BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

POST-HEARING BRIEF OF KANSAS CITY POWER & LIGHT COMPANY

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Kansas City Power & Light Company ("KCPL" or "Company") submits this Post-Hearing Brief in accord with the Commission's Order Setting Briefing Schedule issued October 18, 2007.

STATEMENT OF THE CASE

Fulfilling the commitments that it made in the Regulatory Plan approved by the Commission as part of the 2005 Stipulation and Agreement in Case No. EO-2005-0329 ("Stipulation"), KCPL has embarked upon a series of infrastructure and customer enhancement projects valued at over $1.3 billion. In this second of four rate cases contemplated by the Stipulation, KCPL seeks a decision that appropriately reflects the risks the Company has undertaken in this endeavor, grants necessary increases in revenue, and sets a rate of return that will permit KCPL to remain financially healthy until it files its next rate case in 2008.

In the 2006 Rate Case (No. ER-2006-0314), the first filed under the Regulatory Plan, the Commission's Report and Order allowed KCPL to proceed on schedule with its infrastructure plans, including the construction of 100 MW of wind generation. In particular, the Commission's decision granting a Return on Equity (ROE) of 11.25%, setting rates for Off-System Sales ("OSS") Margin at the 25% percentile level, the use of the Additional Amortizations mechanism to maintain KCPL's investment-grade credit rating, and the Commission's decisions on numerous accounting issues struck an appropriate balance on critical financial and ratemaking issues. KCPL respectfully requests that the course charted in the 2006 Rate Case continue.

Status Report on Comprehensive Energy Plan

Before discussing the specific contested issues in the case, KCPL believes it would be helpful to provide a brief status report on its progress in completing its Comprehensive Energy Plan. First, the wind farm generation near Spearville, Kansas was completed in September 2006. An additional 100 MW of new wind generation facilities is currently being evaluated for installation in 2008. KCPL has shared its initial evaluation with interested parties to the Regulatory Plan. It will provide an updated evaluation and seek additional input from these parties. The emission control equipment, known as Selective Catalytic Reduction equipment, was placed in service on schedule and within budget at LyCygne Unit 1 in May 2007. Work is well underway on the environmental upgrades at Iatan 1, and on the construction of Iatan 2. The Iatan 2 project team has substantially completed its procurement effort of direct cost items. See Ex. 8-NP, Giles Direct, at 4-6, Tr. 35-37.

Since the approval of the Regulatory Plan, KCPL has conducted a pilot inventory of the overhead distribution system, and has completed a variety of projects designed to improve system reliability. See Ex. 8, Giles Direct at 5. A full distribution system assessment is scheduled to be completed by the end of 2008. The objectives of the Asset Management and Distribution Automation infrastructure investments include: (1) the mitigation of the risk of major outages; (2) minimizing the System Average Interruption Duration Index (SAIDI), and (3) minimizing the number of customers with multiple interruptions. See Ex. 16, Herdegen Direct at 2-3.

With regard to customer programs, KCPL has implemented the two affordability programs, seven energy efficiency programs and two demand response programs contemplated by the Regulatory Plan. See Ex. 18, Nathan Direct at 2-18. Since the conclusion of the last rate case, KCPL has also entered into a ground breaking agreement with the Sierra Club and the Concerned Citizens of Platte County, including a set of initiatives to offset carbon dioxide and reduce other emissions for KCPL. Under the agreement, KCPL agreed, subject to regulatory approval, to pursue offsets for all of the carbon emissions associated with its new plant through significant investments in energy efficiency and renewable energy, and to reduce emissions for its existing plants in order to improve air quality in the Greater Kansas City metropolitan area. Sierra Club and the Concerned Citizens of Platte County have also dismissed their appeal of the Commission's decision in the Regulatory Plan case, having resolved its issues with KCPL. See State ex rel. Sierra Club v. PSC, No. SC88530 (Mo., July 11, 2007) (appeal dismissed). The Regulatory Plan stands as approved by the Commission.

Regulatory Challenge of This Case

The task of the Commission in this case is to fashion a second rate order that correctly balances the risks with the benefits as they affect customers, shareholders and creditors. Two major factors that are unique to KCPL among Missouri electric utilities continue to be important: (1) The Company's multi-million dollar construction projects, including the coal-fired Iatan 2 unit, additional new wind generation, and numerous environmental upgrades, which will require KCPL to generate sufficient cash earnings to meet credit ratios; and (2) The risk and uncertainty of the OSS market which in recent years has accounted for approximately 50% of KCPL's revenues.

These two factors continue to pose major risks to the Company. However, the Company believes that if the Commission continues the policies established in the 2006 Rate Case on these issues, a proper balance will again be struck that will permit KCPL to achieve the goals embodied in the Regulatory Plan. In this case, the Company is requesting an ROE of 11.25% so that its history of top-of-the-industry productivity can continue. The Company also believes that the OSS Margins should again be established at the 25th percentile with a continuation of the OSS tracker mechanism, as determined in the 2006 Rate Case. Under that mechanism any margins in excess of the 25th percentile determined in this case will be credited to ratepayers through the establishment of a regulatory liability, lowering their energy bills in the next rate case.

An 11.25% ROE will generate the necessary ROE-related earnings for the Company, independent of other mechanisms like the Additional Amortizations permitted by the Stipulation. The Additional Amortizations (which act like accelerated depreciation and, therefore, an eventual off-set to rate base) are intended to be used as a last resort to maintain KCPL's credit ratios in the event that its earnings, as determined in general rate cases like this one, fail to satisfy certain financial rations. <u>See</u> Stipulation, § III(B)(1)(i) at 19.

Moreover, there are several rate design issues that need to be resolved in this case. As discussed below, KCPL believed that the signatory parties to the Regulatory Plan Stipulation had agreed not to file class cost of service studies or propose rate structure changes in this proceeding. However, there is disagreement among the parties about the parameters of that agreement. Notwithstanding how the Commission interprets the agreements in the previous case, KCPL recommends that the Commission approve an across-the-board increase to all customer classes, and leave more dramatic changes to rate structures for a future case. In addition, KCPL believes that the Commission should not adopt the recommendations of Trigen in this proceeding since these recommendations were largely decided in the 2006 Rate Case, and no further changes related to the general service all-electric and space-heating rates are appropriate at this time.

Proper consideration of these issues, and the use of the tools provided in the 2005 Regulatory Plan Stipulation will lead to a decision that sets just and reasonable rates until the next rate case, and that balances the risks of construction and the wholesale off-system sales electricity market with the benefits to be gained from the Regulatory Plan.

ISSUES IN THE CASE

A. Rate of Return

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

The issue regarding Return on Equity ("ROE") is whether the Commission will continue on the path that it set in 2006 when it determined that KCPL was entitled to an ROE that permitted the Company to maintain its solid financial base and investment-grade credit rating, while it faced significant construction risk as it pursued its comprehensive energy plan. Based on the testimony of Dr. Samuel C. Hadaway, KCPL requests an ROE of 11.25%. Using the same analysis that was accepted by the Commission in KCPL's 2006 Rate Case, Dr. Hadaway has recommended a base ROE of 10.75%, plus an additional 50 basis points to be added for construction risk. See Ex. 11, Hadaway Direct at 6-7; Tr. 251.

A decision by the Commission that is consistent with Dr. Hadaway's testimony would enable KCPL to continue its construction programs while remaining financially healthy, a goal that is consistent with the interests of both ratepayers and shareholders.

a. The Commission's approval of the Regulatory Plan in Case No. EO-2005-0329 does not justify a reduction in the ROE awarded in this case.

In the summer of 2005, the Commission approved a Stipulation and Agreement ("Stipulation") that called for KCPL to embark upon a comprehensive energy plan, including the construction of the new Iatan 2 super-critical coal plant, at least 100 MW of wind generation, and environmental retrofits to reduce emissions at the existing LaCygne 1 and Iatan 1 units. See Report & Order, In re Proposed Regulatory Plan of Kansas City Power & Light Co., No. EO-2005-0329 (Mo. P.S.C., July 28, 2005), as amended, Order Approving Amendments (Aug. 23, 2005). In approving the Regulatory Plan contained in the Stipulation signed by KCPL, Staff, the Office of the Public Counsel ("OPC") and others, the Commission accepted certain concepts and timetables that were agreed to by the signatories.

However, the subjects on which agreement occurred did not eliminate sufficient risks to justify any reduction of ROE. Although the provisions relating to the Additional Amortizations mechanism should ensure adequate cash flow, the Commission's approval of the Stipulation did not pre-approve or otherwise guarantee ratemaking treatment or cost recovery to KCPL that might argue in favor of an ROE reduction.

There are several points to remember about the Stipulation. A number of parties to this rate case, including the Department of Energy and Trigen, did not sign the Stipulation. They are free to object to anything proposed by KCPL, regardless of the provisions of the Stipulation.

Second, the Additional Amortizations mechanism is only used to maintain short-term cash flow, so that KCPL can continue to meet Standard & Poor's BBB investment grade credit metrics and ratios. See Ex. 3-HC, KCPL's Michael Cline Direct at 3-6. Once an Additional Amortizations amount is approved by the Commission, it serves as an off-set to rate base in future rate cases, thereby reducing KCPL's revenue requirement. Id. at 6. Contrary to OPC witness Michael Gorman's testimony that the regulatory plan "mitigates construction and regulatory risks by Commission review and approval of construction cost budgets and rate treatment after the asset is placed in-service," there is no such assurance in the Stipulation. See Ex. 202-HC, Gorman Rebuttal at 6. As Mr. Gorman admitted on cross-examination, there is nothing in the Stipulation that provides for Commission review and approval of construction amounts or budgets. See Tr. 340.

Although the parties to the Stipulation cannot argue that the infrastructure projects were not necessary or timely, or that alternative technologies or fuel should have been used, there are no limits on the prudence inquiries that any party may make related to the execution of the projects. See Tr. 330-31 (Trippensee), 345-49 (Gorman). See also Ex. 29, Stipulation at 36. There are no restrictions on any party asserting that any amount should or should not be included in rate base or that a cost of service amount should be different. See 349-49 (Gorman). The Stipulation calls for a maximum of four rate cases through 2009. No signatory party to the Stipulation approved of or acquiesced in any question of this Commission's authority over any ratemaking principal, including cost of capital or ROE methodology, cost of service methodology, any cost recovery or prudence principal, or any rate design methodology. See Ex. 29 at 52. The Stipulation and the KCPL Regulatory Plan approved by the Commission "does not constitute a contract with the Commission." Id. at 53. As Mr. Gorman admitted, there are no limits or restrictions upon the Commission's power. See Tr. at 350. It could initiate a complaint case tomorrow or direct Staff to open an investigation on any matter.

Finally, contrary to Mr. Gorman, the Stipulation did not "enhance KCPL['s] credit rating during this construction." See Ex. 202-HC, Gorman Rebuttal at 8, line 5. KCPL's credit rating was not raised as a result of either the Commission's approval of the Stipulation in 2005 or its decision in the 2006 rate case. See Tr. 305-06 (Barnes); Ex. 3-HC, Cline Direct, Sched. MWC-3. To the contrary, it has remained steady at a BBB investment grade rating. The goal of the Additional Amortizations mechanism is simply to maintain the investment-grade rating. See Tr. 271-72 (Hadaway). While the mechanism reduces the bondholders' risks, it does not necessarily reduce the shareholders' risk. Id. at 273.

Dr. Hadaway explained it this way:

> . . . if the [regulatory] plan and the [additional] amortizations maintained financial metrics, cash flow metrics to help the company not to increase its bond rating but to simply keep its bond rating, then that does not necessarily reduce the equity holder's risks because the process itself may reduce the equity holder's earnings, and some of them may view that as an increase in their risk.
>
> . . . if we, as Staff has recommended, substitute lower ROE at a higher amortization, the shareholder's earnings are lower even though the bondholder's metrics are quite sound. [See Tr. 273-74.]

Regarding this tradeoff between bondholder and stockholder interests, Dr. Hadaway was asked what would happen if the Commission chose to award a lower ROE and to rely solely upon the Additional Amortizations to achieve necessary cash flow. He explained that while the risks for both interests would be reduced, there would be only a "very minor" reduction for shareholders. See Tr. 274-76. However, as a result, significant risks and problems would arise on the equity side. Shareholder "earnings would be drastically reduced" (Tr. 278), "the cost of equity would go up very, very significantly" (Tr. 276),[1] and a base ROE well above Dr. Hadaway's midpoint recommendation of 10.75% would be required. See Tr. 279-81.

[1] There is a reporter error at 276, lines 4-8. The passage states: "The reduction to shareholders would be large, reduction in risk to shareholders would be large if the potential is that the bond rating would go below investment grade." The inclusion of the second "reduction in" is a

Because the Stipulation approved by the Commission does not provide any appreciable decreased risk to equity shareholders, no reduction in return on common equity is appropriate.

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?

Dr. Hadaway explained in great detail why a 50 basis point adder to account for KCPL's construction risk is appropriate. He first noted that adders have been regularly used by this Commission over the past few years. See In re Aquila, Inc., Case No. ER-2007-0004 (2007)(10-15 basis point adder); In re Kansas City Power & Light Co., Case No. ER-2006-0314 (2006)(25 basis point adder); In re Empire District Electric Co., Case No. ER-2004-0570 (2005)(30 basis point adder). He further relied upon adders and incentives being expressly permitted by the Federal Energy Regulatory Commission. See "Promoting Transmission Investment through Pricing Reform," Order No. 679, 116 FERC ¶ 61,057 at ¶¶ 92-93, 326-27 (July 20, 2006), on rehearing, Order No. 679-A, 117 FERC ¶ 61,345 at ¶¶ 64-68, 86-88 (Dec. 22, 2006). For example, FERC permitted a 50 basis point adder for utilities that joined regional transmission organization Midwest ISO. Midwest Indep. Trans. Operator, Inc., 100 FERC ¶ 61,292 (2002). See Tr. 263-65, 268-69, 283. Other jurisdictions have statutorily permitted commissions the discretion to implement adders, including in Kansas where the Commission may order a 50 to 200 basis point adder (1/2% to 2%) to encourage renewable resource generation and energy efficiency programs. See K.S.A. 66-117(d).

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mistake. The passage should read simply "… the risk to shareholders would be large …." Dr. Hadaway's position was that the risk to shareholders would be large if KCPL's bond rating went below investment grade. That is consistent with his other statements that the reduction in risk to shareholders "would be very minor to the extent that the bond ratings didn't change." See Tr. 276, lines 3-5. See also Tr. 273, lines 1-7, 14-24 ("in the extreme where the company's investment grade bond rating was lost, then clearly the shareholder's risk would be increased").

A 50 basis point adder is appropriate in this case because of the size of KCPL's construction program. The Iatan 2 super-critical pulverized coal plant, the environmental retrofits to Iatan 1 and LaCyne 1, the wind generation projects in Spearville, Kansas, as well as other programs related to distribution and energy efficiency programs are remarkable when compared to the size of KCPL's current plant. When the 2006 Rate Case was filed, KCPL's expenditures over the next five years equaled 95% of the Company's current net plant. See Ex. 11, Hadaway Direct at 5 and Sched. SCH-1. The average spending relative to net plant of other utilities in Dr. Hadaway's peer group was only 62%.

Even taking into account Mr. Gorman's updated figures, which include certain projects that went into rate base earlier this year, KCPL ranks among the top three American utilities with a construction program of almost 85% of its net plant, compared to 66% for other utilities. See Ex. 202, Gorman Rebuttal at 6-7; Ex. 30 at 2.

Given these various ranges, Dr. Hadaway concluded that a 50 basis point adder "is a conservative estimate of the kind of risk adders investors might expect." See Tr. 265. He elaborated:

> If investors perceive that your construction program is one of the largest in the country, which they certainly do, and if they did the analysis that I did that showed that it was one and a half times as large as the average for this comparable group, then the 50 basis points would be a similar kind of compensation for that additional financing risks. See Tr. 269-70.

Because the Commission's objective should be to send a positive signal to investors so that KCPL can "attract the capital in the most reasonable terms that it can to get this plant built as reasonably priced as it can," a 50 basis point adder is appropriate. See Tr. 268 (Hadaway).

c. An 11.25% return on equity, consisting of a 10.75% base ROE and a 50 basis point adder, should be set by the Commission.

KCPL's recommendation is based upon the testimony of Dr. Hadaway. Two other recommendations were provided. Staff witness Matthew Barnes recommended a range of 9.14% to 10.30%, choosing a midpoint of 9.72%. See Barnes Direct at 3, 20; Staff's Statement of Position at 2. OPC witness Michael Gorman endorsed a range of 9.50% to 10.70%, recommending a midpoint of 10.10%. See Gorman Direct at 30.

An analysis of these different recommendations shows that Dr. Hadaway is the only expert who based his opinions on a more reliable, long-term Constant Growth Discounted Cash Flow ("DCF") Model and on a realistic estimate of inflation and current long-term interest rates. He also properly took into account the construction risks now faced by KCPL and the reasonable expectations of investors who would put their money elsewhere if an above-average ROE were not granted to the Company. Both Staff and OPC recommend below-average ROE's for KCPL.

The parties generally agreed at the hearing that the average ROE granted to electric utilities by state commissions in the last three quarters ending June 30, 2007 was approximately 10.31%. The recommendations of OPC and Staff are, roughly, 20 points and 50 points below that average. See Ex. 121.[2] Additionally, as Chairman Davis pointed out, when the data contained in reports issued by firms like Regulatory Research Associates ("RRA") is examined by sorting out the "T and D utilities" (transmission and distribution-only utilities), the ROE's of those companies are lower, thus, skewing the reported ROE numbers that should be consulted for vertifically-integrated companies like KCPL. Indeed, comparing the ROE's for all utilities in the

[2] Exhibit 121 is a Regulatory Study prepared by Regulatory Research Associates, dated July 3, 2007. The non-weighted average of the fourth quarter of 2006 (10.39%) and the first and second quarters of 2007 (10.27% for each quarter) is 10.31%.

three quarters of 2007, the results are, respectively, 10.27%, 10.27% and 10.02%. When the distribution companies (marked with a “D” in the RRA reports) are discarded, the ROE results are 10.44%, 10.33% and 10.40%. See RRA Special Report (Oct. 3, 2007) at 4.

Why is Staff’s recommendation the lowest? The answer is that Mr. Barnes is the only expert who relied upon the Traditional Constant Growth DCF Model, which was rejected by both Dr. Hadaway and Mr. Gorman. See Tr. 307-08. Dr. Hadaway stated that when he performed the Traditional Constant Growth DCF Model analysis, it indicated a range of only 9.4% to 9.5%, which he excluded because it fell more than 100 basis points below his Risk Premium Model’s check of reasonableness that ranged from 10.72% to 11.4%. See Ex. 11, Hadaway Direct at 35-39. As a result, he relied upon a long-term gross domestic product (“GDP”) Growth Rate DCF Model, as well as a two-stage Growth Rate DCF Model, which yielded ranges from 10.5% to 10.8%. Id. at 33-36, 39.

Similarly, Mr. Gorman used a two-stage DCF Model “because the growth rates used in my Constant Growth Model do not reflect reasonable estimates of sustainable long-term growth.” See Ex. 201, Gorman Direct at 20; Ex. 203 Gorman Surrebuttal at 5-6. As a result, Mr. Barnes’ analysis should be rejected because it is outside the accepted norms of financial analysis.

If Dr. Hadaway and Mr. Gorman used the same kinds of models, why is the Gorman ROE recommendation so much lower than Hadaway’s? The answer is that Mr. Gorman uses an unrealistically low GDP growth rate of 5.1% to predict long-term economic growth. See Ex. 201, Gorman Direct at 21, lines 5-7. This extraordinarily low growth figure is by far the lowest proposed by any expert in the case. In contrast, Dr. Hadaway used a 6.6% growth rate. See Ex. 11, Hadaway Direct at 35 and Sched. SCH-5. Staff used a variety of growth rates, none as low as the Gorman 5.1%. Mr. Barnes utilized a low 5.34% Value Line growth estimate, as well as a

6.37% estimate by IBES (Institutional Brokers' Estimate System) and a 6.50% by Standard & Poor's. See Ex. 105, Barnes Direct at 18 and Sched. 15. Mr. Barnes testified that these three projected earnings per share ("EPS") rates yielded an average projected growth rate of 6.07%, almost 100 points higher than Mr. Gorman's but only a 53 points lower than Dr. Hadaway's 6.6%. Id. at 17-18.

The extremely low nature of Mr. Gorman's 5.1% growth estimate is revealed when the expected growth rates of his utility proxy groups are compared. He rejected average growth rates of 6.31% and 6.70% for both Dr. Hadaway's and his own proxy groups. These represented an average of three sources of ratepayer growth estimates from Zack's, Reuters and SNL Financial. See Ex. 201, Gorman Direct at 14, Sched. MPG-4 and MPG-5. Although he testified that these "estimates had been shown to be more accurate predictors of future returns than growth rates derived from historical data," he subsequently rejected them because they exceeded the reference source that he chose to estimate the growth rate, not of the utility industry, but of the overall U.S. economy. Id. at 14-15. However, that growth rate of 5.1% is even lower than the historical growth rates which both Dr. Hadaway and Mr. Barnes believe are unreasonably low, and which Mr. Gorman himself estimated at 5.5% for the last five years and 5.4% for the last 10 years. Id., Sched. MPG-6. In this regard, Dr. Hadaway's conclusion that Mr. Gorman "forced unreasonably GDP growth [rates] into his version of the two-stage DCF Model" is true. See Ex. 12, Hadaway Rebuttal at 4.

Part of the flaw in the Gorman growth analysis is that he used a projected inflation rate of only 2.1% over the next five and ten years. As Dr. Hadaway testified, according to the GDP Implicit Price Deflator index prepared by the Bureau of Economic Analysis, U.S. Department of Commerce, the average GDP inflation rate has been in the range of 3.1%, 100 basis points higher than the Gorman forecast. See Ex. 13, Hadaway Surrebuttal at 10. Additionally, as Dr. Hadaway noted during the hearing, former Federal Reserve Board Chairman Alan Greenspan has predicted a 4% inflation rate. See Tr. 261. "An inflation rate of 4 to 5 percent is not to be taken lightly -- no one will be happy to see his or her saved dollars lose half their purchasing power in 15 years or so." See A. Greenspan, The Age of Turbulence (2007) at 482. "The 4.5 percent inflation rate … is probably not a bad first approximation of what we will face." Id. Therefore, the 3.2% inflation rate utilized by Dr. Hadaway was the more appropriate estimate. See Ex. 11, Hadaway Direct Sched. 5; Ex. 13, Hadaway Surrebuttal at 10.

Dr. Hadaway also considered recent trends in interest rates, including recent action by the Federal Reserve Board in reducing short-term interest rates. Referring to Ex. 28, he noted that when the Federal Reserve Board made its decision on September 18 to reduce the federal funds rate, the 30-year Treasury bond actually went up five basis points, not down. See Tr. 284-85. Furthermore, utility bond rates are 40 to 50 basis points higher than Treasury rates because corporate securities now have "wider spreads off of treasuries because of all the turbulence … in the capital markets in recent months" compared with "eight months ago." See Tr. 285-86. As a result, any short-term rate cuts by the Federal Reserve Board should have little or no influence on the Commission's ROE decision in this case because the DCF analysis is based on long-term financial metrics.

Finally, the Commission must weigh the credibility of the witnesses in judging their opinions and arriving at an ROE decision. Dr. Hadaway brings to this case the highest level of education, as well as experience. He is the only witness with a doctor of philosophy degree, having earned his Ph.D. in finance and econometrics at the University of Texas at Austin. He is also the only witness who has testified in regulatory proceedings on behalf of investor-owned utilities, as well as regulatory commissions. In response to Chairman Davis's observation that his recommendation of 11.25% in this case was the same as the 11.25% ROE determined in KCPL's 2006 case, Dr. Hadaway candidly remarked:

> Mr. Chairman, I will say honestly to you that if I had thought about that, I think I would have asked the Company to change the recommendation by 5 basis points or something so that the argument didn't come up ....
>
> My ROE went down by 25 basis points from 11% ... to 10.75% because interest rates and interest rate forecasts had gone down a little bit since I prepared ... the prior case. See Tr. 250-51.

Dr. Hadaway explained that the 10.75% base ROE that he recommended in this case is the same 10.75% that he has recommended in at least ten other cases, and that the 50 basis point adder matched his 2006 recommendation. See Tr. 251. His responses clearly indicate that if he had wished to provide the Commission a different number to deprive opponents of a point of cross-examination, he would have done so. However, his honesty and integrity in formulating his recommendations would not permit such sophistry.

Staff witness Mr. Barnes simply does not have the background and experience to be able to compete with Dr. Hadaway. Although he properly expanded his utility company proxy group from five companies in 2006 to 16 in the pending case, his strict adherence to the Traditional Constant Growth DCF Model was at odds with both Dr. Hadaway and Mr. Gorman. Moreover, his rejection of his Capital Asset Pricing Model ("CAPM") results, which would have supported a base ROE of approximately 10.5%, impeached the validity of his analysis. See Ex. 12, Hadaway Rebuttal at 10-11; Ex. 13, Hadaway Surrebuttal at 2.

The credibility of OPC witness Michael Gorman was called into account by his errors in rounding, as well as by his apparent willingness to hear only what he wanted to hear. In response to questions regarding Dr. Hadaway's citation to former Chairman Greenspan's prediction of 4% inflation, Mr. Gorman provided the following response:

> Q. Have you read Alan Greenspan's book yet?
>
> A. I have heard -- no, I haven't read it.
>
> Q. So you don't know what growth rate the former Chairman of the Federal Reserve Board --
>
> A. Well, I heard Dr. Hadaway suggests there's gonna be growth to medical costs, but medical costs is only a small element, albeit a growing element, of the overall economy.
>
> Q. Well, I'm not sure that's what he testified. I think what he stated is that Mr. Greenspan had projected inflation over the next few years to occur at 4%.
>
> A. I'm sorry, but what I heard him to say is Mr. Greenspan has projected inflation based on Medicare and Social Security benefits to be something in the area of 4%. That's what I heard Dr. Hadaway say. See Tr. 370.

However, Dr. Hadaway actually testified:

> Professor Greenspan, in his new book as you may have seen, says that the biggest problem we have is that he expects inflation to be 4%, that we're ignoring the realities of where long term inflation is really gonna go.
>
> His focus is on what's gonna happen to the Medicare system when that happens.
>
> See Tr. 261-62 [emphasis added].

Contrary to what Mr. Gorman thought he heard, Dr. Hadaway stated that what Chairman Greenspan predicted was a 4% inflation rate that could be further exacerbated by current federal fiscal policies. In Greenspan's words, that inflation rate "will hit as a significant proportion" of the population retires on "our federal pay-as-you-go health and retirement system." Because those individuals will no longer be contributing to that system, this phenomenon "could add massively to the demand for economic resources and heighten inflationary pressures." See The

Age of Turbulence at 482.[3] Clearly, the Gorman estimate of an inflation rate of 2.1% over the next ten years is outside the norm and not credible.

Finally, in presenting the Commission with his recommended ROE, Mr. Gorman engaged in a variety of mathematical exercises that were not apparent from the face of his testimony. In his Risk Premium Model, Mr. Gorman analyzed the rates of treasury bonds and utility bonds. The treasury bond yield he utilized was 5.2% and the utility bond yield, 5.4%. But, instead of adding them to arrive at an estimated ROE of 10.6%, he utilized a lower figure of 10.5%. See Tr. 371-72. His explanation: "Well, there's some rounding that goes into that." See Tr. 372.

Furthermore, as he developed his Risk Premium ROE range of 9.8% to 11.3%, he advised the Commission that this "produced a midpoint estimate of 10.5%." See Tr. 372. However, when asked on cross-examination if it was true that using the correct math would have resulted in a midpoint of 10.55% -- 5 basis points higher than his midpoint -- he admitted that he rounded that number down as well. See Tr. 372-73. His only explanation? "That wasn't done intentionally." See Tr. 373. Nonetheless, Mr. Gorman's mathematical roundings, always downward to the detriment of KCPL, raise substantial concerns about his forthrightness with the Commission.

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[3] In The Age of Turbulence at page 482, Chairman Greenspan stated:

> The 4.5 percent inflation rate, on average, for the half century following the abandonment of the gold standard is not necessarily the norm for the future. Nonetheless, it is probably not a bad first approximation of what we will face.
>
> … It will hit as a significant proportion of the nation's highly productive population retires to become recipients of our federal pay-as-you-go health and retirement system, rather than contributors to it. Over time, unless this is addressed, it could add massively to the demand for economic resources and heighten inflationary pressures.
>
> Thus, without a change of policy, a higher rate of inflation can be anticipated in the United States.

Considering all of these facts, Dr. Hadaway's recommendation of a 10.75% base ROE, with a 50 basis point construction risk adder, for a total ROE of 11.25% should be adopted.

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

Based on the True-Up Direct Testimony filed by KCPL's Treasurer and Chief Risk Officer Michael W. Cline, the Company proposes the following capital structure.

Debt	40.93%
Preferred Stock	1.45%
Common Equity	57.62%
Total	100%

This capital structure was calculated from the actual capital structure of KCPL's parent company, Great Plains Energy, Incorporated, as of September 30, 2007. See Cline True-Up Direct at 1-2 and Sched. MWC-8. See also Barnes True-Up Direct at 2. It amends and supplants the earlier capital structure set forth in the testimony of KCPL witness Samuel Hadaway. See Ex. 11, Hadaway Direct at 7.

B. 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?

No. In 1999, a boiler explosion occurred at Hawthorn 5, removing the unit from service until it was rebuilt and returned to service in 2001. See Ex. 108, Hyneman Direct at 4. In 2001, KCPL and its insurers filed suit against twelve defendants to recover costs related to the explosion. Tr. 162, lines 9-12; Ex. 108, Hyneman Direct at 4. In 2003 and 2004, KCPL settled and received settlement payments from all but one of the defendants. Following a jury trial against that defendant in early 2004, the court found in favor of KCPL and its insurers. The defendant appealed that judgment. In 2006, the Missouri Court of Appeals, Western District affirmed the lower court's decision. As a result of that decision, the remaining defendant paid KCPL in 2006. Tr. 162, lines 13-14; Ex. 108, Hyneman Direct at 4. KCPL does not expect to receive any additional subrogation proceeds. Tr. 176, lines 16-18. These facts are undisputed.

Similar to the Department of Energy nuclear fuel refund issue discussed below, although KCPL happened to receive the subrogation proceeds in 2006, these proceeds have nothing to do with the test year in this case. Nor do they pertain to or reflect in any way KCPL's ongoing operations. Staff witness Charles Hyneman acknowledged: "If the proceeds were received in 2005 or after the September 30, 2007, true-up date in this case, the Staff would agree with [KCPL and not seek to include those proceeds in this case]." Ex. 108, Hyneman Surrebuttal at 8-9. The pace of the litigation process is solely responsible for KCPL receiving the payment in 2006. Tr. 131, lines 9-15. As such, it is inappropriate to include the proceeds in this case.

Furthermore, KCPL's customers did not pay any of the costs that the subrogation proceeds were intended to recover. KCPL's customers did not pay for the Hawthorn 5 clean up. They did not pay for the replacement power KCPL had to purchase during the outage. And, they did not pay for rebuilding Hawthorn 5. KCPL did not have a fuel adjustment clause that would have recovered replacement power costs. Ex. 9, Giles Rebuttal at 3. KCPL did not request an accounting authority order concerning those costs, nor did it file a request to amortize those costs in any way. Tr. at 175, lines 18-22. KCPL did not seek to increase its rates during the period. Tr. 88, lines 10-12. In fact, KCPL did not request a rate increase until 2006. Tr. 174, lines 20-22. These facts are also undisputed.

Staff argues that the subrogation proceeds should be included in KCPL's cost of service in this case because KCPL "did not demonstrate" that "it was not earning a reasonable rate of return" during the 1999-2001 outage. Tr. 177, lines 21-23. The only evidence in the record concerning the adequacy of KCPL's earnings during the 1999-2001 outage is the following testimony from Mr. Giles: "The two years where we really struggled were '99, 2000 and part of 2001." Tr. 90, lines 21-22.

Even if the record contained more specific information, it would be inappropriate for the Commission to look to KCPL's earnings during the 1999-2001 outage to determine what is appropriate to include in KCPL's 2006 test year in this case. To do so is the very definition of retroactive ratemaking. For Staff's argument to prevail, the Commission would have "to determine what a reasonable rate would have been" during the 1999-2001 outage and set prospective rates accordingly. Utility Consumers Council of Missouri, Inc. v. PSC, 585 S.W.2d 41, 58 (Mo. 1979) (emphasis in original). Such retroactive ratemaking is prohibited.

Staff also argues that because KCPL did not file a rate case until 2006, the cost of operating Hawthorn 5 remained in KCPL's rates during the 1999 – 2001 outage, and that such inclusion was somehow tantamount to a windfall for KCPL. However, as testified to by Mr. Giles, KCPL "incurred about $150 million in purchase power expense above what would have normally been incurred had Hawthorn been operating." Tr. 161, lines 22-25. As a result of these expenses and other expenses related to the explosion, "the expenses associated with Hawthorn 5 outage exceed[ed] those costs that were included [in KCPL's rates for operating Hawthorn 5 at the time of the outage.]" Tr. 168, lines 12-15; Tr. 128, lines 12-16.

It is no more appropriate to include the subrogation proceeds in the present case than it would be for KCPL to attempt in this case to recover the purchased power and other expenses that it incurred as a result of the outage that were greater than the Hawthorn 5 costs included in the Company's rates.

Staff seeks to include the subrogation proceeds KCPL received in 2006 in its cost of service in this case because KCPL happened to receive those proceeds during the test year and because (i) KCPL has not demonstrated that it was under-earning during the 1999-2001 outage and (ii) KCPL's rates during the outage included the cost of operating Hawthorn 5. Staff's rationale fails for several reasons. First, the timing of KCPL's receipt of the litigated portion of the subrogation proceeds is happenstance. It is simply the result of the timing of protracted litigation. Most importantly, the proceeds have nothing to do with KCPL's on-going operations. Tr. 131, lines 9-15. Second, to consider KCPL's earnings during the 1999-2001 outage, as Staff would have the Commission do, constitutes retroactive ratemaking, which is prohibited. Finally, even though KCPL's rates during the outage included the cost of operating Hawthorn 5, KCPL's losses, which the subrogation proceeds are intended to recover, were in excess of those proceeds. Consequently, the Commission should not include the subrogation proceeds in KCPL's cost of service in this case.

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

It is inappropriate to include the Hawthorn 5 subrogation proceeds in KCPL's cost of service in this case. Doing so through an amortization does not change this fact. The purpose of amortization of non-recurring or unusual expenses is to provide recovery of prudently incurred costs over time. Had the Company requested and the Commission granted amortization of the costs of replacement power during the Hawthorn 5 outage and had those costs been reflected in KCPL's rates, it would be appropriate to amortize the subrogation proceeds for purposes of setting rates. However, the Company did not amortize these costs and did not collect these costs in rates. Consequently, amortizing the proceeds does not alter the fact that it would be inappropriate to include them in KCPL's cost of service.

4. 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?

Yes. See the discussion below for Issue 5 which relates to both Long-term and Short-term Incentive Compensation.

5. Short-Term Executive 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?

Yes. In this proceeding, Staff and DOE have recommended the disallowance of both long-term and short-term incentive compensation. Staff and DOE are recommending a 100% disallowance of long-term executive compensation (i.e., $1,314,185)(Tr. 181-82); the portion of short-term executive compensation (i.e., $677,327) that is tied to EPS; and the 20% portion which is a discretionary payment tied to achievement of individual goals. Ex. 113, Traxler Surrebuttal, pp. 21-22; Ex. 802, Dittmer Direct, p 10.

According to Mr. Traxler, the Staff is not recommending that GPE and KCPL restructure their incentive compensation plans to eliminate goals related to EPS. See Ex. 113, Traxler Surrebuttal at 22. However, Staff believes that these costs should be assigned to shareholders, rather than recovered from ratepayers. Id. at 22-23. For the reasons stated below, the disallowances of Staff and DOE on incentive compensation should be rejected.

KCPL witness Michael Halloran, a consultant with Mercer Human Resource Consulting, testified that the use of short-term and long-term incentives are powerful tools to benefit both customers and shareholders. The use of financial measures is a very effective way to reflect performance on a broad range of customer service measures. In particular, a program that focuses on the achievement of EPS is beneficial for customers and shareholders. Ex. 14, Halloran Rebuttal, pp. 3-5.

As Mr. Halloran explained, EPS is a measure related to funds from operations ("FFO") and operating income. These are principal indices of performance for investor-owned entities like KCPL. Because KCPL is a regulated public utility, the organization is committed to its responsibility to achieve its EPS through the provision of efficient, clean, safe and affordable electricity. Therefore, EPS is an important measure of performance and productivity in areas related to product and service delivery. In addition, the Company's incentive plans are based upon individual performance factors relating to the specific employee's responsibilities and contribution to achieving divisional and overall performance objectives. Id. at 3.

Stronger financial performance through improvements in EPS provides additional cash, allowing the Company to invest in ongoing maintenance and upgrading of facilities, which ensures a steady, reliable, low cost supply of electricity to the customer. As Mr. Halloran testified, the use of incentive compensation to focus the management team on the achievement of EPS goals, as well as individual performance goals is a wise and appropriate investment in the business. KCPL believes that incentive compensation that is based on the financial goals tied to EPS is appropriate because a financially sound and stable company provides a direct benefit to all stakeholders, including employees, customers, shareholders and the community in which it operates. Ex. 14, Halloran Rebuttal, p. 3.

For these reasons, KCPL respectfully requests that the Commission reject the disallowances proposed by Staff and DOE related to short-term and long-term incentive compensation.

6. Talent Assessment Program Employee Severance Cost: 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?

Yes. There is a fundamental difference in management philosophy between KCPL and Staff that is reflected in the disparate approaches to the Talent Assessment Program issue in this case. KCPL strongly believes that public utility management should assess its employees to determine if they have the skills, ability, and desire to assist the Company in reaching its strategic objectives, even if it is already providing "safe and adequate" service. KCPL believes that the Talent Assessment Program is a legitimate and necessary business program designed to meet rising performance expectations *in the future*. <u>See</u> Ex. 2, Cheatum Rebuttal, p. 6.

Staff, on the other hand, is taking that position that <u>it is not necessary</u> for KCPL to have a Talent Assessment Program to assess its workforce's skills, abilities, and desires to meet the future needs of the Company and its customers <u>since KCPL is already providing safe and adequate service</u>, and that the costs of the Talent Assessment Program should not be included in rates as a reasonable cost of achieving a level of improved service for the future. (Tr. 473-75). Staff's suggested approach is short-sighted, not in the interest of KCPL's customers, and should be rejected by the Commission.

KCPL has incurred two distinct sets of severance costs during the test period. The first set is severance payments, outplacement service costs, and payroll taxes of 119 employees who left the Company as a result of KCPL's Talent Assessment Program. The purpose of the Talent Assessment Program was to determine if management employees (*i.e.*, employees who are not subject to a collective bargaining agreement) had the skills, ability, and desire to assist the Company is reaching its strategic objectives. Ex. 2, Cheatum Rebuttal at 2-3.

In the fall of 2005, management employees were identified under this program as "Role Models," "Well Placed," or "Not Keeping Pace." Employees identified as "Not Keeping Pace" were given the following options: (i) These employees could attempt to improve any shortcomings identified during the Talent Assessment Program; or (ii) they could voluntarily separate their employment with the Company. Employees who improved their performance and "closed the gap" could either continue their employment or voluntarily separate from KCPL. Id. at 3.

Numerous employees improved their performance and were retained by the Company. Employees who did not improve their performance either voluntarily left their employment, or were involuntarily separated effective on or before March 31, 2006. All employees identified as "Not Keeping Pace" were given the opportunity to receive severance payments under this program. The Company proposed that the costs associated with these severance payments (*i.e.*, $8,960,783)(Tr. 513) be deferred in a regulatory asset and amortized over a five-year period. Ex. 2, Cheatum Rebuttal at 4.

Staff witness Hyneman (Ex. 108, Hyneman Direct, p. 7) has proposed that the Company's severance payments related to the Talent Assessment Program be disallowed in their entirety. Mr. Hyneman supported his position with the following arguments:

(1) There is no evidence that KCPL was not providing safe and adequate service with the employee base that existed prior to the talent assessment severance program. Therefore, there is no evidence that this cost was necessary for KCPL to meet its service obligation.

(2) There is no evidence that the costs of this talent assessment program have yet or will ever provide any benefit to KCPL's customers;

(3) KCPL's management is responsible for the hiring of employees and training of employees. If the employees who were terminated under this program did not meet KCPL's management's performance expectations, then KCPL's management should bear the primary responsibility for this result.

(4) Severance costs of the talent assessment program were removed from KCPL's 2006 earnings in the determination of KCPL's management incentive compensation.

Lora Cheatum, KCPL's Vice-President, Administrative Services, addressed each of Mr. Hyneman's concerns. Ex. 2, Cheatum Rebuttal, pp. 4-6. With regard to his first point, KCPL agrees that safe and adequate service was being provided prior to the Talent Assessment Program, but that is not a reasonable standard to evaluate the proper recovery of the costs of the program. Contrary to the approach being suggested by Staff, KCPL believes that public utilities should be encouraged to improve service to its customers, and not merely be satisfied with a minimum level of service.

With regard to customer benefits of the program, KCPL has achieved Tier 1 status in overall residential customer satisfaction in comparison to other midwest utilities. Mr. Hyneman confirmed that KCPL's ranking among midwestern public utilities rose from 8th to 4th out of 16 public utilities surveyed by J.D. Powers and Associates from 2006 to 2007.[4] Ex. 109, Hyneman Surrebuttal, p. 17; Tr. 468. In addition, KCPL was awarded the Edison Award in 2007 which is a prestigious industry commendation for commitments to operational excellence, reliability, and innovation in the generation and delivery of electricity to customers. (Tr. 470-71). In fact, Staff has been monitoring KCPL's call center performance and its overall reliability indices, and Staff has not identified any long-term trends in this data that should cause concern for the Commission. (Tr. 456). During his testimony at the hearings, Mr. Hyneman conceded that

[4] In 2007, a total of 29,042 telephone interviews were conducted by J.P. Powers measuring 48 satisfaction attributes within the following six components: Power Quality & Reliability, Company Image, Price & Value, Communications, Billing & Payment, and Customer Service. Ex. 109, Hyneman Surrebuttal, p. 17. KCPL ranked 4th among the 16 public utilities surveyed in 2007.

KCPL has been "exemplary" and "performing well as a regulated utility." (Tr. 502.) He also confirmed that "KCPL over the past several years has won many, many awards" for its performance level. (Tr. 470-71).

The Talent Assessment Program allowed KCPL to ensure that the Company had the right people with the right skills in the right roles for the future. Such management of its workforce allows KCPL to be more cost-effective in the long run and to keep customer rates at reasonable levels.

KCPL also agrees with Staff that management is responsible for hiring and training its employees, but it is incorrect to suggest, as Mr. Hyneman does, that the employees who were terminated under the Talent Assessment Program did not meet KCPL's performance expectations. Ex. 2, Cheatum Rebuttal, pp. 5-6. The real issue was whether these employees would be able to meet KCPL's rising performance expectations in the future. Id. Each employee had the opportunity to demonstrate that they could and would meet future expectations or accept a voluntary separation and leave the Company. This program demonstrates that KCPL's management is taking full responsibility to manage its work force to continue to provide reliable energy at a reasonable cost. Id. at 6.

Finally, the Company's treatment of this program in its incentive compensation plan has no bearing upon the legitimacy of this program to benefit the Company and its customers. In fact, Staff does not appear to question that the Talent Assessment Program was incurred for a valid business reason.

In summary, KCPL believes that its Talent Assessment Program was a reasonable and prudent management tool for determining if its workforce had the skills, ability, and desire to assist the Company in reaching its strategic objectives in the future. KCPL's performance levels have improved and been recognized nationally. Nevertheless, the Company wants to continue to improve its service and reliability to its customers. The Talent Assessment Program is one fundamental management program that has provided tangible benefits to KCPL's customers. The Company respectfully requests that the costs of its Talent Assessment Program be included in cost-of-service in this proceeding.

a. If so, should the costs be recognized in cost-of-service using KCPL's proposed deferral and amortization to expense over five years?

Yes. Recognizing that the Talent Assessment Program is a special program designed to ensure that KCPL has skilled, productive, customer-focused employees in place for the future, the Company proposed that these costs be amortized over a five-year period to reflect the fact that there will be benefits that extend over several years, and that the program costs will not recur annually.

KCPL respectfully requests that the Commission allow the recovery of the severance payments, out-placement services, and other payroll taxes related to the Talent Assessment Program, and amortize them over a 5-year period. Id. at 7. This type of program clearly reflects a pro-active management that is concerned about ensuring that KCPL continues to provide the excellent level of service to customers that it has achieved in the past. KCPL's goal was and continues to be to ensure it has the employees with the knowledge, skills, ability, and desire to run an operationally excellent, cost-effective, customer-focused reliable utility. Id. at 7. KCPL believes that it has largely achieved this goal in the past, but it must pro-actively manage its workforce to ensure its excellent record in the past continues into the future.

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?

Yes. As explained by KCPL witness Cheatum, KCPL incurs routine and recurring severance costs due to changing job requirements, corporate reorganizations, and downsizing. Severance payments are a helpful and legitimate business tool to ensure that the Company has the human capital capable of delivering reliable service at reasonable prices. These costs should be included in rates since they are necessary in order to hire and retain the employees to implement the Company's strategic goals and to continue to achieve Tier I level performance for cost, reliability and customer service. <u>See</u> Ex. 2, Cheatum Rebuttal, p. 11.

Staff has not taken the position that severance payments by public utilities are never a legitimate business expense. (Tr. 474) As explained by Mr. Hyneman, "the Staff has allowed recovery of severance costs when a company can demonstrate that the employee reorganization or downsizing that caused an incurrence of severance costs will result in future payroll savings and that the utility has not recovered the affected employees' payroll costs (after being severed) in utility rates." Ex. 108, Hyneman Direct, p. 8. The Staff's standard for including such rates is not appropriate for an expanding company such as KCPL that is in the midst of a $1.3 billion construction program contemplated by the Regulatory Plan. KCPL cannot be expected to "downsize" its future payroll costs under these circumstances, but it should be permitted to utilize severance payments to better position the workforce for the expected tasks of the new undertakings envisioned in the Regulatory Plan.

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

Yes. KCPL is requesting that a three-year average of severance payment amounts be included in the revenue requirement as representative of its ongoing level of severance costs.

The Commission should reject Staff's position that such severance costs are not recurring costs since KCPL incurs such costs every year, and KCPL is requesting only a representative amount be included based upon a three-year average of these routine severance payments. These costs are a recurring, necessary cost of business that allows the Company to hire and retain employees to implement the Company's strategic goals and to achieve high levels of reliability and customer service. It is therefore appropriate that such severance payments be included in the Company's cost of service in this proceeding.

8. Cost-of-Removal Income Tax: Should the tax timing difference for cost-of-removal be reflected under normalization accounting or flow-through accounting for pre-1981 vintage property for purposes of determining income tax expense in KCPL's cost-of-service for this case?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

9. Organization Membership Dues: What level of membership dues that KCPL paid to organizations should be included in cost-of-service for setting KCPL's rates?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

10. Advertising Costs: What level of KCPL's advertising costs should be included in KCPL's cost-of-service for setting KCPL's rates?

KCPL accepts Staff's position on this issue, as set forth in the Surrebuttal Testimony of Staff witness Graham A. Vesely. Mr. Vesely recommended that "the reclassified advertising costs described by [KCPL witness] Mr. Spielberger be allowed in rates, but amortized over a two-year period, consistent with the amortization period ordered by the Commission for all rate case related expenses in previous Case No. ER-2006-0314." Ex. 115, Vesely Surrebuttal at 3-4. The reclassified costs of Mr. Spielberger referred to by Mr. Vesely indicates that Staff's proposal to disallow $644,996 (total company basis) should be reduced to a disallowance of $154,799. Spielberger Rebuttal at 5.

Only Staff and KCPL offered pre-filed testimony concerning this issue. There was no testimony offered at the evidentiary hearing concerning this issue. Moreover, only Staff and KCPL offered a statement of position on this issue. Consequently, to the extent Commission action is required, it should adopt Mr. Vesely's Surrebuttal Testimony recommendation regarding the inclusion and treatment of advertising costs in KCPL's rates.

11. Washington Employee Costs: Should any level of costs associated with KCPL's Washington, D.C. employee who represents KCPL in federal matters be included in KCPL's cost-of-service for setting KCPL's rates?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

12. KCPL Supplemental Executive Retirement Pension (SERP) costs: What level of SERP costs should be included in KCPL's cost-of-service for setting KCPL's rates?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

13. Meal Expenses: What level of local meal expense should be included in KCPL's cost-of-service for setting KCPL's rates?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

14. Off-System Sales Margin: 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?

a. KCPL's rates for non-firm off-system sales margin should continue to be set at the 25% Level as projected, not at the 40% level proposed by OPC.

The Commission should continue to set rates for non-firm off-system sales ("OSS") margin or profits at the 25% Level, as advocated by KCPL and as agreed to by Staff. This would continue the policy set in the 2006 Rate Case. There the Commission properly determined that the risk and volatility of the wholesale off-system electricity market required that OSS margin rates be set in a manner that cautiously evaluated KCPL's prospects of making such sales, in light of the ongoing plant and infrastructure construction program.

To the extent that KCPL does make sales in excess of the 25% Level, those margins will be credited to ratepayers in a future rate case, just as the Commission determined in the 2006 Rate Case.

KCPL's Chris Giles testified that the Commission properly set rates at this level in 2006, in light of the risks facing the Company from the volatile market into which it sells energy and capacity not needed to serve native load. See Ex. 8, Giles Direct at 9-12. Because prices in the marketplace have continued to decline in 2007, Mr. Giles testified that it will be a significant challenge for the Company to reach even the 25% Level this year. See Ex. 9, Giles Rebuttal at 12; Tr. 533-34. Details of the highly confidential revenue figures and the Company's projections were discussed in the *in camera* session conducted on October 3, 2007. See In-Camera Proceedings, Vol. 8, Tr. 537-57. Data reflecting KCPL's OSS margin through August 2007 is reflected in Exhibit 35-HC which was discussed during that *in camera* session. The data represents "total company" gross margin, not just Missouri margin. See Tr. 554-55, 573-75.

Staff concurred in this approach, determining that in light of the Commission's 2006 Order, it would accept OSS margin rates being set at the 25% Level. See Ex. 113, Traxler Rebuttal at 2-3. During the hearing Mr. Traxler stated that if the figures in Exhibit 35-HC were accurate, "then certainly the 25^{th} percentile is in the ballpark and can be justified for purposes of a continuation." See Tr. 581. While the use of projected data to formulate rates differs from the Staff's typical use of historical data (Tr. 578-79), he clarified that the Commission had used forecasted fuel prices in setting rates in the 1980's for electric companies, including KCPL. See Tr. 607.

The only other party offering an opinion on this issue was OPC, which advocated that rates for OSS margin be set at the 40% Level. OPC witness Ted Robertson acknowledged that his position was at odds with both the Company and Staff (Tr. 614-15). He did not accept the data contained in Exhibit 35-HC, which showed the difficulty KCPL has encountered during 2007 in trying to reach the 25% Level. See Tr. 616-17. Given his testimony that the OPC 40% recommendation was based on information provided by KCPL (Tr. 628), the inescapable conclusion is that the Commission should continue to set OSS margins at the 25% Level because the most recent available data demonstrates that OSS margins will barely hit the 25% Level. Indeed, Mr. Giles testified that had OSS margin rates not been set at the 25% Level in the 2006 Rate Case, it is likely that the Company would not have been able to meet its credit metrics and would have seen its financial credit ratings downgraded. See Tr. 540-41.

The Commission should continue to use projected data for setting rates relating to OSS margins and accept the analysis provided by KCPL witness Michael Schnitzer. See Ex. 22, Schnitzer Direct at 2-4. The price swings in natural gas which heavily influence the price of non-firm wholesale electricity sales have continued in 2007. Id. at 6-7; Ex. 23, Schnitzer Surrebuttal at 3-4. Given these variables and the risks that would otherwise be posed by a normalized or historical setting of rates or choosing a higher projected level, as advocated by OPC, the Commission should reaffirm the decision it made in 2006. Particularly in light of the Commission's directive that KCPL not be permitted to use a regulatory asset mechanism for sales up to the 25th percentile, KCPL would continue to book any amounts above the 25% Level as a regulatory liability. Such amounts would flow back to ratepayers in a future rate case. See

Order regarding Motions for Rehearing, In re Kansas City Power & Light Co., No. ER-2006-0314 (Jan. 18, 2007).

Affirmation of this decision, now concurred in by Staff, will provide KCPL with sufficient incentives to reach the 25% Level, yet afford the Company sufficient protection during the current period of market volatility and utility plant construction projects.

b. Interest should be calculated and flowed back to ratepayers on OSS margin that exceeds the 25% Level approved in the 2006 Rate Case.

Although KCPL opposed such a process of interest calculation and flow-back to ratepayers in its pre-hearing Statement of Position, the Company indicated at the hearing that it would be appropriate to pay interest on the amount of off-system sales that exceeded the 25% Level.

Mr. Giles testified that the Company would agree to pay a short-term interest rate on such amounts, consisting of LIBOR (London Interbank Offered Rate) plus 32 basis points. See Tr. 516. Additionally, any such interest paid to ratepayers would not be included in the Company's cost of service. Id. at 516-17.

Although KCPL did not present a specific proposal in writing, Mr. Giles testified in detail that interest on such excess amounts should be tracked on a monthly basis and that the excess should be flowed back to ratepayers in a subsequent rate case. See Tr. 518-22.

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

No. The U.S. Department of Energy ("DOE") overcharged KCPL for uranium enrichment services from 1986 until 1993. See Ex. 109, Hyneman Surrebuttal at 12; Tr. 655, lines 7-11. KCPL filed a lawsuit in 2004 against DOE to recover the amount KCPL was overcharged. The lawsuit ultimately settled, and as a result, KCPL accrued $427,150 in 2006. See Ex. 109, Hyneman Surrebuttal at 12. These facts are undisputed.

Similar to the Hawthorn 5 subrogation proceeds issue, although KCPL happened to receive the refund from DOE in 2006, the refund has nothing to do with the test year in this case. Nor does it pertain to or reflect KCPL's ongoing operations. Staff witness Hyneman acknowledged that "the only tie to the test year in this case is that KCPL happened to receive the refund in 2006." Tr. 658, lines 17-19. Mr. Hyneman also conceded that if the matter had settled quickly and KCPL had received the refund in 2004 when it filed suit, he would not have proposed to include the refund in KCPL's rates in this case. Tr. 656, lines 9-13. The refund KCPL received from DOE represents an unusual non-recurring event. The refund does not reflect the ongoing operating characteristics or cost of service of the Company. Consequently, it should not be included in KCPL's cost of service in this case.

It would be no more appropriate to include the refund in the present case than it would be for KCPL to attempt to reach back to include the overcharges in rates had DOE not issued the refund. In either case, the inclusion would constitute retroactive ratemaking. In Utility Consumers Council of Missouri, Inc. v. PSC, 585 S.W.2d 41, 59 (Mo. 1979), the Supreme Court defined retroactive ratemaking as "the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match expenses plus rate-of-return with the rate actually established." For Staff's position to prevail, the Commission would have to determine that KCPL had excess profits between 1986 and 1993 and conclude that KCPL should, in essence, refund those alleged profits in this case by including the settlement in its cost of service. Such retroactive ratemaking is prohibited.

In addition, there is no indication that KCPL's customers paid for the overcharges that were refunded. During the period of the overcharges, *i.e.*, 1986 to 1993, KCPL did not seek any rate increases, and KCPL's base rates did not increase, KCPL did not have a fuel adjustment charge in place, and KCPL did not seek an accounting authority order concerning the overcharges. Tr. 656, lines 16-25; 657, lines 102. Nor did Commission Staff file a complaint against KCPL alleging overearnings during this period.

For the foregoing reasons, it would be inappropriate for the Commission to include the refunds KCPL received from DOE for overcharges that occurred between 1986 and 1993 in KCPL's cost of service in this case.

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

It is inappropriate to include the DOE refunds in KCPL's cost of service. Amortizing those costs does not cure the impropriety. The purpose of amortizing non-recurring or unusual expenses is to provide recovery of prudently incurred costs over time. The refund relates to costs KCPL incurred, but did not recover, from 1986 until 1993. That fact that a portion of those costs happened to be refunded in 2006 does not justify including them in the test year in this case. Although amortizing the refund may reduce the adverse impact on the Company, it does not change the fact that it is inappropriate to include the refund in KCPL's cost of service.

16. Research and Development Tax Credits: Should research and development tax credits related to amended income tax returns for years 2000 to 2004 be deferred and amortized in KCPL's cost-of-service for setting KCPL's rates if received in the future?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

17. Bad Debt Expense: What bad debt expense factor should be applied to both adjusted and pro-forma revenues to determine the level of bad debt expense to be included in cost of service?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

18. Wolf Creek Refueling Outage Costs: Should the Commission order KCPL to reflect Wolf Creek refueling outage costs under the defer-and-amortize method adopted by KCPL in 2006 in accordance with a new accounting pronouncement or order KCPL to maintain its accounting for regulatory purposes under the prior accrue-in advance method?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

C. Rate Base Issues

19. Rate Case Expense: Should KCPL's rate case expense deferred for future amortization in accordance with the Commission's order in Case No. ER-2006-0314 be included in KCPL's rate base?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

20. Surface Transportation Board Litigation Expenses: Should KCPL's Surface Transportation Board litigation expenses deferred for future amortization in accordance with the Commission's order in Case No. ER-2006-0314 be included in KCPL's rate base?

This issue has been settled and is addressed in the Stipulation and Agreement filed on October 3, 2007 by Staff and KCPL.

D. Class Cost Of Service / Rate Design

Introduction and Overview of KCPL's Position

The Stipulation approved by the Commission in Case No. EO-2005-0329 ("Regulatory Plan Stipulation") laid out the regulatory roadmap for four possible KCPL rate cases. In Rate Case #1 (which was the 2006 Rate Case, Case No. ER-2006-0314), KCPL agreed to file a Class

Cost of Service Study, including certain specifically agreed upon requirements that were contained in Appendix I to the Regulatory Plan Stipulation.

Rate design was a hotly contested issue in the 2006 Rate Case. There were issues related to allocation of production capacity, transmission costs, allocation of distribution costs, allocation of margins for off-system sales, and the computation of coincident peak demands and line losses. In that case, various parties also disagreed about what revenue adjustments among the classes should be implemented, and what percentage increases should be assigned to each class.

The List of Issues in the 2006 Rate Case also contained issues related to the Availability of General Service Space-Heating Rates that are very similar to the issues being raised again by Trigen in this proceeding. With the exception of the Trigen issues which were fully resolved by the Commission in the Report & Order in the 2006 Rate Case, the remaining rate design issues were resolved by a settlement. The Signatory Parties agreed to overall class revenue responsibilities on a revenue-neutral basis that had the effect of increasing the residential class rates by about 2%, decreasing small, medium, and large general service class rates, and decreasing the large power service class rates by 2.54%.

As a part of the rate design settlement in the 2006 Rate Case, the Signatory Parties agreed that the General Service Space Heating and All-Electric Winter Rates would be increased by 5 percentage points more than each class's general application rates. This agreement reduced the difference between the All-Electric rates and other general service rates.

In addition, the Commission resolved the other All-Electric rate issues raised by Trigen in favor of the position espoused by Staff and KCPL. Trigen has appealed that order, but no decision has been issued by the Cole County Circuit Court.

Rate Case Filing #2 (2007 Rate Case)

KCPL was surprised when the rate structure issue became a major issue in this proceeding, Rate Case #2. KCPL believed that the rate structure issues were resolved because of the agreements of the parties in the Regulatory Plan Stipulation related to Rate Case #2 (2007) and Rate Case #3 (2008). KCPL believed that the signatory parties to the 2005 Stipulation had agreed not to re-litigate rate design after the Commission resolved the issues in the 2006 Rate Case.

In the Regulatory Plan Stipulation, the signatory parties agreed to the following with regard to this case, Rate Filing #2 (2007 Rate Case):

> "Rate Design. The Signatory Parties agree not to file new or updated class cost of service studies or to propose changes to rate structures in Rate Filing #2." [See Stipulation, Section III(B)(3)(b)(iv), p. 35.]

As KCPL witness Tim Rush explained in his testimony: It is the Company's opinion that anything other than an equal shift in rates uniformly to all classes does not comply with the provisions of the Stipulation. See Ex. 20, Rush Rebuttal at 2. The Office of the Public Counsel also concurs with the position that any increase should be allocated on an equal percentage, across the board basis in this case.

The same identical provision is included in the Stipulation as relates to Rate Filing #3 (2008 Rate Case):

> The Signatory Parties agree not to file new or updated class cost of service studies or to propose changes to rate structures in Rate Filing # 3. [See Stipulation, Section III(B)(3)(c)(iv), p. 39.]

Since the language related to rate design in the 2005 Stipulation is the same for both this case and the next case, Rate Filing #3, the Commission's decision on whether the Signatory Parties may propose rate design changes under the Stipulation will also have an impact upon whether the Commission and the parties will have to go through another round of rate design hearings in the 2008 Rate Case.

From KCPL's perspective, it is clear that the signatory parties agreed not to file new or updated class cost of service studies or to propose changes in rate structure in both the 2007 and 2008 cases. There are good public policy reasons for taking this approach. All the parties in the 2006 Rate Case carefully considered the results of the various Class Cost of Service Studies, and the Commission made appropriate rate structure changes based upon those class cost of service studies--changes that all of the signatories parties to the Rate Design Stipulation agreed to in the 2006 Rate Case.

Rate design cases are a huge amount of work for everyone, and KCPL believes that it is a waste of resources for the Commission and the parties to go through that process every year when there are not dramatic changes in the underlying costs. Unless there is a major change in the underlying cost structures, such as will occur when Iatan 2 comes into rate base in 2010, it is unnecessary for the Commission to continually readjust the rate design.

An Equal Percentage Increase Is Appropriate In This Case

Even if the Commission decides that the Signatory Parties to the Regulatory Plan Stipulation are not precluded from advocating changes in rate design in this case, the Commission has the clear discretion to allocate the rate increase on an across-the-board basis, as advocated by OPC and KCPL. The Company believes an across-the-board percentage increase is the appropriate decision in this case. The Commission may review more dramatic changes in rate design or rate structure in future cases when the parties present class cost of service studies, and all parties are on notice that rate design will be an issue to be considered.

Large Power Service Class

Mr. Brubaker, on behalf of Ford, Praxair, and MIEC, has sponsored a proposal which will benefit the highest load factor customers in the LPS class, while increasing the cost above the average for the lower factor customers in the LPS class. If Mr. Brubaker's proposal is adopted, then KCPL will not collect all the revenues as a result of this proposed revenue shift. An adjustment would need to be made to increase the LPS customers to account for this lost revenue. Mr. Brubaker agreed that such an adjustment would be appropriate. See Ex.. 602, Brubaker Surrebuttal at 6. On a revenue-neutral basis, the impact of Mr. Brubaker's proposal would be to increase some customers' bills by as much as 6%, and reduce other customers' bills by as much as 9%. See Ex. 20, Rush Rebuttal at 2-4.

Mr. Brubaker's proposal is to decrease the per Kwh energy rate by one cent ($0.01), and to increase the demand charge by the resulting revenue reduction. See Ex. 601, Brubaker Direct at 2. He suggests a tail block rate for the LPS Class of approximately 1.4 cents per KWH annually. KCPL believes that this proposed rate for the tail block is too low. In comparison to the 1.4 cents proposed by Ford and Praxair, KCPL's incremental energy cost reflected in its recent parallel generation tariff is 2.4 cents per KWH. KCPL also believes the Commission should carefully consider the customer impacts of the Ford/Praxair proposal.

Trigen's Issues

Trigen is again recommending that the General Service All-Electric rates and separately metered Space Heating rates be increased by more than the system average increase that is granted in this case. The Company's General Service All-Electric rates and the separately metered Space Heating rates were increased by 5% more than the system average in the 2006 Rate Case, by agreement of all the parties. There is no similar agreement in this case, and KCPL is opposed to allowing Trigen to take another bite out of the apple in this case.

The elimination or phasing out of All-Electric rates would clearly be a change in rate structure, even under Staff's definition of "rate structure" (Tr. 1030). KCPL believes that Trigen is recommending this rate structure proposal to further its own narrow economic and competitive interests by limiting, modifying or discontinuing the All-Electric and Space-Heating rates. Ex. 21, Rush Surrebuttal at 8.

As the Commission's decision in the 2006 Rate Case noted, KCPL's General Service rate design has been in place for many years with the approval of the Commission. See Report & Order, Case No. ER-2006-0314, pp. 82-83. As a matter of fact, in 1996 when KCPL completed its last major rate design case, Trigen agreed to support and endorse before the Commission the Stipulation Agreement that implemented that rate structure, including the All-Electric rates. See Ex. 20, Rush Rebuttal, Sched. TMR-4.

No party to this case has presented competent and substantial evidence (including a cost of service study) that would justify the elimination or phase-out of the Commission-approved rate structure, including the All-Electric rates. If the Commission is going to approve a dramatic change in the rate structure as suggested by Trigen, it should only be done when there is a comprehensive cost of service study and in the context of an overall review of the Company's rate design.

Another issue that was addressed by the Commission in the 2006 Rate Case is Trigen's proposal here to restrict the availability of the All-Electric tariffs to KCPL's existing customers at locations currently being served by such tariffs. The Commission ruled against Trigen on this issue in that case, and should not reverse itself now.

One of the most significant effects of Trigen's proposal is the likely increase in rates for all other customers that would result if Trigen's position is adopted. By limiting, restricting, or curtailing the applications of electric heating, customers will likely turn to natural gas or steam heating. This will result in a reduction of electricity usage in off-peak periods and ultimately increase rates to cover the fixed investments previously being recovered by those customers. Ex. 21, Rush Surrebuttal at 7. If the Commission adopted Trigen's proposal, it would directly affect 2,000 KCPL General Service customers who have revenues in excess of $50 million. There are also numerous existing KCPL customers that are in the process of completing major construction projects in Kansas City. These customers have already made energy investments assuming the availability of KCPL's existing All-Electric and Space-Heating rates. If the Commission adopts Trigen's position and restricts or eliminates the All-Electric and Space-Heating rates, it would jeopardize the energy investments made by these major general service customers in new energy facilities.

KCPL believes that the efforts by Trigen to restrict the availability of the All-Electric and Separately-Metered Space Heating rates are premature and unsupported. Their recommendations are not based on class cost of service studies or studies directed at the specific design of the separated metered space heating and all electric rates. It appears that both Trigen and Staff are trying to undo a rate design that was implemented in 1996 with the support of both Trigen and Staff. See Ex. 21, Rush Surrebuttal at 5.

Finally, Trigen is again requesting that the Commission order KCPL to conduct a cost of service study in the next rate case. The Commission ruled against Trigen in the 2006 Rate Case, and the Company believes that it should do so again in this case. The Regulatory Plan Stipulation lays out the schedule for cost of service studies, and the parties to that Stipulation have specifically agreed not to file new or updated cost of service studies in Rate Case Filing #3. Such cost of service studies are more appropriate when the Commission reviews the impact of Iatan 2 coming into rate base in the future.

KCPL will also address below the specific Rate Design issues contained in the List of Issues filed on September 21, 2007:

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?

No. The Stipulation approved by the Commission in Case No. EO-2005-0329 clearly states the signatory parties' agreement related to rate design issues in this case, "Rate Filing #2," contemplated by the Regulatory Plan:

> "Rate Design. The Signatory Parties agree not to file new or updated class cost of service studies or to propose changes to rate structures in Rate Filing #2." [<u>See</u> Stipulation, Section III(B)(3)(b)(iv), p. 35.]

<u>Definition of the Term "Rate Structure"</u>

In this case, there has been much disagreement concerning the definition of "rate structure." KCPL believes that any change to the rates that will cause customers to re-evaluate the rate they have chosen represents a "rate structure" change. Anything other than an equal shift in rates uniformly to all classes does not comply with the provisions of the Stipulation. Ex. 20, Rush Rebuttal at 2. OPC also concurs with this position. Ex. 204, Meisenheimer Rebuttal at 3-6; Ex. 208, Trippensee Rebuttal at 1-7.

Staff relies upon a definition of "rate structure" that was drafted by Janice Pyatte for purposes of this case, and included in the Staff's Class Cost-Of Service and Rate Design Report. <u>See</u> Ex. 111-HC, Pyatte Surrebuttal, pp. 8-9; Tr. 1030. This definition is not based upon a widely accepted treatise on rate design and rate structure issues, but appears to be a definition drafted by Ms. Pyatte which, according to her, relies upon the following concept: "The simple way to think about it is if it requires new billing units, it's a rate structure change." (Tr. 1027). Staff's proposed definition does not appear to recognize inter-class cost allocations as a component of rate structures (Ex. 204, Meisenheimer Rebuttal, p. 7), and, therefore, appears to support Staff's interpretation of the Regulatory Plan Stipulation language that would permit signatory parties to propose inter-class revenue shifts in this case. From KCPL's perspective, the Staff's proposed definition is much too narrow, does not comport with the regulatory community's generally accepted definition of "rate structure," and should not be relied upon by the Commission in deciding this issue.

Motion To Strike

Staff has also attempted to introduce into this record communications which are clearly "privileged" settlement communications. For the reasons stated in its Motion To Strike filed on October 4, 2007, KCPL renews this motion regarding the portion of Ms. Pyatte's Surrebuttal Testimony beginning at Page 10, Line 5 and continuing through Page 11, Line 12 since this testimony violates the prohibition contained in 4 CSR 240-2.090(7) against the unilateral disclosure of privileged settlement negotiations without the agreement of the other parties to the settlement discussions. The fact that Staff has filed this information as Highly Confidential does not mitigate the prejudicial impact of disclosure of this privileged information. The disclosure of such privileged information is intended to influence the Commission in its deliberations on the merits of the rate design issue. While filing the privileged information under seal protects the information from public disclosure, it does not mitigate the adverse impact of its disclosure to the decision-maker.

Setting aside the particular merits of the rate design controversy in this case, the unilateral disclosure of privileged information by Staff is unfortunate and establishes a terrible precedent for the parties' conduct in the future. The unilateral disclosure of such privileged information by any party, if countenanced by the Commission, will have a chilling effect upon frank and candid exchanges of information, and will serve to compromise positions taken in the settlement process.

The October 29 Staff Reply to OPC's October 19, 2007 Response to Staff's Motion totally glosses over the fact that the emails and other communications contained in Ms. Pyatte's testimony are <u>privileged settlement discussions</u> in a litigated case. <u>These communications were not merely contract negotiations or parol evidence</u>, as suggested by Staff's Reply. It is extremely troubling to KCPL that Staff would feel it is authorized to unilaterally disclose such privileged discussions to the Commission in an attempt to bolster its position on the rate design issues in this case. If such practices are ever countenanced by the Commission, settlement discussions will no longer be considered as "privileged" or even confidential by other parties. Such a decision would adversely affect the ability of litigants to reach compromises and settlements in future cases. The Commission should carefully consider the unfortunate precedent that would be created if Staff prevails on this question.

<u>Regulatory Treatises Support A Broader Definition of "Rate Structure"</u>

OPC witness Meisenheimer cited a recognized treatise, <u>The Regulation of Public Utilities</u> by Charles F. Phillips, Jr., to support her interpretation of the Regulatory Plan Stipulation language on rate design issues. <u>See</u> Ex. 209. This authoritative source supports a much broader definition of the term "rate structure" than proposed by Staff or other intervenors. The following definition of "The Rate Structure" is contained in the Phillips treatise at 171 (Ex. 209, p. 2):

> **The Rate Structure.** The second aspect of rate regulation, the determination of a utility's rate structure, involves the establishment of rates (prices) to be charged consumers. The problem is complex. For many public utilities, nonallocable (common and joint) costs represent a significant percentage of total costs. All public utilities have various degrees of monopoly power in the market areas they serve and all have unused capacity some of the time. For these reasons, rate structures are differentiated: both supply (cost of service) and demand (value of service) considerations enter into their development. Utilities, for example, see the same service to different classes of buyers with the classes largely determined by differences in demand elasticities. They do not charge each class the same rate. Often, differences in rates can be justified by differences in costs. Sometimes they cannot, and discrimination occurs.

In addition to the Phillips treatise, Ms. Meisenheimer also cited to the earlier seminal treatise, Principles of Public Utility Rates by Dr. James C. Bonbright, which listed the following eight criteria of a sound or desirable "rate structure" (Ex. 209, p. 410):

1. The related, "practical" attributes of simplicity, understandability, public acceptability, and feasibility of application.
2. Freedom from controversies as to proper interpretation.
3. Effectiveness in yielding total revenue requirements under the fair-return standard.
4. Revenue stability from year to year.
5. Stability of the rates themselves, with a minimum of unexpected changes seriously adverse to existing customers. (Compare "The best tax is an old tax.")
6. Fairness of the specific rates in the apportionment of total costs of service among the different consumers.
7. Avoidance of "undue discrimination" in rate relationships.
8. Efficiency of the rate classes and rate blocks in discouraging wasteful use of service while promoting all justified types and amounts of use:
   (a) in the control of the total amounts of service supplied by the company;
   (b) in the control of the relative uses of alternative types of service (on-peak versus off-peak electricity, Pullman travel versus coach travel, single-party telephone service versus service from a multi-party line, etc.

Both of these recognized treatises on utility regulation and rate design clearly consider the definition of "rate structure" to be much more expansive than Staff's view that "if it requires new billing units, it's a rate structure change." (Tr. 1027) The development of billing determinants and rate levels themselves are merely small aspects of the much broader concept of "rate structure."

As the Commission interprets the language contained in the Regulatory Plan Stipulation related to the signatory parties' agreement not to propose rate structure changes, it should keep in mind that "rate structure" changes, as traditionally discussed in these recognized treatises, include much more than "billing determinants," as suggested by Staff. Rate structure changes, from KCPL's perspective, include inter-class shifts that cause customers to re-evaluate the appropriate rate schedule from which they will take service.

While Staff and DOE have advocated various inter-class shifts in revenues, KCPL believes that such proposals are inconsistent with the Stipulation and should be rejected by the Commission. A proposed class revenue shift, as suggested by Staff or DOE, will require addressing all customers that may potentially shift between classes. The revenue shortfall as a result of the shifts will need to be reflected in the overall rates established in this case. Ex. 20, Rush Rebuttal at 5-7.

KCPL believes that rate design and class cost of service ("COS") studies were specifically excluded from this case because it would not be in the best interest of customers and the Company to keep making changes in rate design and shifting revenues between classes during the series of rate cases contemplated by the Stipulation. The 2006 Rate Case which just concluded with rates going into effect in January 2007 reflected numerous rate design changes. KCPL believes it would be more appropriate and in the customers' best interest to address rate design and class cost of service after the Iatan 2 plant comes on line in 2010.

Mr. Gary C. Price, on behalf of DOE, also recommends that the changes in class cost of service to achieve a levelized rate of return be implemented over the next three rate cases. He presented testimony based on his class cost of service study and recommended changes to rates both in this case and in future cases. Ex. 804, Price Direct at 9-12. However, his proposal would cause significant problems in implementation as it would require ongoing evaluation and adjustment to achieve the proposed levels. Ex. 20, Rush Rebuttal at 7. The impacts from Mr. Price's proposal would not be limited to this case, but would affect all of the remaining rate cases anticipated by the Regulatory Plan Stipulation. Id.

The Commission should maintain the *status quo* in this case, as contemplated by the Regulatory Plan Stipulation, and approve any increase in revenues on an equal percentage basis.

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

For the reasons stated above, KCPL opposes such inter-class shifts in this case.

22. Large Power Service Rate Design: 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?

No. As stated in its position on Issue 21, the signatory parties to the Regulatory Plan Stipulation may not propose rate structure modifications within the Large Power Service rate schedule.

Mr. Maurice Brubaker, on behalf of Ford Motor Company and Praxair, Inc., has recommended realignment of the Large Power Service (LPS) rate by reducing revenues collected under the energy charge and, correspondingly, increasing revenues collected through the demand charge. Essentially, his proposal is to decrease the per Kwh energy rate by one cent ($0.01), and to increase the demand charge by the resulting revenue reduction. See Ex. 601, Brubaker Direct at 2. This proposal has the effect of increasing the demand charges over 100% to compensate for the reduction in the energy rates. Since Ford and Praxair were signatories to the Regulatory Plan

Stipulation, KCPL does not believe that the Ford/Praxair proposal is consistent with the agreements in that case since this proposal involves a "rate structure" change.

Mr. Brubaker's proposal will benefit the highest load factor customers in this class, while increasing the cost above the average for the lower load factor customers in the class. Ex. 20, Rush Rebuttal at 3. His proposal requires additional adjustment because many of the customers on this rate will now be better off moving to the Large General Service class and the Company will not collect all the revenues as a result of this shift. In order to correct for this shift in revenues between classes, an adjustment is needed to correct for the deficiency. See Ex. 602, Brubaker Surrebuttal at 6. This recommended change on a revenue-neutral basis would result in an increase to some customers up to about 6.37% and decrease others up to 9.06%. These shifts would occur before reflecting any change in rates due to the increase requested by the Company. Ex. 20, Rush Rebuttal at 2-4.

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

KCPL opposes any changes in these charges, for the reasons noted above.

23. General Service All-Electric Tariffs and General Service Separately-Metered Space-Heating Tariff Provisions:

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?

No. The Company in the 2006 Rate Case did, in fact, increase the Space Heating rates by 5% above the system average increase. No further adjustments should be made until a COS study is completed.

b. Should KCPL's General Service All-Electric tariffs and Separately-Metered Space Heating rates be phased-out and, if so, over what period?

No. The Company opposes the recommendations of both Trigen and Staff to begin phasing-out the All-Electric tariffs and Separately-Metered Space Heating rates. Such dramatic changes in rate structure for these customers would clearly be inconsistent with the terms and conditions of the Regulatory Plan Stipulation where the Signatory Parties agreed: "Rate Design: The Signatory Parties agree not to file new or updated class COS studies or to propose changes to rate structures in Rate Filing #2." See Regulatory Plan Stipulation, Section III(B)(3)(b)(iv) at 35. Staff witness Janice Pyatte conceded that the elimination of a rate schedule would be a "rate structure" change. (Tr. 1030) Clearly, a phase-out of the All-Electric and Separately-Metered Space Heating schedules would also represent such a prohibited "rate structure" change. Ex. 21, Rush Surrebuttal at 8.

Additionally, KCPL believes that Trigen is recommending this proposal to further its own narrow economic interests by limiting, modifying or discontinuing the All-Electric and Separately-Metered Space Heating rates. A rate design and class COS study should be conducted before any further modifications are made to these rates. The Commission's decision in the 2006 Rate Case and the agreement by the parties to increase these rates more than the standard comparable rate was a reasonable step to address their concerns until a cost study is completed. No further steps are necessary or reasonable in this case. Id. at 8-9.

As the Commission's decision in the 2006 Rate Case noted, KCPL's General Service rate design has been in place for many years with the approval of the Commission. See Report & Order, Case No. ER-2006-0314, pp. 82-83. KCPL participated in an extensive class COS study and rate design case in 1996. At that time, rates were established based on that study, and rate design changes were made that changed the overall price structure. Trigen also "agree[d] to support and endorse before the Commission the Stipulation and Agreement filed by the signatory parties on May 29, 1996" which implemented the current rate structure. See Ex. 20, Rush Rebuttal at 10.

For these reasons, Trigen's position on this issue should again be rejected by the Commission.

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)?

No. Trigen recommends that the Commission restrict the availability of these tariffs to existing customers of KCPL who qualify for the rate at a location other than the physical location at the time of the true-up. This issue was addressed in the 2006 Rate Case, and the Commission ruled against Trigen. Although Trigen is appealing the Commission's decision on this issue, it has not yet been ruled on by the Cole County Circuit Court. KCPL disagrees with Trigen's position and believes that this issue should be addressed in the context of an overall study.

One of the most significant effects from Trigen's proposal is the likely increase in rates for all other customers that would result if Trigen's position is adopted. By limiting, restricting, or curtailing the applications of electric heating, customers will likely turn to natural gas or steam heating. This will result in a reduction of electricity usage in off-peak periods and ultimately increased rates to cover the fixed investments previously being recovered by those customers. The electric heating rates were designed to encourage customers to use electric heat and to consume electricity during off-peak periods. Originally, electric heating rates provided sharp discounts, but recovered variable costs and made a contribution to the fixed costs of the Company. This is still true, except that electric heating rates today are no longer as sharply discounted, and these rates now make a significant contribution to the fixed costs of the Company. Ex. 21, Rush Surrebuttal at 7.

KCPL believes that the efforts by Trigen and Staff to restrict the availability of the All-Electric and Separately-Metered Space Heating rates are premature and unsupported. Their recommendations are not based on class COS studies or studies directed at the specific design of the Separated Metered Space Heating and All-Electric rates. It appears that both Trigen and Staff are trying to undo a rate design that was implemented in 1996 with the support of both Staff and Trigen. Ex. 21, Rush Surrebuttal at 5.

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?

No. This issue is clearly addressed by the Regulatory Plan Stipulation approved by the Commission. KCPL, Staff, OPC, and all the other signatory parties to the case have already agreed:

> "The Signatory Parties agree not to file new or updated class cost of service studies or to propose changes to rate structures in Rate Filing #3." [See Stipulation, Section III(B)(3)(c)(iv), p. 39.]

In the 2006 Rate Case, the Commission ruled in favor of KCPL on this issue. The Company continues to support the Commission's decision, and believes that the time to conduct the cost studies is at the conclusion of the last rate case anticipated by the Regulatory Plan, when Iatan 2 comes on-line. KCPL believes any cost studies concerning the All-Electric tariff and the Separately-Metered Space Heating rates should be part of a larger comprehensive rate design study. Ex. 20, Rush Rebuttal at 12.

(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?

With regard to the "imputation of revenues" recommendation, KCPL opposes imputing revenues for these classes. The All-Electric and Space Heating rates have been approved by this Commission for years. It would be improper and unlawful for the Commission to require the Company to impute a higher rate for these services than the rate lawfully approved by the Commission. See Ex. 20, Rush Rebuttal at 12.

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?

No. Such "eligibility investigations" are currently addressed through the internal processes at the Company for placing customers on the appropriate rates. KCPL believes that it has the appropriate procedures and safeguards for correctly placing customers on the appropriate rates. No such further study is warranted. See Ex. 20, Rush Rebuttal at 12-13.

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

Yes. KCPL believes that it would be appropriate to rename its General Service "All-Electric" tariffs as "Space Heating" Tariffs.

E. KCPL Experimental Regulatory Plan Additional Amortizations

24. What, if any, Additional Amortizations are required by KCPL's Experimental Regulatory Plan approved by the Commission in Case NO. EO-2005-0329?

Assuming the adoption of KCPL's positions in this case, there would be a need for $14,155,968 in Additional Amortizations. See Michael Cline True-Up Direct Testimony at 3 and Sched. MWC-9.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been hand delivered, emailed or mailed, postage prepaid, this 5th day of November, 2007, to all counsel of record.

/s/ Karl Zobrist
Karl Zobrist