently has over $21 million of additional amortization expense to provide stronger cash flows to support its credit metrics during construction, and the Company has proposed to increase that amortization expense by over $17 million in this proceeding. This regulatory plan amortization expense significantly strengthens KCPL's cash flow during construction which mitigates its construction risk at significant cost to retail ratepayers. It is unreasonable for

[13] Ex. 202 (Gorman Rebuttal HC) at 8: "A rational investor will assess KCPL's risk based on its total investment risk, not on only limited components of total risk as suggested by Dr. Hadaway. Hence, selecting companies with similar total investment risk to KCPL can then be used to estimate a fair rate of return to compensate investors for KCPL's total investment risk. Importantly, in my direct testimony, I demonstrated that both my proposed proxy group and Dr. Hadaway's proposed proxy group reasonably approximate KCPL's total investment risk. KCPL's construction risk is part of its total investment risk. Therefore, no return on equity adder is needed to fairly compensate KCPL for its total investment risk."

> Dr. Hadaway to ask for additional compensation on top of this significant ratepayer funded risk mitigation provided to KCPL to support its construction program.
>
> KCPL's regulatory plan also mitigates construction and regulatory risks by commission review and approval of construction cost budgets and rate treatment after the asset is placed in-service.
>
> Finally, the risks Dr. Hadaway identifies for KCPL are only components of KCPL's total investment risk. It is the total risk that determines KCPL's cost of capital not the limited components of investment risk that Dr. Hadaway is focused on.

Ex. 202 (Gorman Rebuttal HC) at 5-6.

In summary, OPC witness Gorman characterized Dr. Hadaway's recommendation thus: "Dr. Hadaway's proposed return on common equity recommendation is inflated because he compensates KCPL for risk that it shares with customers." Ex. 203 (Gorman Surrebuttal) at 4.

Final Analysis:

With Dr. Hadaway's adder stripped away, the recommendations of the experts are as follows:

Adjusted ROE Recommendations	
Analyst	**ROE**
Hadaway (KCPL)	10.75
Gorman (OPC)	10.10
Barnes (Staff)	9.72
Exhibits 11, 105 and 201.	

The range between Matt Barnes' recommendation of 9.72 percent and Dr. Hadaway's adjusted recommendation of 10.75 percent is now only 103 basis points, worth some $13,369,400. The three recommendations cluster evenly around the national average of 10.27 percent; Dr. Hadaway's recommendation is 48 basis points above the average and Matt Barnes' is 55 basis points below. The average of the three recommendations is 10.19 percent, a figure that falls between Mr. Gorman's recommendation of 10.10 percent and the national average of

10.27 percent.

Conclusion:

KCPL is in the position of a homeowner who wants to make a significant home improvement and now faces the problem of financing. This Commission has already given KCPL the equivalent of a home equity line of credit by permitting KCPL to accelerate the depreciation of its plant in service in order to provide cash flow to keep its credit metrics high. But KCPL is not content with that home equity line of credit. Instead, KCPL seeks a windfall in the form of the highest ROE in the land, fully 35 basis points higher at 11.25 than the next highest ROE of 10.90. KCPL wants to do its home improvement with free money; it doesn't want to see its rate base and, thus, its profits reduced for the future by taking accelerated depreciation now. Instead, KCPL wants money with no strings and no obligations from its customers – it wants its customers to keep its credit metrics high by paying higher rates.

For these reasons, Staff urges the Commission to adopt an ROE within the range determined by the recommendations of the non-Company expert witnesses, 9.72 percent to 10.10 percent. Ideally, the Commission should adopt the recommendation of Staff's expert witness, Matt Barnes. Staff's recommended ROE, 9.72 percent, is demonstrably sufficient, with the regulatory plan amortizations, to maintain KCPL's credit rating, maintain continued confidence in its financial integrity, provide a commensurate return to equity investors, and support the construction of Iatan II.

2. <u>Capital Structure</u>: What capital structure should be used for determining KCPL's rate of return?

   Great Plains Energy capital structure as of March 31, 2007, which had a consolidated capital structure that consisted of 66.01 percent common equity, 1.67 percent preferred stock, and 32.32 percent long-term debt. Staff's capital structure for KCPL was based on March 31, 2007, actual known and measurable data that did not include consolidated group's debt issuances in May and September. Staff noted in Direct Testimony that it would update the capital structure through September 30, 2007, once data is known and measurable. Staff has not traditionally used projected data to determine the rate-of-return for a company. Staff will update the capital structure in True-up Direct that is to be filed November 2, 2007.

Staff and KCPL have, in their true-up filings, proposed identical capital structures and embedded costs of debt and preferred stock as set out below:

Capital Structure as of September 30, 2007 Great Plains Energy				
Capital Component	**Dollar Amount**	**Percentage of Capital**	**Embedded Cost**	**Weighted Cost**
Debt	1,103,699,000	40.93%	5.93%	2.43%
Preferred Stock	39,000,000	1.45%	4.29%	0.06%
Common Equity	1,553,527,000	57.62%	--	--
Total Capitalization	$ **2,696,226,000**	**100.00%**		
Barnes, True-up Direct: Sch. 1 & 3; Cline, True-up Direct, p.1.				

Consequently, this is no longer a contested issue that the Commission must resolve.

EXPENSE ISSUES

3. Hawthorn 5 Subrogation Proceeds: Should subrogation proceeds KCPL received in 2006 concerning the 1999 Hawthorn 5 boiler explosion litigation be included in cost of service for setting KCPL's rates?

Summary: The $23.1 million (total company) of Hawthorn 5 boiler explosion insurance subrogation proceeds KCPL received in 2006, the ordered test year, should be treated in the same way as extraordinary expense items that the Commission allows to be included in cost of service under accounting authority orders. These proceeds represent reimbursed expenses that KCPL's ratepayers already paid. After the Hawthorn 5 explosion KCPL's customers continued to pay a financial return on the destroyed plant as well as depreciation and property taxes, but did not get any benefit from these payments, as the plant was not providing electric service. In addition, strong evidence exists that KCPL was earning a reasonable rate of return during the period Hawthorn 5 was out of service. KCPL could have sought a rate increase to cover any increase in cost or, at a minimum, filed for an accounting authority order to defer any material increased costs. That KCPL did not seek rate relief strongly suggests it was earning a satisfactory rate of return and all expenses were being recovered in existing rates. Therefore, the $23.1

> million should be straight-line amortized over five years ($4.6 million total company per year) and the amount of $2.5 million (Missouri jurisdictional) should be included in KCPL's cost of service for purposes of setting rates in this case.

Allowing the financial benefit of these proceeds to be shared among KCPL's shareholders and customers is the most appropriate way to treat this issue in this case. KCPL received the monies from the Hawthorn 5 subrogation payments in the test year in this case. This makes these dollars an issue that has to be addressed to determine KCPL's revenue requirement in this case. Because the event giving arise to this revenue shares many of the same characteristics as an extraordinary cost (*e.g*. KCPL's 2001 ice storm costs), such being unusual and infrequent, the Staff believes that the rate treatment should be similar to the treatment given to extraordinary expense items that the Commission allows to be included in cost of service under accounting authority orders. These proceeds should be amortized as a reduction to expense over five years with no rate base treatment. Not including these dollars in rate base allows KCPL's shareholders to have the cost-free use of these funds until they are fully amortized. The amortization, as a reduction to expense, lowers KCPL's cost of service, thus benefiting KCPL's customer.

This issue involves but one of a number of potential adjustments that fall into the pattern of KCPL taking positions on the ratemaking treatment of these adjustments most favorable to KCPL. Where the atypical (extraordinary, or not a normal or recurring revenue or expense incurred in providing utility service) revenue or expense would increase KCPL's revenue requirement, KCPL takes the position the revenue or expense should be amortized and included in rate base, but, where the revenue or expense would decrease KCPL's revenue requirement, KCPL takes the position that making the adjustment would be retroactive ratemaking. (Ex. 9, KCPL witness Giles Rebuttal p. 2-4; KCPL witness Giles Vol. 5, Tr. 92-93, 117; Ex. 109, Staff witness Hyneman Surrebuttal pp. 2-4; Ex. 803, DOE witness Dittmer Surrebuttal pp. 4-5). The other remaining potential adjustment that remains a contested issue and falls into this pattern is Issue No. 15 (Department of Energy Nuclear Fuel Overcharge Refund), which is addressed later in this brief.

Staff witness Hyneman presented in his surrebuttal testimony a chart demonstrating KCPL's disparate treatment to KCPL's advantage of potential adjustments of this nature in this case and its last rate case, Case No. ER-2006-0314. The chart also contrasts KCPL's treatment to the Staff's consistent approach. A reproduction of that chart follows:

	RR Impact	Rate Base	Amortization	No Ratemaking
KCPL Positions Taken				
January 2002 Ice Storm AAO	Increase	X	X	
Deferred Costs LED-LDI project	Increase	X	X	
Deferred Costs CORPDP-KCPL project	Increase	X	X	
STB Litigation Costs	Increase	X	X	
Hawthorn V Litigation Proceeds	Decrease			X
Nuclear Fuel Overcharges	Decrease			X
Staff Positions Taken				
January 2002 Ice Storm AAO	Increase		X	
Deferred Costs LED-LDI project	Increase		X	
Deferred Costs CORPDP-KCPL project	Increase		X	
STB Litigation Costs	Increase		X	
Hawthorn V Litigation Proceeds	Decrease		X	
Nuclear Fuel Overcharges	Decrease		X	

(Ex. 109, Staff witness Hyneman Surrebuttal p. 3).

Further, in response to KCPL's argument about excluding items that occur outside the test year, Mr. Hyneman pointed out that the January 2002 ice storm did not occur during a rate case test year, yet KCPL sought, and received, recovery in rates of a portion of its January 2002 ice storm costs through its rates that became effective January 1, 2007, in KCPL's last rate case, Case No. ER-2006-0314. By KCPL seeking rate recovery in its last rate case of the ice storm expense that did not occur in a test year, KCPL's position in this case that a revenue caused by an event that occurred outside of a test year should not be considered for rate treatment in a rate case reflects a ratemaking bias by KCPL in its disparate treatment of similar events. As shown above, KCPL's approach to rate treatment depends on how the issue affects its shareholders. In deciding this issue and related issues in this case, the Commission should strongly consider this KCPL bias.

In 1999 the boiler of unit 5 at KCPL's Hawthorn electricity generating station exploded. (Ex. 108, Staff witness Hyneman Direct p. 3-4; Ex. 802, DOE witness Dittmer Direct p. 13; KCPL witness Giles Vol. 5 Tr. 98-99) The cost of KCPL's unit 5 was part of the cost of the Hawthorn electricity generating station included the rate base used to set KCPL's electric rates in effect when the boiler exploded and after. (KCPL witness Giles Vol. 5 Tr. 93). Those rates paid by KCPL's Missouri customers were designed for KCPL to recover, with regard to the Hawthorn unit 5, both depreciation and a return on KCPL's investment. (Ex. 109, Staff witness Hyneman Surrebuttal pp. 6-8 and 11). This point was affirmed by KCPL witness Giles on cross-examination. (Vol. 5 Tr. 167).

Those rates remained in effect until January 1, 2007, when the Commission approved KCPL's compliance tariffs in Case No. ER-2006-0314, and KCPL charged its customers those rates, even when Hawthorn unit 5 was out of service due to the explosion. (Ex. 109, Staff witness Hyneman Surrebuttal pp. 6-7; Ex. 9, KCPL witness Giles Rebuttal pp. 3 and 5). Although the boiler explosion was a nonrecurring atypical, even extraordinary, event, KCPL neither sought from this Commission an accounting authority order nor filed with this Commission a rate case based on a test year that included the expenses KCPL incurred due to the boiler explosion. (Ex. 109, Staff witness Hyneman Surrebuttal p. 7; Ex. 9, KCPL witness Giles Rebuttal pp. 3 and 5). However, KCPL did pursue litigation for recovery of those expenses. (Ex. 108, Staff witness Hyneman Direct p. 4; Ex. 9, KCPL witness Giles Rebuttal p. 2; Ex. 802, DOE witness Dittmer Direct pp. 13-14).

During calendar year 2006, the test year in this case, KCPL received $23.1 million in insurance subrogation proceeds from that litigation. (Ex. 108, Staff witness Hyneman Direct p. 4; Ex. 109, Staff witness Hyneman Surrebuttal pp. 5-6; Ex. 9, KCPL witness Giles Rebuttal p. 2). Because KCPL already recovered its Hawthorn unit 5 expenses due the 1999 boiler explosion through the rate revenues it collected from its Missouri customers at the same time it incurred those expenses, KCPL would reap a windfall it were to retain all of the benefits of the subrogation proceeds.

Staff does not argue that if a utility such as KCPL incurs an expense for something that benefits its customers and that expense is extraordinary or nonrecurring, the utility should not be allowed to recover all or a part of that expense. In fact, the Staff has included such unusual and nonrecurring expenses in KCPL's cost of service in this case. For example, the Staff has included KCPL's Surface Transportation Board litigation expenses in KCPL's cost of service in this case. (Ex. 109, Staff witness Hyneman Surrebuttal pp. 24-25).

It is the Staff's position that, likewise, when a utility recovers from a third party for expenses it incurred to provide service to the utility's customers, but the utility already recovered for those expenses in the rates it charged its customers, the utility's customers should share in the benefit of the recovery. Rather than applying the recovery as a direct offset to expenses in determining cost of service, the Staff proposes the amount recovered be straight-line amortized over a period of years and the annual amount be included in the utility's cost of service. In this case the Staff proposes a five-year amortization period. (Ex. 108, Staff witness Hyneman Direct pp. 4-5; Ex. 109, Staff witness Hyneman Surrebuttal pp. 4-5). Likewise, DOE proposes a five-year amortization period and that the annual amount be included in KCPL's cost of service. (Ex. 802, DOE witness Dittmer Direct p. 14)

Therefore, in this case the Staff proposes the $23.1 million (total company) of Hawthorn 5 boiler explosion insurance subrogation proceeds KCPL received in 2006 be straight-line amortized over five years ($4.6 million total company per year) and the amount of $2.5 million (Missouri jurisdictional) be included in KCPL's cost of service for purposes of setting rates in this case.

4. Executive Long-term Incentive Compensation: Should the costs of KCPL's and GPE's long-term incentive compensation plans be included in cost of service for setting KCPL's rates?

Summary: GPE's and KCPL's Executive Long-term Incentive Compensation Plan provides stock based compensation driven primarily by earnings per share (EPS) and return on total capital. Achievement of these goals benefits the shareholders of GPE, not ratepayers. Equity compensation does not require a cash outlay by KCPL, but KCPL is seeking a cash recovery in rates from ratepayers. The cost of Executive Long-term Incentive Compensation should be assigned to GPE's shareholders. The Staff position is consistent with its position on this issue in KCPL's last rate case, Case No. ER-2006-0314, and the Commission's *Report and Order* on this issue in Case No. ER-2006-0314.

Long-term incentive compensation provided to the executive management of GPE and KCPL is in the form of three types of equity compensation in GPE stock:

(1) Restricted Stock is stock which must be held for a specified period of time before it can be sold

(2) Performance Shares is stock awarded based upon the achievement of goals which are entirely or primarily the achievement of EPS and return on total capital

(3) Stock Options provide the potential opportunity to buy GPE stock at a discount

(Ex. 112, Traxler Direct, p. 30, l. 20 – p. 31, l. 4). KCPL's 2006 test year reflects recognition of $2,433,537 (total Company) in long-term incentive compensation as an expense for which KCPL is seeking $2,433,537 in cash recovery from ratepayers for an expense that will never recover a cash outlay by KCPL. The shares of stock issued to GPE and KCPL executive management will earn a return based on the return on equity collected from ratepayers in rates. (*Id*. at p. 31, l. 5 –

p. 32, l. 7). The rationale and prior Commission decisions addressed above in the subsection on Executive Short-term Incentive Compensation are equally applicable to and support for the Staff's position that there should be no ratemaking recovery from KCPL's ratepayers of Executive Short-term Incentive Compensation primarily tied to earnings per share (EPS) and return on total capital.

The Staff's Reconcilement/Reconciliation filed on November 5, 2007 shows the Missouri jurisdictional revenue requirement value of the Executive Long-term Incentive Compensation issue to be $1,314,185.

> 5. Executive Short-term Incentive Compensation: Should part of the costs of KCPL's and GPE's short-term executive compensation plans be excluded from cost of service for setting KCPL's rates?

> **Summary:** Fifty percent of GPE's and KCPL's Executive Short-term Incentive Compensation is based on goals tied to earnings per share (EPS) for GPE. The shareholders of GPE, not KCPL's ratepayers are the beneficiaries of achieving goals tied to EPS. The Staff has eliminated from its determination of KCPL's revenue requirement the cost of the GPE and KCPL Executive Short-term Incentive Compensation Plans related to achievement of the EPS goals. Twenty percent of GPE's and KCPL's Executive Short-term Incentive Compensation represents discretionary bonuses. The Staff has disallowed recovery of this portion because it is not tied to achievement of any well-defined goals which would demonstrate a benefit to KCPL's ratepayers. The Staff position is consistent with its position on this issue in KCPL's last rate case, Case No. ER-2006-0314, and the Commission's *Report and Order* on this issue in Case No. ER-2006-0314.

Mr. Traxler explained in his surrebuttal testimony that the issue is not whether earnings per share (EPS) and return on total capital should be goals in the GPE and KCPL Executive Incentive Compensation Plans. The Staff is not recommending that GPE and KCPL restructure their incentive compensation plans to eliminate goals related to achievement of financial goals. Rather the issue is the proper assignment of costs of the program to those who benefit from the achievement of the goals of the program, shareholders rather than ratepayers. (Ex. 114, Traxler Surrebuttal, p. 22, ls. 14-22).

KCPL filed the rebuttal testimony of Mr. Michael Halloran, a senior consultant with Mercer Human Resource Consulting, to support its effort to obtain ratemaking recovery of its Executive Incentive Compensation Plans. (Ex. 14, Halloran Rebuttal). Mr. Halloran asserts that KCPL's use of the financial goal EPS in its incentive plans benefits ratepayers in various ways. He contends that it provides cash that allows KCPL to invest in ongoing maintenance and upgrading of facilities which ensures a steady, reliable low cost supply of electricity. (Ex. 14, Halloran Rebuttal, p. 3, ls. 19-23). Mr. Traxler responded that a regulated utility is not dependent upon EPS for the cash required to maintain and upgrade its facilities. He stated that the funds required for a Commission regulated electric utility to maintain its facilities providing electric service to its customers are provided by including a normal level of maintenance expense in the cost of service calculation used to determine the utility's overall revenue requirement. The question whether executive incentive compensation tied to EPS or return on total capital should be recovered in rates is unrelated to the cash required to maintain the assets used in providing electric service. (Ex. 114, Traxler Surrebuttal, p. 23, ls. 1-12; Vol. 5, Tr. 184, l. 25 – Tr. 185, l. 14).

Mr. Traxler also disagreed with Mr. Halloran's attempt to justify ratemaking recovery of incentive compensation tied to EPS on the basis that increasing EPS improves funds from operations (FFO), and FFO divided by debt and FFO divided by interest are two credit metrics, which credit rating agencies use to evaluate utilities. Mr. Traxler testified that the most cost effective method for providing the FFO required for KCPL to maintain its credit rating is the Regulatory Plan Additional Amortization provided for in the *Stipulation and Agreement* in Case No. EO-2005-0329. He stated that Mr. Halloran, among other things, does not consider the tax consequences of his position set forth in his rebuttal testimony. The Regulatory Plan Additional

Amortization is in effect an accelerated recovery of depreciation expense. Mr. Traxler explained that because depreciation expense is tax deductible, a $1.00 increase in depreciation expense requires a $1.00 cash outlay from ratepayers, whereas a $1.62 cash outlay is required from ratepayers for a $1.00 increase in return on equity (ROE), and thus for a resulting increase in EPS, since ROE is not tax deductible.[14] (Ex. 114, Traxler Surrebuttal, p. 23, l. 13 – p. 24, l. 23).

Mr. Traxler also noted that Mr. Halloran's attempt to justify ratemaking recovery for incentive compensation tied to EPS on the basis that increasing EPS results in lower borrowing costs for the utility fails to consider the tax consequences of an increase in ROE and resulting increase in EPS. (Ex. 114, Traxler Surrebuttal, p. 25, ls. 1-15).

Regarding Discretionary Incentive Compensation to executives under the under the Executive Short-term Incentive Compensation Plans, Mr. Halloran implied in his rebuttal testimony that he had knowledge that the goals supporting the discretionary payments are (1) related to customer benefits and (2) unrelated to the achievement of any financial goals. Mr. Traxler testified that KCPL had failed to provide to the Staff any evidence which would support Mr. Halloran's testimony, i.e., KCPL has not identified and provided to the Staff any evidence that there are defined goals which support the discretionary payments to GPE and KCPL executives. (Ex. 114, Traxler Surrebuttal, p. 25, l. 16 – p. 26, l. 13).

Counsel for the Department of Energy asked Mr. Halloran regarding Mr. Halloran's assertion that KCPL's "Tier 1 standing" and "Edison award" are "clear evidence of the benefit KCPL delivers to its customers through its approach to performance incentives" in the context of his claim that there is a strong connection between EPS and benefits for customers. (*See* Ex. 14, Halloran Rebuttal, p. 4, ls. 12-21). Mr. Halloran eventually admitted what was obvious in the hearing room that (1) Mr. Halloran did not know the specifics about KCPL's Tier 1 standing and

[14] Assumed effective tax rate of 38%. (Ex. 114, Traxler Surrebuttal, p. 24, l. 5).

KCPL's Edison award and (2) he could not truly say whether KCPL's customers benefited from KCPL's attaining Tier 1 status and the Edison award. (Vol. 5, Tr. 143, l.14 – Tr. 146, l. 2). Counsel for DOE also asked Mr. Halloran about Mr. Halloran's statement that "[t]he discretionary component of KCPL's incentive program ensures that the management team understands that strong performance for the customer unrelated to financial results will be recognized and rewarded." (Ex. 14, Halloran Rebuttal, p. 5, ls. 11-14). Mr. Halloran could not provide any actual examples respecting KCPL. (Vol. 5, Tr. 146, l. 3 – Tr. 147, l. 12).

For 2006, Mr. Halloran testified that he was certain that over 90% of the GPE and KCPL executives eligible for short-term discretionary incentive compensation awards received an award and that for KCPL executives the short-term discretionary incentive compensation awards ranged from \$3,500 to \$48,750 and for GPE executives the short-term discretionary incentive compensation awards ranged from \$9,975 to \$130,000. (Vol. 5, Tr. 151, l. 24 – Tr. 152, l. 22).

Respecting incentive compensation, the Commission stated, in part as follows, at page 58 of its December 21, 2006 *Report and Order* in KCPL's 2006 rate increase case, Case No. ER-2006-0314:

> . . . KCPL management is free to offer whatever compensation packages it wants. Nevertheless, if the method KCPL chooses to compensate employees shows no tangible benefit to Missouri ratepayers, then those costs should be borne by shareholders, and not included in cost of service.

KCPL did not seek judicial review of the Commission's *Report and Order* in Case No. ER-2006-0314, and incentive compensation is not one of the issues that the Office of the Public Counsel or Praxair, Inc. raised in either of their Petitions For Writs Of Review in Cole County Circuit Court respecting the Commission's *Report and Order* in Case No. ER-2006-0314.

Also on December 21, 2006, the Commission reached a similar result regarding incentive compensation in The Empire District Electric Company rate increase case. The Commission stated, in part as follows, at page 49 of its *Report and Order* in Case No. ER-2006-0315:

> Finding: The Commission finds that the Staff reasonably applied objective criteria for exclusion of certain incentive compensation. The Staff disallowed compensation related to charitable activities and activities related to the provision of services other than retail electric service. The Staff disallowed the Lighting Bolts incentive compensation, as they did not relate to the provision of electric service and there were no performance criteria for receipt of the awards; they were given solely at the Company management's discretion.
>
> Conclusion: We conclude that incentive compensation for meeting earnings goals, charitable activities, activities unrelated to the provision of retail electric service, discretionary awards, and stock options should not be recoverable in rates.

In *Re Staff v. Union Electric Company,* Case No. EC-87-114 et al., *Report and Order*, 29 Mo.P.S.C.(N.S.) 313 (1987), the Staff's 1987 excess earnings complaint case against Union Electric Company (UE), UE proposed to include $1,186,000 in Missouri jurisdictional cost of service for its management incentive plan. The Staff opposed the adjustment and the Commission concurred on the following grounds, *Id*. at 325:

> The Commission believes that programs designed to improve management performance should be encouraged and is not opposed, in principle, to cost of service recovery of the costs associated with such programs. However, the Staff's criticism of the Company's plan for ratemaking purposes is well taken. At a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan. The Company's management incentive plan meets neither of these minimum standards. Accordingly, the Commission determines that the Company's adjustment should be rejected.

The Commission historically has not allowed incentive payments for goals either ill-defined or related to financial performance tied primarily to shareholder wealth maximization which primarily benefits shareholders. The Commission stated this position in a 1997 Missouri Gas Energy (MGE) rate case, Case No. GR-96-285, *Report and Order*, 5 Mo.P.S.C.3d 437, 458

(1997) ("The Commission finds that the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers."), and reaffirmed its position in a 2004 MGE rate case, Case No. GR-2004-0209, 12 Mo.P.S.C.3d 581, 606-07 (2004):

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

The Staff would note that in 2001 the Commission approved KCPL's application in *Re Kansas City Power & Light Co.*, Case No. EM-2001-464, *Order Approving Stipulation and Agreement and Closing Case*, 10 Mo.P.S.C.3d 394 (2001) for authorization to reorganize itself into a holding company. Thus, the *Report and Order* issued in the Staff's 1988 excess earnings/revenues complaint case against Southwestern Bell Telephone Company (Southwestern bell), Case No. TC-89-14, et al., wherein the Commission stated, in part as follows, is particularly relevant, 29 Mo.P.S.C. (N.S.) 607, 627 (1989):

> In the Commission's opinion the results of the parent corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the State of Missouri. Achieving the goals of SBC [the parent company] and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers. Accordingly, the Staff's proposed disallowances in the senior management's long-term and short term incentive plans…should be adopted.

The Commission reiterated its position in its *Report and Order* in the Staff's 1993 excess earnings/revenues complaint case against Southwestern Bell, Case No. TC-93-224, et al., 2 Mo.P.S.C.3d 479, 531-32 (1993), in language that is even more clearly on point to the instant KCPL case:

> The structure of the plan provides an implicit incentive for participants to try to increase SBC's stock price. This in turn could encourage senior managers to spend a greater percentage of time on non-regulated companies and discourage time and effort spent on Missouri operations…The likelihood of SBC managers emphasizing whatever they perceive will cause the market to react favorably to SBC stock, including giving priority to unregulated subsidiaries, further convinces the Commission that Missouri ratepayers should not fund the long-term incentives.

Clearly, the Commission for ratemaking purposes has the authority to disallow expenses which the utility does not establish benefit the general body of ratepayers. *State ex rel. Laclede v. Public Serv. Comm'n*, 600 S.W.2d 222, 228 (Mo.App. W.D. 1980), *appeal dismissed*, 449 U.S. 1072, 101 S.Ct. 848, 66 L.Ed.2d 795 (1981); *State ex rel. Southwestern Bell Tel. & Tel. Co. v. Public Serv. Comm'n*, 645 S.W.2d 44, 55-56 (Mo.App. W.D. 1982).

The Staff's Reconcilement/Reconciliation filed on November 5, 2007, shows the Missouri jurisdictional revenue requirement value of the Executive Short-term Incentive Compensation issue to be $757,420.

6. <u>Talent Assessment Program Employee Severance Cost</u>: Should the severance and other associated costs of KCPL employees terminated under KCPL's talent assessment program be included in cost of service for setting KCPL's rates?

Summary: KCPL has shown no benefit to its customers from the $8.9 million in severance and associated costs KCPL incurred in carrying out its talent assessment program in 2005 and 2006 were specifically excluded from the earnings calculation that formed the basis of KCPL's 2006 executive incentive compensation plan. With the loss of experience in the group of 119 KCPL employees terminated under the talent assessment program, the program may actually prove to be detrimental to the effectiveness of KCPL's workforce over the next few years.

KCPL describes its talent assessment program as "a [workforce alignment] process [it undertook] to assess, improve and reposition the skill sets of [non-bargaining unit] employees for implementation of [KCPL's] comprehensive energy plan." (Ex. 108, Staff witness Hyneman Direct pp. 6-7). Under the talent assessment program KCPL incurred severance payments, outplacement service costs, and payroll taxes totaling $8.9 million for 119 employees who voluntarily or involuntarily terminated their employment with KCPL. (Ex. 2, KCPL witness Cheatum Rebuttal pp. 2-3, as corrected by KCPL counsel Fischer during the evidentiary hearing at Vol. 7 Tr. 513-14; Staff witness Hyneman Surrebuttal p. 14). Officers of KCPL were not evaluated under the talent assessment program, nor were union employees, including customer service employees. (KCPL witness Cheatum Vol. 7, Tr. 405-07). About 800 employees were evaluated under the talent assessment program, unknown numbers were identified as "role models" or "well-placed," and over 200 were identified as "not keeping pace," of which 119 left employment with KCPL, involuntarily or voluntarily. (KCPL witness Cheatum Vol. 7, Tr. 404-05).

The Staff cannot support recovery through rates of expenses a utility incurs where there is no showing of any benefit to the utility's customers. In this case KCPL has shown no benefit to its customers, and the Staff has found none, resulting from the $8.9 million in severance and associated costs KCPL incurred in carrying out its talent assessment program in 2005 and 2006. (Ex. 108, Staff witness Hyneman Direct p. 7; Ex. 2). In fact, not only has the Staff found no customer benefits from this program, it has concerns about a potential detriment with the loss of experience with the loss of this group of 119 KCPL employees. (Staff witness Hyneman Vol. 7, Tr. 504).

In particular, the Staff found no indication KCPL was not providing safe and adequate service when the employees whose employment was terminated under the talent assessment program were still employed by KCPL. There is nothing showing any benefit to KCPL customers resulting from the talent assessment program; and, further, any failure on the part of KCPL's management to fulfill its responsibility to hire and train its employees should not be borne by KCPL's customers, and the severance costs of the talent assessment program were removed from KCPL's 2006 earnings in KCPL's determination of the incentive compensation paid to KCPL's management for 2006, a factor the Commission found decisive in rejecting KCPL's severance cost recovery proposal in KCPL's last rate case. (Ex. 108, Staff witness Hyneman Direct pp. 7-8). As Staff witness Hyneman stated in his direct testimony,

> The severance payments made by KCPL are not recurring costs of the type that should be borne by regulated customers, nor are they expenditures that will result in any payroll savings costs. There is no indication that the normalized severance payments in which KCPL is seeking to recover in this case will provide any benefit to its customers.

Ex. 108, Staff witness Hyneman Direct p. 8.

KCPL agreed with the Staff that KCPL was providing safe and adequate service when the employees whose employment was terminated under the talent assessment program were still employed by KCPL, but asserted J.D. Powers & Associates survey results showed increased KCPL customer satisfaction relative to other Midwest electric utilities after the program. (Ex. 2, KCPL witness Cheatum Rebuttal p. 5; KCPL witness Cheatum Vol. 7, Tr. 407-08).

During the hearing KCPL witness Cheatum testified that KCPL's payroll did not reduce as a result of the talent assessment program; KCPL had 37 more non-officer management employees after the program than before. (Vol. 7, Tr. 406). More significantly, she testified that most of KCPL's customer service personnel were union employees not evaluated under the talent assessment program. (Vol. 7, Tr. 407). The Staff did not rely on the J.D. Powers & Associates customer survey results in developing it position, but responded to KCPL's reliance on them. (Staff witness Hyneman Vol. 7, Tr. 511). Staff witness Hyneman presented J.D. Powers & Associates customer satisfaction results for KCPL for years 2003-07 that he obtained from KCPL through discovery in this case. That table follows:

Year	Score (max. 1000 points)	Midwest Region Index Ranking (comparison to 16 utilities)
2003	721	Tied for 5th
2004	702	Tied for 8th
2005	706	9th
2006	679	8th
2007	697	Tied for 4th

Based on the raw scores of the J.D. Powers & Associates customer service surveys for KCPL for these years, KCPL's customer satisfaction declined after KCPL undertook its talent assessment program in 2005-06. KCPL relies on the changes in it rankings with respect to other Midwest electric service providers as reflected in the J.D. Powers & Associates customer service surveys between 2006 and 2007 as support for customer benefit from its talent assessment program. (Ex. 2, KCPL witness Cheatum Rebuttal p. 5). As this Commission is well aware, KCPL was spared the impacts of the severe storms that struck large regions of the Midwest in late 2006 and early 2007 causing numerous and lengthy customer service outages. (Staff witness Hyneman, Vol. 7 Tr. 511-12). Such outages negatively affect customer satisfaction, and could readily explain KCPL's precipitous rise in J.D. Power & Associates customer satisfaction survey result rankings between 2006 and 2007 relative to other Midwest electric service providers such Union Electric Company, d/b/a AmerenUE, despite the decline in KCPL's raw score. (Staff witness Hyneman, Vol. 7 Tr. 511-12). Also, KCPL does not address how the Midwest ranking of five it attained in 2003 with pre-talent assessment employees is significantly different from attaining a ranking of four in 2007 with post-talent assessment employees.

During the hearing, KCPL witness Cheatum agreed that it was reasonable for a company to do a cost-benefit analysis before spending $9 million on a project, but that KCPL had not done so before initiating this talent assessment program. (Vol. 7 Tr. 409-13).

Part of the severance package was an agreement by the severed employee not to bring litigation against KCPL over the employment termination. (KCPL witness Cheatum Vol. 7, Tr. 415-16). Further, in responding to questions by Chairman Davis during the hearing, KCPL witness Cheatum testified these terminated employees were at-will employees terminable by KCPL at any time for any lawful reason and without cause. (Vol. 7, Tr. 451).

The Commission should also note KCPL did not include its severance and associated costs incurred with its talent assessment program when it calculated earnings per share for purposes of determining executive compensation. (KCPL witness Cheatum Vol. 7, Tr. 417). In its *Report and Order* in Case No. ER-2006-0314, this Commission stated the following regarding severance costs KCPL incurred in 2005: "The Commission sees no equity in allowing KCPL to recover these costs from ratepayers when its own management excludes those same costs from its EPS calculation, to the enrichment of its executives via the incentive compensation plan." (Ex. 109, Hyneman Surrebuttal pp. 20 and 22). KCPL witness Cheatum is herself a part of the KCPL management team that is attempting to make KCPL's customers responsible for the cost of the talent assessment program while simultaneously not subjecting itself responsible for the costs of that program. (Ex. 2, KCPL witness Cheatum Rebuttal p. 1; KCPL witness Cheatum Vol. 7 Tr. 405-06).

For all the foregoing reasons, the Commission should not include the costs of KCPL's talent assessment program in KCPL's cost of service used to set rates in this case.

7. Employee Severance Cost: Should the severance costs of KCPL employees terminated for reasons other than KCPL's talent assessment program be included in cost of service for setting KCPL's rates?

   a. If so, is it appropriate to include a three-year average of those costs?

Summary: KCPL proposed recovery of these types of severance costs in its 2006 rate case, Case No. ER-2006-314, and the Commission rejected that proposal. KCPL provided no new reasons or evidence as to why the Commission should change its position. KCPL paid these severance costs solely to protect shareholders, they are not recurring costs of the type KCPL's customers should bear, they did not result in a decrease in KCPL's payroll, and there is no indication they will provide any benefit to KCPL's customers; therefore, these employee severance costs also should not be included in KCPL's cost of service.

This employee severance expense issue is worth approximately $0.5 million (total company). (Ex. 108, Staff witness Hyneman Direct p. 5; Ex. 2, KCPL witness Cheatum Rebuttal p. 2).

In addition the severance costs of its talent assessment program, KCPL is seeking rate recovery of a three-year average of other employee severance costs. KCPL paid these severance costs solely to protect shareholders and are not recurring costs of the type KCPL's customers should bear. In addition, KCPL's employment severance payments did not decrease KCPL's payroll, and there is no indication they will provide any benefit to KCPL's customers; therefore, these employee severance costs also should not be included in KCPL's cost of service. (Ex. 108, Hyneman Direct pp. 4-5, 7-8).

KCPL made this same proposal in its 2006 rate case, Case No. ER-2006-314, and the Commission rejected it. (Ex. 108, Staff witness Hyneman Direct pp. 5-6; Ex. 109, Staff witness Hyneman Surrebuttal pp. 20-21). KCPL has not provided anything new to persuade the Commission to change a position it took less than 12 months ago.

In the 2006 rate case, the Commission found that the competent and substantial evidence supported Staff's position, and decided this issue in favor of Staff. The Commission found that KCPL's severance costs were designed to protect KCPL against such issues as sexual harassment or age discrimination, and that such costs are not recoverable in rates. The Commission contrasted KCPL's severance payments, made only to protect shareholders, with severance payments made to decrease payroll, which could be included in cost of service because of the benefit to ratepayers. KCPL has presented nothing new in this case to justify why the Commission should overturn a decision it made just a few months ago. (Ex. 108, Staff witness Hyneman Direct, pp. 5-6 & 7-8).

For the same reasons it rejected recovery for these employment severance costs in KCPL's last rate case, Case No. ER-2006-0314,—that they provide no benefit to KCPL's customers and were designed to protect KCPL against such issues as sexual harassment or age discrimination—the Commission should not include them in KCPL's cost of service in this case.

14. <u>Off-system sales margin</u>:

a. Should KCPL's rates continue to be set at the 25th percentile of non-firm off-system sales margin as projected in this case for 2008 as proposed by KCPL, and accepted by the Staff, or at the 40th percentile as proposed by Public Counsel?

b. Should interest be calculated and flowed to ratepayers on the off-system sales margin that exceeds the off-system sales margin level the Commission approved to be recovered in rates in Case No. EO-2006-0314?

Summary: Mr. Schnitzer's current recommendation for off-systems sales margin at the 25th percentile level in his current analysis in the instant case should be used for setting the appropriate level of Off-System Sale Margin. While not a Staff issue, KCPL witness Mr. Chris Giles testified during the hearing that KCPL was amenable to paying interest on off-system sales that exceed the 25th percentile and that KCPL did not propose to include the cost of such interest in its cost of service for recovery from ratepayers. Mr. Giles testified the appropriate rate of interest would be the London Interbank Offered

> Rate (LIBOR) plus 32 basis points, which he identified as "the short-term interest rate KCPL pays to banks today.

The Commission decided the issue of the method to be used to determine the appropriate level of Off-System Sales Margin in Case No. ER-2006-0314 by adopting the margin at the 25th percentile level as determined by the analysis of KCPL witness Michael M. Schnitzer in that case. The Staff's position, as reflected in the rebuttal testimony of Staff witness Steve M. Traxler, is to follow the Commission's *Report and Order* in Case No. ER 2006-0314 by reflecting Mr. Schnitzer's current recommendation for off-systems sales margin at the 25th percentile level in his current analysis in the instant case. (Ex. 113, Traxler Rebuttal, p. 1, l. 19 – p. 2, l. 9). As of September 30, 2007, KCPL has not experienced off-systems sales margin above the 25th percentile level which the Commission adopted for ratemaking purposes in Case No. ER-2006-0314. Therefore, as of September 30, 2007, there are no off-system sales margin funds to be flowed back to customers as a reduction to cost of service established in this case as of the true-up.

The Commission's *Report and Order* in Case No. ER-2006-0314 makes no specific provision as to how KCPL might reflect in the instant case, Case No. ER-2007-0291, off-system sales margin above the 25th percentile level received by KCPL after September 30, 2007, the end date of the true-up period. The Commission's Case No. ER-2006-0314 *Report and Order* does not address in any detail the timing and mechanics of any flowback methodology. The language in the Commission's *Report and Order* in Case No. ER-2006-0314 generally indicates that the regulatory liability for any excess margin in 2007 will be flowed back in KCPL's "next rate case." (*Report and Order*, p. 33). The "next rate case" for off-system sales margin above the 25th percentile level received by KCPL after the end of the true-up period is not this rate case,

Case No. ER-2007-0291, but "the next rate case," KCPL's 2008 rate case. (Ex. 113, Traxler Rebuttal, p. 7, ls. 1-14).

Although the Staff did not support the Office of Public Counsel's proposal in this case that KCPL be required to accrue interest on the excess of actual margin above the 25th percentile level, KCPL's witness on this issue, Mr. Chris Giles, stated on the witness stand on October 3, 2007, that KCPL was now amenable to paying interest on the amount of the off-system sales that exceeds the 25th percentile, should KCPL exceed that level, and that KCPL did not propose to include the cost of such interest in its cost of service for recovery from ratepayers. Mr. Giles said that the appropriate rate of interest would be the London Interbank Offered Rate (LIBOR) plus 32 basis points. He identified this rate as "the short-term interest rate that the company pays today to banks." (Vol. 7, Tr. 515, l. 24 – Tr. 517, l. 3).

Finally, Mr. Traxler proposed adoption of the "cumulative until and after baseline is met" tracking method proposed by Office of Public Counsel witness Ted Robertson in his direct testimony. (Ex. 113, Traxler Rebuttal, p. 3, ls.10-22).

15. <u>Department of Energy Nuclear Fuel Overcharge Refund</u>: Should the Department of Energy Nuclear Fuel Overcharge Refunds for 1986 through 1993 KCPL received during the test year in this case be included in KCPL's cost of service for setting KCPL's rates?

Summary: The $427,150 in litigation proceeds KCPL received in 2006 for claims that the Department of Energy had in earlier years overcharged KCPL for nuclear fuel enrichment services provided for fuel purchased from 1986 to 1993 should be treated in the same way as extraordinary expense items that the Commission allows to be included in cost of service under accounting authority orders. KCPL's utility rates include the cost of nuclear fuel. If KCPL was overcharged for nuclear fuel, then its customers were overcharged as well. KCPL's position that only its shareholders bore the overcharge is biased and is not supported by logic. Therefore, the $427,150 should be straight-line amortized over five years ($85,000 total company per year) and the amount of $46,000 (Missouri jurisdictional) should be included in KCPL's cost of service for purposes of setting rates in this case.

During calendar year 2006, the ordered test year in this case, KCPL received $427,150 in litigation proceeds for claims that the Department of Energy had in earlier years overcharged KCPL for nuclear fuel enrichment services provided for fuel purchased from 1986 to 1993. (Ex. 9, KCPL witness Giles Rebuttal p. 6; Ex. 109, Staff witness Hyneman p. 12). On the Staff's reconciliation marked as exhibit 104, this amount for the Department of Energy litigation proceeds is consolidated with the amount for the Hawthorn 5 subrogation proceed. (Staff witness Hynemen Vol. 9 Tr. 659).

This issue is one of those issues that involves the question of whether the Commission should treat financial benefits KCPL received during the test year as recovery of expenses KCPL incurred to serve its ratepayers in years before the test year similarly to how it treats rate case expense, extraordinary expenses and amounts remaining under accounting authority orders. It is, like the Hawthorn 5 subrogation issue, but one of a number of potential adjustments that fall into the pattern of KCPL taking positions on the ratemaking treatment of these adjustments favorable to KCPL. Where the atypical (extraordinary, or not a normal or recurring revenue or expense incurred in providing utility service) revenue or expense would increase KCPL's revenue requirement, KCPL takes the position the revenue or expense should be amortized and included in rate base, but, where the revenue or expense would decrease KCPL's revenue requirement, KCPL takes the position that making the adjustment would be retroactive ratemaking. (Ex. 9, KCPL witness Giles Rebuttal p. 2-4; Ex. 109, Staff witness Hyneman Surrebuttal pp. 2-4).

For the same reasons presented in that part of this brief above addressing issue no. 3 (Hawthorn 5 subrogation proceeds), the Commission should presume KCPL recovered from its customers in the rates KCPL charged from 1986 through 1993, the fuel enrichment overpayments KCPL made to the Department of Energy. As a result, in the rates set in this case based on a 2006 test year, KCPL's customers should receive a benefit from the Department of Energy Nuclear Fuel Overcharge Refunds for 1986 to 1993 KCPL received in the 2006 test year by including the refunds in KCPL's cost of service in this case. (Ex. 109, Staff witness Hyneman Surrebuttal pp. 12-14).

a. If so, should the five-year amortization period proposed by Staff by adopted?

Similar to how extraordinary costs are amortized and the resulting annual amount is included in rates, the Staff recommends the Commission amortize over five years the $427,150 fuel enrichment litigation proceeds obtained from the Department of Energy for nuclear fuel enrichment services and include the resulting annual amount in KCPL's cost of service. With this recommendation $85,000 total company ($46,000 Missouri jurisdictional) is included in KCPL's cost of service for purposes of setting rates in this case, and KCPL's shareholders receive the benefit of the cost-free use of that part of the proceeds not included in cost of service for at least a period of time. (Ex. 109, Staff witness Hyneman Surrebuttal p. 12).

CLASS COST OF SERVICE / RATE DESIGN

21. Effect of Case No. EO-2005-0329 Stipulation and Agreement on Inter-class Shifts: Does the Stipulation and Agreement incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO-2005-0329 allow the signatories to the Stipulation and Agreement to propose inter-class revenue shifts in this case?

Summary: In implementing the general rate increase sought in this case, KCPL and OPC advocate increasing each rate component equally by the same percentage as the overall increase in revenues allowed in this case. The Staff recommends taking the opportunity of this rate increase case to address remaining inequalities between class revenue contributions and cost of service that were identified in the Class Cost of Service studies performed for the last rate filing. Specifically, the Staff recommends increasing the revenue responsibility of the Residential class by approximately 1.8% and reducing the revenue responsibility of the Medium General Service class by approximately 5% to shift revenues of precisely $3,536,542 from the Medium General Service class to the Residential class. Similarly, DOE/NNSA recommends moving toward equalizing the classes' rates of return (based on its class cost-of-service studies performed in each case) over a period of three (3) rate cases.

The Stipulation and Agreement ("S&A") entered into in Case No. EO-2005-0329, the Kansas City Power & Light Company Experimental Regulatory Plan, is no barrier to the inter-class revenue shifts that Staff proposes or to similar shifts NNSA/DOE proposes. (see S&A, Exhibit 29). In that Staff's proposal does not involve adding or deleting a class, or changing the rate elements within a class, Staff's proposal is not prohibited by the KCPL experimental regulatory plan S&A. (Ex. 111, Staff witness Pyatte Surrebuttal, pp. 7 – 11). **** HC **** _____

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The claim of KCPL and OPC that the meaning of "rate structure" as used in the KCPL experimental regulatory plan S&A includes not only the presence of possible rate components on a rate schedule, but also the relationship of the value of each rate component to the value of each other rate component leads to the conclusion that OPC's and KCPL's definition of "rate structure" has the same meaning as the more common term "rate design." All of the experts who testified on this issue, but one, KCPL witness Rush, testified that "rate structure" is not synonymous with "rate design." (OPC witness Meisenheimer Vol. 11 Tr. 823; OPC witness Trippensee Tr. 933; Ford/MIEC/Praxair witness Brubaker Vol. 13 Tr. 1038; Trigen witness Herz Vol. 13 Tr. 1100.). During the main evidentiary hearing, Mr. Rush testified that he believes the

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terms "rate design" and "rate structure" are synonymous, "in a very general way." (Vol. 11 Tr. 748).

If KCPL witness Rush is correct that "changes to rate structure" is any change in rates that causes a customer to make choices in the terms under which they take service (Vol. 11 Tr. 787-88), then a simple rate increase by equal percentages would be prohibited, as customers might chose to switch from utility sourced electricity to customer-owned solar panels, customer-owned wind generation, chilled water or steam, or gas for all or some portion of their energy needs. KCPL witness Rush testified that the S&A does not "anywhere say that only an across-the-board increase to all of the rate classes is the only acceptable form of increase in this case or in the next case." (Vol. 11 Tr. 729).

If OPC witness Meisenheimer's definition that "rate structure involves the specific determinations of rates" is accepted, then a simple rate increase by equal percentages in this case would be prohibited by the S&A. (Vol. 13 Tr. 1032).

a. If so, should any inter-class revenue shifts be implemented in this case?

The Staff recommends increasing the revenue responsibility of KCPL's Residential class by approximately 1.8% and reducing the revenue responsibility of KCPL's Medium General Service class by approximately 5% to shift precisely $3,536,542 from the Medium General Service class to the Residential class. This revenue-neutral shift should be accomplished by reducing the medium general service (MGS) class rates by applying an equal percentage reduction to each demand charge and energy charge rate component, and increasing the residential class rates by applying an equal percentage increase to every residential class rate component. Any overall rate increase should be implemented thereafter as an equal percentage increase to each rate component of each rate schedule. (Ex. 116, Staff witness Watkins Direct, pp. 2-3). The purpose of this shift is to bring the revenues generated by each of KCPL's customer classes closer to the cost of serving each class.

At hearing, KCPL witness Rush testified that KCPL generally agrees with and supports the principle that an electric utility rate for a ratepayer should be based on what it costs the supplying electric utility to provide electrical service to that ratepayer. (Vol. 11 Tr. 698). Mr. Rush also stated that there are not currently equal rates of return among customer classes on the investments KCPL has made to provide electrical service to those customer classes. (Vol. 11 Tr. 699). Mr. Rush testified that the more closely a company's rates come to providing that company with equal rates of return from each class, the closer that company's rates are to compliance with the principle of cost-based rate making. (Vol. 11 Tr. 700).

During the main evidentiary hearing, Mr. Rush testified that he believes KCPL's residential rates will increase when Iatan 2 comes into service. (Vol. 11 Tr. 710). The Staff is not proposing inter-class changes due to the anticipated addition of Iatan 2 to rate base. Staff's proposed interclass shifts of revenue responsibility are necessary due to inequalities and imbalances identified over two years ago, and which have not been sufficiently mitigated since then. (Vol. 11 Tr. 713). While Staff believes it is possible, and perhaps likely, that the addition of Iatan 2 to rate base will cause a substantial enough increase in the rates for all rate classes that it would be unpalatable to adopt inter-class shifts in conjunction with increasing rates due to the addition of Iatan 2 to rate base, the shifts Staff proposes in this case are appropriate at this time, even absent that factor.

The NNSA/DOE has put forth a proposal to move toward equalizing the rates of return on investment that each customer class provides to KCPL, along with a supporting class cost-of-service study. As a non-signatory to the S&A, the NNSA/DOE's proposal is not prohibited by the S&A; the NNSA/DOE is not bound to an agreement to which it is not a party. The S&A cannot and does not limit the ability of the Commission to adopt, or adopt with modification, the proposal of inter-class shifts by one who is not a party to the S&A. Staff does not agree with the NNSA/DOE's mechanism for addressing and continuing the revenue shifts, and certainly does not endorse NNSA/DOE's study. However, the Commission should note the underlying similarity of both Staff's and NNSA/DOE's concerns with the discrepancy between the revenues generated by each of KCPL's customer classes and the cost of serving each class; and their concomitant proposals to mitigate those concerns.

22. <u>Large Power Service Rate Design</u>:

a. Does the Stipulation and Agreement incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO-2005-0329 allow the signatories to the Stipulation and Agreement to make rate design modifications within the Large Power Service rate schedule?

For the same reasons outlined above regarding inter-class shifts, intra-class revenue shifts are also not barred by the S&A. In that the Praxair/FORD/MIEC proposal does not involve adding or deleting a class or changing the rate elements within a class, it is not prohibited by the S&A. (Ex. 111, Staff witness Pyatte Surrebuttal, pp. 7-11).

b. If so, what are the appropriate demand and energy charges for the Large Power Service rate schedule?

Summary: Ford Motor Company, Praxair, Inc. and Missouri Industrial Energy Consumers, propose to reduce the energy charges and increase the demand charges on the Large Power Service rate schedule. While the Staff considers such a shift ill-advised, it has prepared a modified version of the industrial's proposal that addresses Staff's concerns with customer impacts and revenues lost to rate switching, so long as the reduction in energy rates does not reduce the rates to below KCPL's filed avoided cost rate.

The Staff recommends to the Commission that the Commission reject any proposal to reduce energy rate values below KCPL's incremental energy cost. (Ex. 118, Staff witness

Watkins Surrebuttal, p. 9). It cannot be overemphasized that Staff does not believe that any change should be made to the relationship between the demand and energy charges in the Large Power Service (LPS) rate schedules. However, if the Commission should deem it appropriate to adjust the relationship between the LPS demand and energy charges, the Staff considers a number of conditions absolutely necessary to offset undesirable ramifications. Those conditions follow. Any reduction to existing energy rate values should be accomplished on a proportional or equal-percentage basis. (Ex. 117, Staff witness Watkins Rebuttal, p. 6). Any offsetting increases to the demand rate values that result from reducing energy rate values should be applied so as to reduce or eliminate the declining block feature of the existing LPS demand charge. (Ex. 117, Staff witness Watkins Rebuttal, p. 7). Any revenue reduction from customers presently being served on the Large Power Service rate schedule due to existing LPS customers switching to the Large General Service rate schedule should be recovered from the remaining LPS customers by proportionately increasing the demand and energy charges of the Large Power rate schedule. (Ex. 117, Staff witness Watkins Rebuttal, p. 7).

KCPL witness Rush testified that, if the Praxair/Ford/MIEC proposal is implemented, 75 of KCPL's 89 LPS customers will experience increased bills, before any general rate increase is implemented. (Vol. 11 Tr. 739). Mr. Rush also testified that 47 of KCPL's 89 LPS customers would benefit by taking service on a different rate schedule, but still would experience increased bills above and beyond the general increase, if Praxair/Ford/MIEC's proposal is adopted. (Vol. 11 Tr. 741-42).

Mr. Rush testified that 14 of KCPL's 89 LPS customers will see decreased bills, before a general rate increase is implemented, if Praxair/Ford/MIEC's proposal is adopted. (Vol. 11 Tr. 738). During the main evidentiary hearing and also in his prefiled direct testimony, Mr. Rush testified that at least one of those customers would experience a 9% decrease in its bill, prior to the implementation of the general increase. (Vol. 11 Tr. 738; Ex. 20, KCPL Witness Rush Rebuttal p. 3).

23. General Service All-electric tariffs and general service separately-metered space-heating tariff provisions:

Summary: Trigen-Kansas City Energy Corporation presents a proposal to address what it, and the Staff, consider discriminatory rates offered to KCPL's non-residential, General Service All-Electric and Space Heating Customers. Because the Staff is not convinced that there remains any justification for negotiated lower priced rates for all electric or space heating applications, the Staff agrees that the all electric and space heating rates should be increased by more than the general application rates. The Staff advocates restricting the availability of the all electric and space heating rates to customers currently served on those rates, and further restricting the availability to those customers who remain continuously on those rates. The Staff also supports providing KCPL an opportunity to present a complete cost-of-service study and/or cost-effectiveness study and analysis in its next rate case to justify any rate discounts for space heating and, if KCPL cannot provide evidence to justify the discounts, to allow KCPL the opportunity to present its preferred phase-out plan. The Staff does not agree with Trigen, however, that increasing each of the winter energy blocks of the all electric rates and the separately metered rate by five percent (5%) is the most effective means of taking a further step to eliminate these rates; nor that KCPL should be required to present a complete cost of service study in the next rate case; nor that revenues should be imputed to KCPL on this matter; nor that KCPL should be required to actively investigate the customers receiving these rates.

a. Should KCPL's general service all-electric tariff rates and separately-metered space heating rates be increased more (i.e., by a greater percentage) than KCPL's corresponding standard general application rates and if so, by how much more?

The Staff agrees with Trigen that the All-Electric and separately-metered space heating rates should be increased in this case by more than the general application rates. (Ex. 117, Staff witness Watkins Rebuttal, p. 4). The separately-metered space heating rates should be increased by 10%, on a revenue-neutral basis (i.e., prior to any shifts in class revenue responsibility), to eliminate a significant portion of the discount that is being provided to customers with low load factors. None of the Staff-proposed reduction in revenue responsibility for the Medium General

Service (MGS) rate class should be applied to the MGS separately-metered space heating rate. (Ex. 117, Staff witness Watkins Rebuttal, p. 5). The initial winter energy block of the All-Electric rates should be increased by ten percent (10%) and the second winter block of the All-Electric rates should be increased by five percent (5%) to move these rate values closer to the corresponding general application rate values. (Ex. 117, Staff witness Watkins Rebuttal, p. 5).

Trigen finds Staff's proposal on this issue acceptable. (Vol. 13 Tr. 1100).

b. Should KCPL's general service all-electric tariffs and separately-metered space heating rates be phased-out, and if so, over what period?

The Staff proposes that a step towards phasing out the General Service All-Electric rate schedules and the separately-metered space heating rate values be taken in this case. (Ex. 117, Staff witness Watkins Rebuttal, p. 5). There is no justification for disparate treatment of similarly-situated customers. (Vol. 13 Tr. 1105).

c. Should the availability of KCPL's general service all-electric tariffs and separately-metered space heating rates be restricted to those qualifying customers commercial and industrial physical locations being served under such all-electric tariffs or separately-metered space heating rates as of the date used for the billing determinants used in this case (or as an alternative, the operation of law date of this case) and should such rates only be available to such customers for so long as they continuously remain on that rate schedule (i.e., the all-electric or separately-metered space heating rate schedule they are on as of such date)?

The Staff supports restricting the availability of the General Service All-Electric rate schedule and the separately-metered space heating rates to customers currently served on one of those rate schedules, but only for so long as they continuously remain on that rate schedule. (Ex. 117. Staff witness Watkins Rebuttal, p. 4).

d.

i. Should the Commission require KCPL, as soon as possible but not later than its next rate case, to present complete cost of service and/or cost-effectiveness studies and analyses of KCPL's general service all-electric tariffs and separately-metered space heating rates and, consistent with the findings of such studies and analyses, allow KCPL the opportunity at that time to present its preferred phase-out plan for the remaining commercial and industrial customers served under the all-electric tariffs and separately-metered space heating rates?

The Staff supports providing KCPL an opportunity to present a complete cost-of-service study and/or cost-effectiveness study and analysis in its next rate case to justify any rate discounts for space heating and, if not justified, to allow KCPL the opportunity to present its preferred phase-out plan. (Ex. 117, Staff witness Watkins Rebuttal, pp. 4, 5).

ii. In the event that KCPL does not file such cost of service and/or cost-effectiveness studies before or as part of its next rate case, should the Commission require KCPL to impute the revenues associated with the discounted rates in the all-electric general service tariffs and separately-metered space heating provisions of its tariffs and impute revenues equal to KCPL's cost of administering these discounted rates as part of its next rate case?

KCPL should not be required to file a study of the all electric and separately-metered space heating rates in its next case. And if it does not, revenues should not be imputed for all separately-metered space heating and all electric customers. (Ex. 117, Staff witness Watkins Rebuttal, p. 5).

e. Should the Commission require KCPL to (a) investigate and determine whether the commercial and industrial customers currently served under the general service all-electric tariffs and the separately-metered space heating provisions of the standard general service tariffs continue to meet the eligibility requirements for those discounted rates; (b) remove from the discounted rates those customers which KCPL's investigation determines are no longer eligible for such discounted rates; and (c) monitor and police the eligibility requirements of those customers receiving such discounted rates for reporting in KCPL's direct testimony in its next rate case filing?

KCPL should not be required to investigate and determine whether customers served under these rate schedules remain eligible for these rates. This would be a very awkward (from a customer service standpoint), time consuming and costly venture to embark on when the rates are being phased out anyway. (Ex. 117, Staff witness Watkins Rebuttal, p. 6).

f. Should the Commission approve KCPL's proposal to rename its general service "All-Electric" tariffs as "Space Heating" tariffs?

As there has been no justification for KCPL's approval to rename its general service "All-Electric" tariffs as "Space Heating" tariffs, it is inappropriate to do so. (Ex. 117, Staff witness Watkins Rebuttal, p. 8).

CONCLUSION

For the reasons stated herein the Commission should adopt the Staff's positions on the remaining contested issues in this case.

WHEREFORE the Staff submits the foregoing as its posthearing brief for this case.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 6th day of November 2007.

/s/ Nathan Williams