BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2014-0370

SURREBUTTAL TESTIMONY

AND EXHIBITS

OF

LANE KOLLEN

ON BEHALF OF THE

MIDWEST ENERGY CONSUMERS' GROUP

AND THE

MISSOURI OFFICE OF THE PUBLIC COUNSEL

J. KENNEDY AND ASSOCIATES, INC.
ROSWELL, GEORGIA

JUNE 2015

BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2014-0370

SURREBUTTAL TESTIMONY OF LANE KOLLEN

Q. Please state your name and business address.

A. My name is Lane Kollen. My business address is J. Kennedy and Associates, Inc. ("Kennedy and Associates"), 570 Colonial Park Drive, Suite 305, Roswell, Georgia 30075.

Q. Did you previously file Direct Testimony in this proceeding?

A. Yes.

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of my testimony is to respond to Kansas City Power & Light Company (“KCP&L”or “Company”) witness: (1) Mr. Ronald A. Klote’s Rebuttal Testimony opposing two of the adjustments to the Company’s Corporate General Allocator that I proposed; (2) Mr. Ryan A Bresette’s Rebuttal Testimony criticizing the administrative and general expense (“A&G”) comparisons that I presented, presenting various expense comparisons performed by PA Consulting, and opposing the management audit that I proposed; and (3) Mr. Darrin R. Ives’ Rebuttal Testimony opposing the management audit that I proposed.

Q. Please summarize your Surrebuttal Testimony.

A. In Mr. Klote's Rebuttal Testimony, the Company agreed to accept two of my recommendations: to adopt the Corporate General Allocator for the test year and to modify income tax expense inputs to the Corporate General Allocator so that negative income tax expense for any affiliate is set to zero. However, the Company opposes two of my recommendations: (1) to modify the Corporate General Allocator so that 5% of the Company's A&G expenses are allocated to Great Plains Energy, Incorporated ("GPE"), KCP&L's parent company, and (2) to modify the interest expense and income tax expense inputs to the Corporate General Allocator to reflect the Company's cost of capital.

I continue to recommend that the Commission modify the Corporate General Allocator so that 5% of the Company's A&G expenses are allocated to GPE. This is necessary to ensure that KCP&L and its customers do not subsidize GPE for the costs that KCP&L incurs on behalf of GPE to manage its diversified portfolio of regulated and unregulated businesses. The 5% allocation is a modest charge for providing these services. I also continue to recommend that the Commission modify KCP&L's interest and income tax expense inputs to the Corporate General Allocator to reflect KCP&L's cost of capital and income tax expense on investments incurred to provide services to the other GPE affiliates. Again, this is necessary to ensure that KCP&L and its customers do not subsidize other GPE affiliates.

In Mr. Bresette's Rebuttal Testimony, the Company criticized the A&G metrics that both Staff and I used to compare the Company's performance to GMO and other utilities in the region and provided other metrics in the form of a "benchmarking study" prepared by PA Consulting. Mr. Bresette, along with Mr. Ives, opposed my recommendation that the Commission direct the Company to undergo a detailed management audit.

As I stated in my Direct Testimony, the A&G metrics that I presented are not determinative, but indicative and they indicate that the Company's A&G expenses may be excessive. There may be many reasons for this, which is why the Commission should investigate the Company's cost structure through a detailed management audit. The Company's "benchmarking study" does not demonstrate that the Company's A&G expenses are less than other utilities in the region, let alone that there are no opportunities to improve efficiencies and reduce costs.

I continue to recommend that the Commission order the Company to undergo a management audit for the purpose of increasing efficiencies and reducing costs. There is no downside to this recommendation and there may be significant savings available that could mitigate future rate increases.

Q. Mr. Klote opposes your recommendation to modify the Corporate General Allocator to charge GPE a 5% management fee for managing its portfolio of

regulated and unregulated companies. Did Mr. Klote address the fact that the Corporate General Allocator presently allocates a mere 0.49%, or $175,000, of KCP&L's indirect costs to GPE?

A. No. It is one thing to discuss the allocation methodology in the abstract; it is another matter altogether to consider the result. The result, an allocation of only $175,000, is inconsistent with managing a multi-billion investment portfolio for GPE. This result could only be achieved by locating the centralized service functions within the utility so that the utility and its customers, rather than the parent company, retains all costs that are not assigned or allocated to other affiliates. The Commission should decide if this result is reasonable or whether GPE would incur a greater allocation of the service company costs if the centralized service functions were not located within and the costs retained by the utility and its customers. Ameren Services Company allocates 6.9% of its indirect costs to Ameren Corporation and Southern Company Services allocates 3.8% of its indirect costs to Southern Company. In contrast, KCP&L's allocation to GPE is a mere fraction of the charges from these other service companies to their parent companies.

Q. Did the Company dispute that its allocations to GPE were a mere fraction of the allocations by Ameren Services Company and Southern Company Services to their parent companies?

A. No.

Q. Mr. Klote claims that you did not perform a comparison of the similarities and differences between KCP&L operations and the operations of Ameren Services Company and Southern Company Services. Is such a comparison necessary?

A. No. It isn't necessary because KCP&L performs all of the functions for GPE that Ameren Services Company and Southern Company Services perform for their parent companies. The only distinction is that KCP&L is not a centralized service company separate from the utility, but rather is a centralized service provider located within the utility; however, that is more of a legal distinction without a substantive difference. It does not justify allocating less cost to the parent company and retaining more cost for the utility and its customers.

Q. Mr. Klote claims that the 5% allocation that you propose is "arbitrary." Do you agree?

A. No. First, the 5% is less than the average for indirect costs allocated to Ameren and Southern Company by their respective service companies. Second, even with the increase to GPE on a dollar basis, the charge to GPE still is far less than Ameren Services and Southern Company Services charge their parent companies to manage their multi-billion portfolios of regulated and unregulated businesses. The increase to GPE on a total Company basis is only $1.031 million, or $0.571 million on a jurisdictional basis. Third, the Company offered no evidence that 5% was not reasonable. I offered evidence not only that the present 0.49% is unreasonable, but also that the 5% is reasonable based on comparisons to charges from other service companies to their parent companies. As I previously noted, the Company did not dispute the evidence that I provided for Ameren and Southern Company in support of my recommendation.

Q. Mr. Klote claims that your recommendation is disproportionate to GPE's net income in 2014. Is that a relevant comparison?

A. No. The allocation of direct and indirect costs, except for income taxes, generally is independent of net income. It is based on the cost to provide the services to the parent company and other affiliates. In any event, a more appropriate size-based comparison would be to revenues, assets, or operating expenses before income taxes. For example, on a total Company basis, my recommendation is a mere 0.04% of revenues, 0.01% of assets, and 0.06% of operating expenses before income taxes.[1]

Q. Did Mr. Klote address or disagree with any of your substantive reasons for modifying the Corporate General Allocator to reflect the Company's actual cost

[1] I used the revenues, operating expenses, and assets reported by GPE in its 2014 10-K. I have replicated the relevant pages from this 10-K as my Exhibit___(LK-22).

of capital and the related income tax expense on investments incurred to provide services to other GPE affiliates?

A. No. Mr. Klote simply opposed these modifications because they were not included in the Staff recommendation in KCP&L's Cost Allocation Manual ("CAM") docket in File No. EO-2014-0189. With all due respect, the Staff recommendation in the CAM docket also did not include my recommendation in this proceeding to remove all negative income tax expense data inputs, yet the Company agrees with that recommendation.

Regardless of the Staff recommendation in File No. EO-2014-0189, the Commission's primary concern in this proceeding should be to ensure that the resulting costs retained by KCP&L are just and reasonable and that there is no subsidization of other GPE affiliates. Without the modifications that I recommend, the Company and its customers will subsidize the carrying costs on investments incurred by the Company to provide services to other GPE affiliates. That is not a just and reasonable result.

Q. Mr. Bresette claims that it is inappropriate to compare A&G expenses among utilities by FERC account. Do you agree?

A. No. However, as I stated in my Direct Testimony, the results are indicative, not determinative, and that there are differences in accounting among utilities that affect the results. Nevertheless, the comparisons provide sufficient evidence that the

Company's costs may be excessive and that the Company and its customers could benefit from a management audit to identify efficiencies in operations and cost reductions.

Q. Mr. Bresette presents a summary comparison of the costs to perform certain functions/activities prepared by PA Consulting. Please comment.

A. First, I would note that such a summary comparison is indicative at best, not determinative, and does not demonstrate, conclusively or otherwise, that the Company is a poor or good performer in all areas of its operations and activities, let alone in all A&G activities and expenses. Second, it does not demonstrate that there are no opportunities to achieve additional efficiencies in operations and cost reductions.

Q. Is the benchmarking study performed by PA Consulting useful in a rate case context?

A. No. First, the comparisons are function/activity based and are not structured by FERC account in the same manner that test year costs are developed and presented.[2] Second, the Company refused to provide the cost data in response to Staff Question 0553 in this proceeding, so the results could not be verified or evaluated. I have

[2] The Company provided a copy of the benchmarking study results provided by PA Consulting in response to Staff Question 0553.

attached a copy of the Company's response to Staff Question 0553, without attachments, as my Exhibit___(LK-23). Third, the comparisons were not comprehensive, but were limited to specific functions/activities.

Q. Is the data you relied upon reliable?

A. Yes. The data provided in an electric utility FERC Form 1 is compiled, segregated and assigned to specific accounts pursuant to detailed account definitions and instructions. These accounts, definitions and instructions are known as the FERC Uniform System of Accounts.[3] Furthermore, the utility is required to attest that the data conforms to the Uniform System of Accounts. Finally, the FERC Form 1 is required to be signed by an independent auditor. As such, there is a heightened level of reliability underlying this data and, as a result of common accounts and definitions, an increased level of comparability between different utilities. It is uncertain whether the same level of reliability and comparability applied to the PA consulting study.

Q. Mr. Bresette and Mr. Ives both cite to a Commission Order in Missouri Gas Energy Case No. GR-2004-0209 wherein the Commission describes the

[3] See, FERC Uniform System of Accounts for Electric Utilities, 18 CFR, Chapter I, Subchapter C, Part 101.

difficulty of assessing the "management efficiency" of that utility through a simple comparison of "operating and maintenance expense." Please comment.

A. Context in any case is important, particularly when a party attempts to export and impose the determination in one case to support an argument in another case. Mr. Bresette claims that the Commission recognized that using FERC Form 1 data to make comparisons between utilities was inappropriate. That conclusion is not correct and ignores the context and application of the comparisons in that case compared to this proceeding.

In Case GR-2004-0209, Missouri Gas Energy sought an additional return on equity for its alleged "management efficiency." It provided a comparison of financial metrics based on FERC cost data in support of its request.

The Commission denied Missouri Gas Energy's request based on its precedent in several recent cases. The Commission stated that it had "moved away from the idea of adjusting a company's rate of return for perceived management efficiency or inefficiency." The Commission determined that "a rate of return adder is inappropriate in concept and unworkable in practice." The Commission also determined that "[a]s a practical matter, an adder is nearly impossible to support by any objective evidence" and then proceeded with the discussion cited by Mr. Bresette and Mr. Ives. Mr. Bresette and Mr. Ives failed to provide this context and failed to provide the first sentence in the paragraph from the Order that they replicated.

In the Missouri Gas Energy case, the Commission did not find that such comparisons are inappropriate in any and all circumstances; it found only that they did not provide sufficient objective evidence of that utility's "management efficiency" to justify overturning precedent and authorizing an increase in the return on equity. To ensure that the Commission's actual findings in that case are easily accessible, I have attached a copy of the relevant pages from the Commission's Order in the Missouri Gas Energy case as my Exhibit___(LK-24).

In this case, the comparisons that I and the Staff presented are indicative and provide evidence that the Company's A&G expenses may be excessive. I do not recommend that the Commission find that the comparisons that I performed of the Company's A&G expenses are determinative, that the Company's A&G expenses are excessive, or that there should be any disallowance based on the comparisons. However, I do recommend that the Commission direct the Company to undergo a management audit to identify efficiencies in operations and cost reductions. This is a constructive recommendation, not a punitive recommendation, with the perspective of benefiting the Company and its customers, and one that also would benefit the other GPE affiliates, including GMO.

Q. Both Mr. Bresette and Mr. Ives oppose your recommendation to direct the Company to undergo a management audit. Do either of them cite any substantive reason why the Commission should not do so?

A. No. Both claim that the A&G comparisons that I presented do not demonstrate that the Company's A&G expenses are excessive, but neither offer any substantive reason not to undertake a management audit and neither make the claim that a management audit would not identify efficiencies in operations or cost reductions.

Q. Is there any downside to the Company and its customers if the Commission directs the Company to undergo a management audit?

A. No. While there is an initial cost involved to implement such an audit, customers should benefit on an order of magnitude greater, particularly when you compare the one-time cost of an audit to the sum of annual savings over a number of years. There is significant upside if the management audit is focused on identifying and achieving efficiencies and cost reductions rather than simply justifying the present cost structure. While KCP&L witnesses attempt to portray regulatory lag as a negative aspect of the current Missouri regulatory paradigm, there is no question that it can work to the benefit of utility shareholders. Specifically, in those situations where costs decrease between rate cases, those savings completely inure to the benefit of the utility shareholders until such time as another rate case is initiated and rates are rebased. Similarly, to the extent that a management audit identifies cost savings, KCP&L shareholders will retain the entirety of those cost savings until a subsequent rate case. As such, my recommended management audit may be beneficial to KCP&L shareholders.

Q. Are there firms that specialize in advising utilities on achieving efficiencies and cost savings as well as perform utility management audits ordered by the utility's regulators?

A. Yes. There are many well known firms that perform such services, such as Accenture (http://www.accenture.com/us-en/industry/utilities/Pages/utilities-index.aspx), Energy & Resource Consulting Group, LLC ("ERG Consulting") (http://www.ergconsulting.com/), and Liberty Consulting Group (http://libertyconsultinggroup.com/index.html), among others. For example, Liberty Consulting Group lists on its website the following utilities that it has audited on behalf of public utility commissions:

- Baltimore Gas & Electric Company
- Central Hudson Gas & Electric Company
- Cincinnati Gas & Electric Company
- Cleveland Electric Illuminating Company
- Columbus Southern Power Company
- Commonwealth Edison Company
- East Kentucky Power Cooperative, Inc.
- Hawaiian Electric Company
- Illinois Power Company
- Kentucky Utilities Company
- Louisville Gas and Electric Company
- Metropolitan Edison Company
- Monongahela Power Company
- New York Power Authority
- New York State Electric & Gas Corp.
- Ohio Edison Company
- Ohio Power Company
- Pennsylvania Electric Company
- Potomac Electric Power Company
- Public Service Company of New Hampshire

- Public Service Electric & Gas Company
- Toledo Edison Company
- Virginia Power Company
- West Penn Power

Accenture claims on its website that "[u]sing our proprietary assets combined with utilities services, Accenture has helped utilities achieve step-change reduction in cost to serve, drive digital interaction and enhance the customer experience." Altogether, these auditors have identified hundreds of millions of dollars in savings for the utilities and their customers.

Q. Has a public utilities commission recently ordered a management audit based on your recommendation to do so?

A. Yes. The Kentucky Public Service Commission ("KPSC") ordered Big Rivers Electric Corporation on April 25, 2014 to undergo a management and operations audit in Case No 2013-0199. After a Request for Proposal ("RFP") was issued, the KPSC selected Concentric Energy Advisors to perform the audit. A description of the audit and a copy of the RFP utilized can be found on the homepage of the KPSC website at the following link: http://psc.ky.gov/. I have attached a copy of the RFP cover letter issued by the KPSC as my Exhibit___(LK-25).

Q. Have you been involved in management audits related to other public utilities?

A. Yes. I was one of three members of the Centerior Audit Advisory Committee, along with representatives from Centerior Energy Corporation and the Ohio Office of Consumers Counsel, which oversaw the audit of Centerior in the late 1980s. I represented the industrial customers on the Committee and was active in overseeing the audit and advocating additional savings. Rate increases were tied to the achievement of savings. Kennedy and Associates has also performed various management audits of Gulf States Utilities Company, South Central Bell, and various Louisiana cooperatives.

Q. How should the Commission proceed with such a management audit?

A. The Commission should direct the Company to undergo a management audit, subject to the oversight by the Commission and Staff. The Commission should oversee the process from start to finish to ensure that the management audit is focused on achieving savings and cost reductions without compromising safety or customer service. The first steps in the process will be to develop and issue a Request for Proposal and to develop a timeline for awarding the contract for the audit, completion of the audit, submission of a report, and implementation of the recommendations.

After proposals are received, the Company should rank the firms that submitted proposals and submit a short list to the Staff. This should be followed by interviews by the Company and the Staff of the short list firms. The Company should select the auditor, subject to review and agreement by the Staff. The auditor should develop and submit a timeline and detailed audit workplan for review and approval by the Company and the Staff and then conduct the audit. It should prepare and submit monthly progress reports to the Company and Staff and then a draft of the Report, including its findings and recommendations to the Company and Staff. The Report should include a timeline for implementation and quantification of the savings that may be achieved for each recommendation if the Company successfully implements the recommendation.

The Company should provide a detailed response to the Report indicating its agreement or disagreement with each recommendation along with detailed reasons for disagreeing with any recommendation. The Staff should moderate any such disagreements.

Finally, the Company should implement the recommendations and provide the Staff monthly progress reports, including proof and quantification of the achieved savings.

Q. Does this complete your Surrebuttal Testimony?

A. Yes.

AFFIDAVIT

STATE OF GEORGIA)

COUNTY OF FULTON)

LANE KOLLEN, being duly sworn, deposes and states: that the attached is his sworn testimony and that the statements contained are true and correct to the best of his knowledge, information and belief.

Lane Kollen

Sworn to and subscribed before me on this
5th day of June 2015.

Jessica K. I

Notary Public

JESSICA K INMAN
MY COMMISSION EXPIRES
NOTARY
PUBLIC
JULY 31, 2015
CHEROKEE COUNTY, GEORGIA

BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2014-0370

EXHIBITS

OF

LANE KOLLEN

ON BEHALF OF THE

MIDWEST ENERGY CONSUMERS' GROUP

AND THE

MISSOURI OFFICE OF THE PUBLIC COUNSEL

J. KENNEDY AND ASSOCIATES, INC.
ROSWELL, GEORGIA

JUNE 2015

EXHIBIT ____ (LK-22)

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The market approach analysis is most significantly impacted by management's selection of relevant peer companies as well as the determination of an appropriate control premium to be added to the calculated invested capital of the reporting unit, as control premiums associated with a controlling interest are not reflected in the quoted market price of a single share of stock. Management determined an appropriate control premium by using an average of control premiums for recent acquisitions in the industry. Changes in results of peer companies, selection of different peer companies and future acquisitions with significantly different control premiums could result in a significantly different fair value of Great Plains Energy's reporting unit.

Income Taxes

Income taxes are accounted for using the asset/liability approach. Deferred tax assets and liabilities are determined based on the temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted statutory tax rates in effect for the year in which the differences are expected to reverse. Deferred investment tax credits are amortized ratably over the life of the related property. Deferred tax assets are also recorded for net operating losses, capital losses and tax credit carryforwards. The Company is required to estimate the amount of taxes payable or refundable for the current year and the deferred tax liabilities and assets for future tax consequences of events reflected in the Company's consolidated financial statements or tax returns. Actual results could differ from these estimates for a variety of reasons including changes in income tax laws, enacted tax rates and results of audits by taxing authorities. This process also requires management to make assessments regarding the timing and probability of the ultimate tax impact from which actual results may differ. The Company records valuation allowances on deferred tax assets if it is determined that it is more likely than not that the asset will not be realized. See Note 22 to the consolidated financial statements for additional information.

GREAT PLAINS ENERGY RESULTS OF OPERATIONS

The following table summarizes Great Plains Energy's comparative results of operations.

	2014	2013	2012
		(millions)	
Operating revenues	$ 2,568.2	$ 2,446.3	$ 2,309.9
Fuel	(489.2)	(539.5)	(539.5)
Purchased power	(253.3)	(125.9)	(94.0)
Transmission	(74.7)	(53.2)	(35.4)
Gross margin [(a)]	1,751.0	1,727.7	1,641.0
Other operating expenses	(910.5)	(868.8)	(834.1)
Voluntary separation program	—	—	4.3
Depreciation and amortization	(306.0)	(289.7)	(272.3)
Operating income	534.5	569.2	538.9
Non-operating income and expenses	12.5	8.8	(13.2)
Interest charges	(188.5)	(198.4)	(220.8)
Income tax expense	(115.7)	(129.2)	(104.6)
Loss from equity investments	—	(0.2)	(0.4)
Net income	242.8	250.2	199.9
Preferred dividends	(1.6)	(1.6)	(1.6)
Earnings available for common shareholders	$ 241.2	$ 248.6	$ 198.3

(a) Gross margin is a non-GAAP financial measure. See explanation of gross margin below.

2014 Compared to 2013

Great Plains Energy's 2014 earnings available for common shareholders decreased to $241.2 million or $1.57 per share from $248.6 million or $1.62 per share in 2013.

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GREAT PLAINS ENERGY INCORPORATED
Consolidated Balance Sheets

	December 31	
	2014	2013
ASSETS	(millions, except share amounts)	
Current Assets		
Cash and cash equivalents	**$ 13.0**	$ 10.6
Funds on deposit	**1.2**	0.8
Receivables, net	**160.3**	162.2
Accounts receivable pledged as collateral	**171.0**	175.0
Fuel inventories, at average cost	**90.1**	76.4
Materials and supplies, at average cost	**152.7**	152.3
Deferred refueling outage costs	**12.5**	29.5
Refundable income taxes	**3.1**	10.5
Deferred income taxes	**78.1**	80.3
Assets held for sale (Note 12)	**—**	36.2
Prepaid expenses and other assets	**36.9**	33.2
Total	**718.9**	767.0
Utility Plant, at Original Cost		
Electric	**12,128.7**	11,575.3
Less - accumulated depreciation	**4,828.3**	4,628.4
Net utility plant in service	**7,300.4**	6,946.9
Construction work in progress	**900.0**	736.7
Nuclear fuel, net of amortization of $187.5 and $161.4	**79.2**	62.8
Total	**8,279.6**	7,746.4
Investments and Other Assets		
Nuclear decommissioning trust fund	**199.0**	183.9
Regulatory assets	**1,034.6**	849.7
Goodwill	**169.0**	169.0
Other	**74.6**	79.4
Total	**1,477.2**	1,282.0
Total	**$ 10,475.7**	$ 9,795.4

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

EXHIBIT ____ (LK-23)

KCP&L
Case Name: 2014 KCPL Rate Case
Case Number: ER-2014-0370

Response to Majors Keith Interrogatories - MPSC_20150512
Date of Response: 05/26/2015

Question:0553

Issue: Other - Other
Description: Reference Ryan Bresette rebuttal testimony, Case No. ER-2014-0370, page 5, lines 9-23 through page 6, lines 1-5: 1. Please identify each of the 14 other utilities included the "benchmarking study facilitated by PA Consulting Group" that was based on 2013 financial statements. 2. Provide all information relating to each of these individual utilities including the information identified at page 5, lines 14-23 and page 6, lines 1-5 of Mr. Bresette's rebuttal testimony. 3. Do all the 15 panel members referenced in Mr. Bresette's rebuttal testimony have nuclear generation? Identify which utilities in the benchmarking have nuclear generation and which do not. 4. Identify all utilities shown on Schedule RAB-1 attached to Mr. Bresette's rebuttal and where each utility stands. 5. Provide the schedule attached as Schedule RAB-1 to Mr. Bresette's rebuttal testimony with the entire study group shown individually identified for comparison purposes (all 15 entities) that is part of the "benchmarking study" KCPL participates in. 6. Provide the entire PA Consulting Group study with each participating utility identified by name along with supporting material relating to Schedule RAB-1 attached to Mr. Bresette's rebuttal. Data Request submitted by Keith Majors (keith.majors@psc.mo.gov).

Response:

KCP&L is objecting to questions 1, 2, 4 and 5.

3. No, not all 15 panel members have nuclear generation. Six of the panel members have nuclear generation
6. See Attachment RAB-4

Attachment: Q0553_Verification.pdf

EXHIBIT ____ (LK-24)

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service	)))	**Case No. GR-2004-0209** Tariff No. YG-2004-0624

REPORT AND ORDER

Issue Date: September 21, 2004

Effective Date: October 2, 2004

4. Cost of Preferred Stock

Issue Description: *What is the appropriate cost of MGE's preferred stock in calculating MGE's cost of capital?*

There was no disagreement about this issue. Staff, Public Counsel, and MGE agree that the appropriate cost of preferred stock as of April 30, 2004, is 7.758%. Therefore, the Commission finds that the cost of preferred stock is 7.758%.

5. Rate of Return Adder

Issue Description: *Should MGE be granted an additional 25 basis points of rate of return on account of its level of management efficiency?*

MGE asks the Commission to add 25 basis points to MGE's authorized rate of return in recognition of its high management efficiency. Thus if the Commission were to determine that the appropriate rate of return was 8%, MGE asks that the Commission authorize a rate of return of 8.25%.

MGE claims that such an adder is appropriate because MGE is currently operating very efficiently and should be rewarded for its efforts. In particular, MGE contends that it is providing good customer service and that its operating and maintenance expenses are low when compared to other Missouri local distribution companies. MGE points out that the Commission made such an upward adjustment for management efficiency in at least two rate cases in the early 1980s[40] and that in MGE's last two litigated rate cases, the Commission made a downward adjustment to MGE's allowed return because of customer

[40] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58 (1983) and In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104 (1983).

service problems.[41] MGE asks that the Commission recognize MGE's improved efficiency by bumping up its rate of return in this case.

MGE is correct that for a period in the early 1980s, the Commission had a policy of explicitly adjusting rates of return for the perceived efficiency or inefficiency of the utility. That policy actually began in a 1982 rate case for Missouri Public Service Company.[42] In that case the Commission was quite concerned about the company's failure to deal with a problem of unaccounted-for-water being lost from its water system. As a result, the Commission reduced the rate of return on the company's water rate base by a full percentage point.[43] A year later, in the cases cited by MGE, the Commission explicitly rewarded the affected utilities for management efficiency. Empire District Electric and Kansas City Power & Light Company were rewarded with a .4% increase to their return on equity.[44]

By 1986, however, the Commission had rejected that approach. In a Kansas City Power & Light rate case,[45] the Commission held as follows:

> In the Company's last rate case ... the Commission awarded the Company a 40 basis point upward adjustment to its return on common equity for its efforts in improving management efficiency. ... The Commission has reevaluated its prior order and determined it is not necessary nor appropriate to upwardly adjust the return on equity which has been found to be reasonable 'to encourage the provision of energy on the most efficient and

[41] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437 (1997) and In Re: Missouri Gas Energy, 7 Mo.P.S.C. 3d 394 (1998).

[42] In Re: Missouri Public Service Company, 25 Mo.P.S.C (N.S.) 136 (1982).

[43] In Re: Missouri Public Service Company, 25 Mo.P.S.C. (N.S.) 136, 177-180 (1982).

[44] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58, 70 (1983), In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 150 (1983).

[45] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228 (1986).

> economical basis possible.' Adequate encouragement is given through the recovery of all prudently incurred costs.[46]

The Commission again addressed the question of adjusting return based on management efficiency in a 1989 case, where the Commission explained that it was rejecting Staff's suggestion to set a company's rate of return at the low end of Staff's recommended range for alleged management inefficiency:

> The Commission has determined that it is not appropriate to adjust the rate of return SWB will be authorized to earn for management decisions. Now the Commission has determined that where it has made adjustments to ROE in other cases, these types of adjustments can rarely be supported by sufficient evidence to warrant such a decision. The difficulty of deciding how much value a certain management decision has in terms of ROE makes the determination almost impossible. The evidence in this case provides no real guide to the Commission on how to value the various allegations of inefficient management. The more appropriate method for making adjustments to a public utility's revenue requirement is where specific dollar adjustments can be addressed, not by adjusting the ROE.[47]

Clearly, the Commission has moved away from the idea of adjusting a company's rate of return for perceived management efficiency or inefficiency.

MGE correctly points out that in MGE's last two litigated rate cases the Commission cited MGE's failure to provide quality customer service as the basis for allowing the company a lower rate of return than it might have otherwise received. In the 1997 case, the Commission set the authorized rate of return on equity at 11.3%, which was the low end of Staff's recommendation, because of a great increase in the number of customer complaints after Southern Union bought the MGE system in 1994. In comparison, MGE's expert witness in that case recommended a return on equity in the range of 11.5% to

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[46] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228, 247 (1986).

[47] Staff v. Southwestern Bell Telephone Company, 29 Mo.P.S.C. (N.S.) 607, 654 (1989).

12.5%. Public Counsel's expert recommended a return on equity of 10.75%.[48] Similarly, in the 1998 case, the Commission set the authorized rate of return on equity at 10.93%, which was the midpoint of the range recommended by Staff. In doing, so the Commission again cited MGE's continuing customer service problems as one reason, among several others, for accepting Staff's recommended return on equity. MGE's expert had recommended a return on equity of 12%, with Public Counsel recommending 10.7%.[49]

In those cases, the Commission appropriately took into consideration the quality of service provided by MGE in determining a just and reasonable rate of return for the company. In both cases the allowed rate of return was within the range supported by the testimony of financial experts. The Commission did not determine a just and reasonable rate of return and then reduce that rate to punish MGE. In sum, the Commission did not, by citing the poor customer service record of MGE, return to the practice of using adjustments to the rate of return to reward or punish utilities for efficient or inefficient management practice.

As the Commission found in 1986, and as was demonstrated in this case, a rate of return adder is inappropriate in concept and unworkable in practice. Conceptually, the Commission must determine a just and reasonable rate of return for the utility that it regulates. To then tack an additional percentage to the rate as a reward for efficiency means that the company would be receiving a rate of return that is higher than the just and reasonable rate. In essence, the Commission would be making a gift to the company from the ratepayer's pocket. Obviously, that is not acceptable.

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[48] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437, 467-468 (1997).

[49] In Re: Missouri Gas Energy, 7 Mo.P.S.C 3d. 394, 401-404 (1998).

As a practical matter, an adder is nearly impossible to support by any objective evidence. As was demonstrated in this case, there is really no way to determine with any degree of certainty that one company is more efficient than another. MGE attempted to do so by comparing its annual operating and maintenance expense to that of other Missouri gas companies.[50] However, as Staff pointed out, operating and maintenance expenses are subject to many variables and are not a good basis for determining management efficiency.[51] Although none of the evidence presented actually demonstrates that MGE is any more or less efficient than other gas companies, there was a lot of evidence filed on that question and its presentation took up a good deal of hearing time. The Commission does not wish to encourage a flood of indeterminate and ultimately pointless testimony on the question of management efficiency in future rate cases.

The Commission finds that a rate of return adder is not appropriate and will not be ordered in this case.

Operating Expense Issues

A second group of issues concerns the expenses that MGE incurred during the test year and will likely incur in the future. MGE asks to recover these expenses from its customers through the rates that will be established in this case.

6. Capacity Release/Off System Sales

Issue Description: *What, if any, is the appropriate level of capacity release/off-system sales revenues to be used in calculating MGE's cost of service? As an alternative to including capacity release/off-system sales revenues in the calculation of MGE's revenue*

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[50] Noack Direct, Ex. 8, Page 24, Lines 14-18, and Schedule G-1.

[51] Oligschlaeger Rebuttal, Ex. 829, Pages 3-4, Lines 22-23, 1-5.

EXHIBIT _____ (LK-25)

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David L. Armstrong
Chairman

James W. Gardner
Vice Chairman

Linda Breathitt
Commissioner

August 14, 2014

Dear Consultants:

The Kentucky Public Service Commission ("Commission") is seeking proposals for all consulting services required to perform a focused management and operations audit of Big Rivers Electric Corporation, (Big Rivers). Big Rivers' headquarters are located in Henderson, Kentucky. The business address is Big Rivers Electric Corporation, 201 Third Street, Henderson, KY 42420.

An electronic copy of the Request for Proposal (RFP) and the standard information package can be found on the Commission's website at http://psc.ky.gov. If your firm is interested in responding to the RFP, please do so by September 17, 2014.

Additional information beyond that provided in the standard information package should not be requested from and will not be provided by the Commission.

Important dates to remember are as follows:

Proposals due to Commission - September 17, 2014
Begin audit on or about - November 19, 2014
Final Report will be due within approximately 5 months of start of audit

It should be noted that the cost of the audit will be borne by Big Rivers Electric Corporation. Therefore, cost will be an important factor, although not the only factor, in the selection of the consultant.

Should you have any questions concerning this Request for Proposal, please contact Mr. Daryl E. Newby, Director, Financial Analysis Division, at Daryl.Newby@ky.gov or 502-782-2645 at the Commission's offices.

Sincerely,

Jeff DeRouen
Executive Director