MISSOURI PUBLIC SERVICE COMMISSION

STAFF REPORT

REVENUE REQUIREMENT

COST OF SERVICE

VEOLIA ENERGY KANSAS CITY, INC.

CASE NO. HR-2014-0066

Jefferson City, Missouri
May 1, 2014

**** Denotes Highly Confidential Information ****

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COST OF SERVICE REPORT

I. Executive Summary

This Cost of Service Report provides the results of Missouri Public Service Commission ("Commission") Staff's review into the general rate increase request made by Veolia Energy Kansas City, Inc. (Veolia Kansas City or Company) on November 27, 2013.

Staff's review involved several members of the Commission's Staff who examined all relevant and material components making up the revenue requirement calculation. These items can be broadly defined as capital structure and return on investment, rate base investment and income statement results, including revenues, operating and maintenance expenses, depreciation expense, and related taxes, including income taxes.

Staff's audit findings, based on its review of Veolia Kansas City's current cost structure, supports an increase in rates of between $1.5 million to $1.7 million based on a range of rate of return from 8.5 percent to 9.5 percent with an increase of $1.6 million using Staff's mid-range of the rate of return of 9.0 percent, and the latest information available through December 31, 2013, for the material items affecting the revenue requirement calculation. In its direct filing, Veolia Kansas City calculated a revenue requirement of $2.8 million based on use of the 12-months ending June 30, 2013 test year updated for 12-months ending December 31, 2013, but chose to limit its rate increase request to approximately $1 million, or a 14.4 percent increase, for the reasons stated in its filing.

Staff Expert/Witness: Karen Lyons

II. Background of Veolia Energy Kansas City, Inc.

Veolia Energy Kansas City, Inc., formally known as Trigen Kansas City Energy Corporation (Trigen), is a steam production and distribution company, serving the downtown central district of the City of Kansas City, Missouri, and two industrial process steam users. Originally, Veolia Kansas City steam operations were owned and operated by Kansas City Power & Light Company (KCPL). Trigen purchased the Grand Avenue production facilities and the distribution system from KCPL in 1990. The Commission approved the sale in Case No. HM-90-4, along with approval by the Commission for Trigen to acquire the assets and

receive a certificate of public convenience and necessity (CCN) in Case No. HA-90-5. The Commission approved the sale and CCN by Orders on December 29, 1989.

On March 10, 2011, Trigen filed a request with the Commission to change its name to Veolia Kansas City., in Case No. HN-2011-0286. The Commission approved the name change and the accompanying tariffs sheets on April 10, 2011.

Veolia Energy Missouri (Veolia Missouri) is a non-regulated affiliate of Veolia Kansas City providing chilled water service in the central downtown district of Kansas City. Veolia Kansas City and Veolia Missouri are wholly owned subsidiaries of Thermal North America, Inc. (Thermal North America or TNAI). Veolia Energy North America, LLC, a management service company, is a wholly owned subsidiary of Thermal North America. Thermal North America was purchased by Veolia Energy North America Holdings, Inc., in December 2007. Thermal North America has several other wholly owned subsidiaries managed by Veolia Energy North America, LLC, and are referred to herein as the Veolia Companies. Veolia Energy North America, LLC, directly assigns or allocates certain corporate costs it incurs directly to the Veolia Companies. The Veolia Companies are located in the following locations: Baltimore, Maryland; Boston, Massachusetts; Trenton, New Jersey; Philadelphia, Pennsylvania; Oklahoma City, Oklahoma; Tulsa, Oklahoma; St. Louis, Missouri; Kansas City, Missouri; Las Vegas, Nevada; Atlanta, Georgia; and Los Angeles, California. The Veolia Companies located in Philadelphia, Pennsylvania, St. Louis, Missouri and Kansas City, Missouri are subject to state or local regulation. Veolia Kansas City currently serves approximately 54 retail customers all located in the downtown central district of the City of Kansas City, otherwise known as the "downtown loop."[1] In addition to the retail customers, Veolia Kansas City also sells process steam to two large industrial customers located outside the downtown loop. The Company meters the steam sold to these customers at the Grand Avenue production facility.

Staff Expert/Witness: Karen Lyons

A. Veolia Energy Kansas City, Inc. 2011 Rate Case

On November 27, 2013, Veolia Kansas City filed a general rate increase case for approximately $1 million, a 14.4 percent increase. This is the fourth rate increase request that

[1] The downtown KC area is no longer served by a true "loop." In the construction of the Sprint Arena, a steam pipe was truncated in Case No. HC-2005-0331.

Veolia Kansas City has filed since taking over the steam operations in 1990. However, the Company withdrew its first rate increase request filed in the early 1990s. So in actuality, this case is the Company's third full rate relief request since acquiring the steam system in Kansas City in early 1990.

Previously, rates were increased by $1.379 million in the last rate case (HR-2011-0241) and became effective October 19, 2011. Prior to that increase, rates were increased $1.228 million on November 1, 2008 (HR-2008-0300). Before the 2008 rate change, Veolia Kansas City's customers had not experienced a rate increase since 1982 when KCPL owned the steam operations (Case No. HR-82-67). The following table identifies the original amount requested which was also the amount authorized by the Commission, the amount the Company justified in its revenue requirement calculation, and the test year and update period used in each case:

Case Number	Effective Date of Rates	Amount Rate Request/ Full Amount Awarded	Overall percent increase	Case Justified	Test Year	Update Period
HR-2014-0066	pending	$1.0 million	14.4%	$2.8 million	June 30, 2013	December 31, 2013
HR-2011-0241	Oct 19, 2011	$1.379 million	19%	$3.7 million	December 31, 2010	June 30, 2011
HR-2008-0300	Nov 1, 2008	$1.228 million	19.5%	$2.6 million	December 31, 2007	June 30, 2008

Staff Expert/Witness: Karen Lyons

B. Test Year

The test year used in this case is the 12-month period ending June 30, 2013. The Commission authorized the use of the test year in its *Order Setting Procedural Schedule, Establishing Test Year And Guidelines For Discovery ("Order")*, issued January 16, 2014.

Known and measurable changes are ratemaking events that have occurred subsequent to the test year. These events are certain to occur, or have occurred, and can be quantified for measurement. Included in the Commission's *Order* establishing the June 30, 2013 ended test year, the Commission also established an update period for known and measurable changes through December 31, 2013. Staff's audit found that the Company planned a payroll rate increase effective on January 1, 2014. Staff determined that the payroll increase was a material

cost to the Company, so the Staff included it in the payroll annualization in this case. To maintain the integrity of the relationship between revenues, costs and rate base, Staff reflected all material costs including plant in service, accumulated depreciation reserve, depreciation expense and other items through December 31, 2013.

Staff Expert/Witness: Karen Lyons

III. Rate of Return and Capital Structure

A. Introduction

An essential ingredient of the cost-of-service ratemaking formula provided above is the rate of return ("ROR"), which is designed to provide a utility with a return of the costs required to secure debt and equity financing. This ROR is usually premised on the utility's weighted average cost of capital ("WACC"), which is calculated by multiplying each component ratio of the appropriate capital structure by its cost and then summing the results. While the proportion and cost of most components of the capital structure are a matter of record, the cost of common equity must be determined through expert analysis.

Staff's expert financial analyst, Shana Atkinson, has determined Veolia Kansas City cost of common equity by applying a well-respected and widely-used methodology[2] to data derived from a carefully-assembled group of comparable companies.

Due to the limited amount of publicly-traded market data available for steam-heat utility operations such as those of Veolia Kansas City, Staff used a proxy group of natural gas distribution companies as a proxy for a fair and reasonable cost of equity, debt and capital structure for purposes of ratemaking for Veolia Kansas City's operations. Natural gas distribution companies operate in a similar economic and capital market environment as Veolia Kansas City's regulated operations and are limited to the distribution of utility services. As can be derived from the debt and equity ratios (See schedule 7), the proposed capital structure is based on an approximate average of the proxy group of natural gas distribution companies used by Staff.

[2] Staff relied primarily on its Discounted Cash Flow ("DCF") analysis of a group of comparable utilities, checking the reasonableness of its result with a Capital Asset Pricing Model ("CAPM") analysis as well as by other corroborating data.

Staff then used that cost of common equity, together with other capital component information as of the update period, December 31, 2013, to calculate Veolia Kansas City's fair rate of return, as follows:

TABLE ONE: Veolia Energy Kansas City, Inc.'s Rate of Return:

Capital Component	Percentage of Capital	Embedded Cost	Weighted Cost of Capital Using Common Equity Return of: **8.50%**	**9.00%**	**9.50%**
Common Stock Equity	48.00%	----	4.08%	4.32%	4.56%
Long-Term Debt	52.00%	5.27%	2.74%	2.74%	2.74%
	100.00%		**6.82%**	**7.06%**	**7.30%**

As contained in Table One, Staff recommends, based on its expert analysis, a return on common equity ("ROE") range of 8.50 percent - 9.50 percent and an overall ROR range of 6.82 percent - 7.30 percent, with mid-point estimates of 9.00 percent ROE and resulting in 7.06 percent overall ROR. Staff's recommended "ROE" incorporates a 70-basis point credit-rating differential adjustment. Veolia Environnement, parent to Veolia Energy Kansas City, Inc., has a 'BBB' credit rating and Staff's proxy group has an average credit rating of 'A.'[3] Staff used Veolia Environnment's credit rating because, to Staff's knowledge, it is the only entity in the Veolia family of companies that is rated. Presumably, this rating would also apply to its subsidiaries, at least based on Standard & Poor's ratings methodology. Further details of Staff's analysis and recommendations are presented in Appendix 2, Schedules 1-14, attached to this report.

Staff's cost of equity estimate is primarily based on the constant-growth Discounted Cash Flow (DCF) model results. The major assumption made when the constant-growth DCF model is applied to mature companies, such as natural gas distribution companies, is that mature companies experience constant growth into perpetuity. The constant growth (perpetual growth) used in Staff's constant-growth DCF model is premised on Staff's assumption that Staff's set of

[3] Standard and Poor's Research Update: France-Based Veolia Environnement Downgraded To 'BBB' On Squeezed Profitability And Subdued Recovery in Credit Metrics; Outlook Neg. November 15, 2013.

comparable natural gas distribution companies (proxy group)[4] should not experience a compound annual perpetual growth rate much, if any, higher than those actually achieved for the natural gas distribution industry over a prolonged time period. As Staff explains in detail later in this Section of the Cost of Service Report, the constant-growth rate should not be any higher than 5 percent based on actual experience.

B. Analytical Parameters

The determination of a fair rate of return is guided by principles of economic and financial theory; and by certain minimum constitutional standards. Investor-owned public utilities such as Veolia Environnement are private property that the state may not confiscate without appropriate compensation. The United States Constitution requires, therefore, that utility rates set by the government must allow a reasonable opportunity for the shareholders to earn a fair return on their investments. The United States Supreme Court has described the minimum characteristics of a Constitutionally-acceptable rate of return in two frequently-cited cases. In ***Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia,*** the Court stated:[5]

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Similarly, in the later of the two cases, ***Federal Power Commission v. Hope Natural Gas Co.,*** the Court stated:[6]

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[4] Schedule 6-2.

[5] 262 U.S. 679, 692-93, 43 S.Ct. 675, 679, 67 L.Ed. 1176, 1182-83 (1923).

[6] 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333, 345 (1943).

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

From these two decisions, Staff derives and applies the following principles to guide it in recommending a fair and reasonable ROR:

1. A return consistent with returns of investments of comparable risk;
2. A return sufficient to assure confidence in the utility's financial integrity; and
3. A return that allows the utility to attract capital.

Embodied in these three principles is the economic theory of the opportunity cost of an investment. The opportunity cost of an investment is the return that investors forego in order to invest in similar risk investment opportunities, which will vary depending on market and business conditions.

The methodologies of financial analysis have advanced greatly since the ***Bluefield*** and ***Hope*** decisions. Additionally, today's utilities compete for capital in a global market rather than a local market.[7] Nonetheless, the parameters defined in those cases are readily met using current methods and theory. The principle of the commensurate return is based on the concept of risk. Financial theory holds that the return an investor may expect is reflective of the degree of risk inherent in the investment, risk being a measure of the likelihood that an investment will not perform as expected by that investor. Any line of business carries with it its own peculiar risks and it follows, therefore, that the return Veolia Kansas City may expect is equal to that required for comparable-risk utility companies.

Financial theory holds that the results of a company-specific DCF method satisfies the constitutional principles inherent in estimating a return consistent with those of companies of

[7] Neither the DCF nor the CAPM methods were in use when those decisions were issued.

comparable risk;[8] however, Staff recognizes that there is also merit in analyzing a comparable group of companies as this approach allows for consideration of industry-wide data. Because Staff believes the cost of equity can be reliably estimated using a comparable group of companies and the Commission has expressed a preference for this approach, Staff relies primarily on its analysis of a comparable group of companies to estimate the cost of equity for Veolia Kansas City.

In this case, Staff established the following: 1. Veolia Kansas City is not a publicly traded entity; and 2. Veolia Kansas City and its parent company, Veolia Energy North American Holdings, Inc. (VENAH), do not have market-based capital structures that represent a fair and reasonable capitalization when compared to the manner in which the natural gas distribution companies in Staff's proxy group are generally capitalized. In order to derive a hypothetical capital structure, Staff selected 8 companies (proxy group) and computed an average capital structure for these companies (see Schedules 6-1, 6-2 and 7).

Staff then applied the comparable company approach through the use of both the DCF method and the Capital Asset Pricing Model (CAPM). Properly used and applied in appropriate circumstances, both the DCF and the CAPM methodologies can provide accurate estimates of a utility's cost of equity. Because it is well-accepted economic theory that a company that earns its cost of capital will be able to attract capital and maintain its financial integrity, Staff believes that authorizing an *allowed* return on common equity no lower than the *cost* of common equity is consistent with the principles set forth in ***Hope*** and ***Bluefield***.

C. Current Economic and Capital Market Conditions

Determining whether a cost of capital estimate is fair and reasonable requires a good understanding of the current economic and capital market conditions, with the former having a significant impact on the latter. With this in mind, Staff emphasizes that an estimate of a utility's cost of equity should pass the "common sense" test when considering the broader current economic and capital market conditions.

[8] Because the DCF method uses stock prices to estimate the cost of equity, this theory not only compares the utility investment to other utilities, but it compares the utility investment to all available assets. Consequently, setting the allowed ROE based on a market-determined cost of equity is necessarily consistent with the principles of ***Hope*** and ***Bluefield***.

1. Economic Conditions

For the 2013 calendar year, the U.S. economy expanded in all four quarters. Real GDP increased 1.1 percent in the first quarter, 2.5 percent in the second quarter, 4.1 percent in the third quarter and 2.6 percent in the fourth quarter.[9] The Bureau of Economic Analysis attributes the deceleration in real GDP growth from the third quarter to the fourth quarter to a downturn in inventory investment, a larger decrease in federal government spending, and a downturn in housing investment. As of March 19, 2014 the Federal Reserve Bank (Fed) projected the economy would grow between 2.8 percent and 3.0 percent this year and between 3.0 percent and 3.2 percent next year. Assuming the projected economic growth does not cause inflation rates to rise above the Fed's target inflation rate of 2 percent and the unemployment rate continues to trend toward 6.5 percent, the Fed's actions should be consistent with what it has communicated to markets.

Information released from the recently held Federal Open Market Committee (FOMC) meeting held on March 19, 2014, share the FOMC's view that the data received since the last meeting in January indicate that growth in economic activity decelerated. Labor market indicators showed further improvement, but the unemployment rate remains elevated. The FOMC reduced its overall bond purchase program by another $10 billion per month beginning April 2014; and also indicated that it will continue to taper the bond purchase program if the incoming information and financial developments exhibit substantial improvement.

The FOMC updated its forward guidance based on the unemployment rate now nearing 6.5 percent. The following excerpt reflects the FOMC's current stance:

> To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to ¼ percent target range for the federal funds rate, the Committee will assess progress–both realized and expected—toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it

[9] Bureau of Economic Analysis, GDP Growth Slows in Fourth Quarter, March 27, 2014 and National Income and Product Accounts Gross Domestic Product, 4th quarter and annual 2013 (third estimate); Corporate Profits, 4th quarter and annual 2013.

> likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.
>
> When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.[10]

Some of Staff's proxy group companies issuances of long-term debt offer evidence of the existence of the still-low long-term debt cost environment. On August 13, 2013, Laclede Gas Company issued $450 million of first mortgage bonds 3.34 percent (average) debt series ($100 million 5-year term 2.00 percent series debt, $250 million 10-year term 3.40 percent series debt and $100 million 30-year term 4.625 percent series debt) compared with Laclede Gas Company's 6.5 percent $25 million first mortgage bonds paid at maturity on October 15, 2012. On August 19, 2013, Northwest Natural Gas Company issued 3.542 percent $50 million first mortgage bonds with a 10-year maturity. Another example is AGL Resources issued $500 million in 30-year senior notes with a fixed interest rate of 4.4 percent on May 16, 2013.

2. Capital Market Conditions

a. Utility Debt Markets

Utility debt markets clearly indicate a lower cost-of-capital environment. If one were to assume that the risk premium[11] required for investing in utility stocks rather than utility bonds were constant, then the currently low utility debt yields clearly translate into a lower required return on equity. In other words, lower cost of debt is indicative of lower cost of capital, all else being equal.

Although long-term interest rates –as measured by 30-year Treasury Bonds "T-Bonds" and utility bond yields–increased during the 2013 calendar year, they have decreased slightly the first three months of 2014 and are still low when compared to long-term interest rates

[10] Federal Reserve Press Release March 19, 2014.

[11] Risk Premium in this context is the excess required return to invest in a company's equity rather than its debt.

experienced prior to and immediately after the end of the most recent recession in June 2009 (*see* Schedules 4-2 and 4-3, and Schedules 4-1 and 4-3 respectively). As of March 2014, the average spread between 30-year T-bonds (3.62 percent) and average utility bond yields (4.74 percent)[12] was 112 basis points, which is 42 basis points below the average of such yields displayed in the period since 1980 (*see* Schedule 4-4). Utility bond yields over the last couple of years continue to remain at levels not experienced since the 1960s.[13]

b. Utility Equity Markets

Investors view regulated utility company stock investments as a close alternative to bond investments. Therefore, similar to bond investments, typically when long-term interest rates fall, regulated utility company stock prices rise. This is what largely triggered utility company stocks, specifically natural gas utility stocks, to outperform the broader markets until approximately May 2013. During the next few months, interest rates started to increase out of fear that the Fed would start tightening monetary policy in the near future, which caused returns on utility stocks to lag that of the S&P 500 by a fairly wide margin for the rest of the 2013 calendar year. The total return on the S&P 500 for 2013 was 32.39 percent compared to a total return of 21.08 percent for Staff's natural gas utility proxy group.

The broader markets have moderated a bit during the first quarter of 2014. This appears to be largely due to concerns about valuation levels of growth stocks as it compares to the prospects for future growth. This appears to have caused some movement back to utility stocks. During the first quarter of 2014, the S&P 500 had total return of 1.81 percent as compared to the total return on Staff's natural gas utility proxy group of 3.96 percent. For the twelve months ended, March 31, 2014, the total return on the S&P 500 was 22.40 percent as compared to the total return on Staff's natural gas utility proxy group of 13.61 percent.

Because regulated utilities had been trading at a premium to the S&P 500 before the rally in the broader markets during the latter half of 2013, it appeared that investors were fairly risk averse and seeking yield through investment in utility stocks and other defensive sectors.

[12] The 4.74 percent yields is based on an average from data obtained from BondsOnline.com For utility bond yields Staff provides prior to September 2010, Staff used Mergent Bond Record. Staff has canceled its subscription to Mergent Bond Record and will rely on data it receives from BondsOnline pursuant to a subscription agreement.

[13] Because Staff does not have utility bond yield data dating back to the 1960s, this is based on Staff's review of general corporate bond yields that were available from the St. Louis Federal Reserve website. This data showed that the general level of bond yields was much lower in the 1960s.

However, investors became more willing to increase their risk exposure in the broader markets during the latter half of 2013. But this trend has not continued during the first quarter of 2014. Investors have shown that they continue to value dividend paying stocks as compared to growth stocks. In a recent Wall Street Journal article, investors' favor of dividend stocks for the first part of 2014 was discussed:

> The shift from last year, when so-called growth stocks were in favor, reflects rising concern that corporate earnings are running out of gas and the economic recovery will be stuck in low gear. Few investors expect the market to deliver the gains seen last year, when the S&P 500 returned 32% including dividends…
>
> …An unexpected drop in interest rates this year has increased the appeal of dividend-paying stocks. Despite the Federal Reserve's staggered withdrawal of its rate-lowering stimulus measures, the yield on 10-year Treasury notes stands at 2.726%, down from 3% at the start of this year.[14]

It appears that investors have pulled back from growth stocks because of reduced expectations for growth in earnings for the broader markets. The appeal of some dividend paying stocks, such as Staff's natural gas distribution proxy group, is they offer dividend yields that are higher than yields on Treasury Bonds and they offer a fairly predictable growth rate in the dividends assuming the natural gas distribution company does not expose itself to unpredictable non-regulated operations.

However, it is important to understand that while Staff's natural gas proxy group lagged behind the S&P 500 for the twelve months ended through March 31, 2014, the returns were still well above what can be explained by expected earnings growth. Because the valuation levels of the stocks of Staff's natural gas utility proxy group have increased since Staff last sponsored testimony in the Kansas City Power & Light Company (KCPL), Ameren Missouri and Empire rate cases, this supports Staff's position that investors are still not requiring a very high return to invest in gas utility companies. In fact, some investment analysts believe at current valuation levels utility stocks won't experience any capital appreciation in 2014.[15]

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[14] Dan Strumpf, "Dividend Stocks Bear Fruit: *As Shares Get Pricey, More Investors Pick Steady Payouts Over Rapid Growth*," April 7, 2014, P. C1, Wall Street Journal.

[15] Shahriar (Shah) Pourreza, Sophie K Karp, Ryan Levine and Mark Rudovic, "FY 2014 utility Sector Sneak Peak: Stock Pickers Market – Select Winners and Losers Exist in '14," January 2, 2014, Citi Research.

D. Veolia Energy Kansas City, Inc. Operations

The following excerpt from Veolia Energy North America website provides a good description of Veolia Kansas City's current business operations:

> In Kansas City, Veolia Energy's district energy network serves approximately 60 customers in the central business district, with more than 4 million square feet of commercial space.
>
> The district energy network provides centrally-produced steam and chilled water for their customers, and the facility also cogenerates electricity.[16]

E. Veolia Energy Kansas City, Inc.'s Credit Ratings

Veolia Energy Kansas City, Inc. is not publicly traded and is not rated on a stand-alone basis. However, its ultimate French parent company, Veolia Environnement has a 'BBB' credit rating from S&P. The following excerpt from Veolia Environnement's 2012 Annual Financial Report provides a good description of Veolia Environnement's share capital management objectives, policies and procedures:

> Veolia Environnement manages its share capital within the framework of a prudent and rigorous financial policy that seeks to ensure easy access to French and international capital markets, to enable investment in projects that create value and provide shareholders with a satisfactory remuneration, while maintaining an "Investment Grade" credit rating.

Veolia Environnement's 'BBB' credit rating is a reflection of its consolidated risk profile. The rating implies that Veolia Environnement and its subsidiaries are more risky than that of the average risk of the companies in Staff's proxy group, which has an average 'A' credit rating.

F. Cost of Capital

In order to arrive at Staff's recommended ROR, Staff specifically performed (1) a capital structure analyses, (2) an embedded cost of debt analyses, and (3) a cost of common equity analyses.

[16] http://www.veoliaenergyna.com/veolia-energy-north-america/locations/kansas-city.htm.

1 Capital Structure

Schedules 7 and 14 present the hypothetical capital structure for Staff's proxy group. As can be derived from the debt and equity ratios, the proposed capital structure is fairly consistent with the way in which natural gas distribution companies are generally capitalized. The resulting hypothetical capital structure consists of 48 percent common stock equity and 52 percent long- term debt.

2. Embedded Cost of Debt

Staff's embedded cost of debt of 5.27 percent is an average of the stated cost of outstanding long-term debt for its proxy group – see Schedule 8-9.

3. Cost of Common Equity

Staff's expert financial analyst, Shana Atkinson, estimated Veolia Kansas City's cost of common equity through a comparable company cost-of-equity analysis of a proxy group of eight companies using the Discounted Cash Flow ("DCF") methodology. Additionally, Staff used a CAPM analysis and a survey of other indicators as a check of the reasonableness of its recommendations.

a. The Proxy Group

First, Staff formed a group of comparable companies for the commensurate return analysis. Staff started with 20 market-traded natural gas utilities, as classified by SNL Financial (*see* Schedule 6-1). Staff decided to start using SNL Financial for purposes of selecting its proxy group and estimating the cost of common equity because it is widely used by investors, utilities, industry associations and public service commissions throughout the country. In fact, SNL acquired Regulatory Research Associates, a publication cited in almost every major rate case in Missouri. To the extent SNL Financial does not provide the same data Staff relied on from Value Line to estimate the cost of equity, Staff has replicated the same or similar data by extracting it from the SNL database. Additionally, the source of the companies' financial data can be verified by direct links to the companies' SEC financial statements. Lastly, SNL Financial provides more details on equity analysts' projections as tracked by FactSet, which is the type of information many rate of return witnesses claim is influential in understanding how investors determine the price they are willing to pay for stocks.

Staff applied a number of criteria to develop a proxy group comparable in risk to Veolia Kansas City:

1. Stock publicly traded (1 company eliminated, 19 remaining);
2. At least 65% Operating Income from Distribution (8 companies eliminated, 11 remaining);
3. At least 65% of Assets are Distribution Assets (0 companies eliminated, 11 remaining);
4. Two analysts for long term projected EPS growth available within the last 90 days, with at least one estimate available within last 30 days (3 companies eliminated, 8 remaining);
5. Positive historical 5-year compound annual growth rate in dividends per share through most recent 5 years (0 companies eliminated, 8 remaining); and
6. At least investment grade credit rating (0 companies eliminated, 8 remaining).

This resulted in a group of eight publicly-traded natural gas utility companies ("the comparables/proxy group") that could be used as a proxy for estimating Veolia Kansas City's cost of common equity. The comparables are listed on Schedule 6-2.

b. The Constant-growth DCF

Next, Staff estimated Veolia Kansas City's cost of common equity applying values derived from the proxy group to the constant-growth DCF model. The constant-growth DCF model is widely used by investors to evaluate stable-growth investment opportunities, such as regulated utility companies. The constant-growth version of the model is usually considered appropriate for mature industries such as the regulated utility industry.[17,18] It may be expressed algebraically as follows:

[17] Aswath Damodaran, *Investment Valuation: Tools and techniques for determining the value of any asset,*University Edition, John Wiley & Sons, Inc., 1996, p. 195-196.

$$k = D_1/P_0 + g$$

Where: k is the cost of equity;

D_1 is the expected next 12 months dividend;

P_S is the current price of the stock; and

g is the dividend growth rate.

The term D_1/P_0, the expected next 12 months dividend divided by current share price, is the dividend yield. Staff calculated the dividend yield for each of the comparable companies by dividing the weighted average of equity analysts' projected dividends per share (DPS) for the 2014 fiscal year and 2015 fiscal year, as reported by FactSet (*see* Schedule 12), by the monthly high/low average stock price for the three months ending March 31, 2014 (*see* Schedule 12).[19] Staff weighted the DPS projections in this manner in order to reflect the approximate amount of time remaining in the 2014 fiscal year for each comparable company. Staff used the above-described stock price because it reflects current market expectations. The projected average dividend yield for the eight comparable companies is approximately 3.80 percent, unadjusted for quarterly compounding.

c. The Inputs

In the DCF method, the cost of equity is the sum of the dividend yield and a perpetual growth rate ("g") that is intended to replicate the projected capital appreciation of the stock. In estimating a growth rate, Staff analyzed both actual and projected dividends per share ("DPS"), earnings per share ("EPS") and book value per share ("BVPS") for each of the comparable companies (*see* Schedules 9-1 through 9-4). Staff also reviewed equity analysts' consensus estimates for long-term compound annual growth rates as reported by FactSet and provided by SNL Financial. The average consensus long-term EPS growth rates for the proxy group is currently 3.89 percent. (*see* Schedule 9-4).

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[18] John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of EquityInvestments: Valuation*, Association for Investment Management and Research, 2002, p. 64.

[19] The monthly high/low averaging technique minimizes the effects of short-term stock market volatility on the calculation of dividend yield. P0 is calculated by averaging the highest and the lowest price for each month during the selected period.

In Staff's experience, historical and projected growth rates for natural gas distribution utilities had been fairly consistent. Based on the shorter-term data shown on Schedule 9-5, it would appear that a growth rate range of 4.0 to 5.0 percent would be reasonable for an estimate of the cost of equity using the constant-growth DCF, but this does not give consideration to empirical and logical information that suggest that utility companies should grow at a rate less than that of the overall economy due to the mere fact that investors invest in utility companies for yield and not growth. In fact, considering that companies in the S&P 500 (a proxy for the U.S. capital markets) in recent years have retained approximately 65% to 70% of their earnings for reinvestment,[20] while natural gas distribution utilities' retention ratio has been approximately half that of the S&P 500,[21] it makes logical sense that utilities will grow at a rate less than that of nominal GDP growth. Consequently, a projected long-term, steady-state nominal GDP growth rate should be considered as an upper constraint when testing the reasonableness of growth rates used to estimate the cost of equity for a regulated gas utility.

Because the constant growth rate is assumed to last in perpetuity, the projected economic growth rates that are most pertinent for evaluating the sustainability of a growth rate for a given industry are those that are based on a steady-state economic environment for the country in which that industry operates. In the case of natural gas distribution utilities, it is important to project long-term, sustainable growth rates consistent and reasonable with the projected lower growth of the United States' developed domestic economy. Although some analysts try to infer potential future economic growth in the U.S. from historical growth rates, it is clear that most economic experts believe that the U.S. economy has developed to the extent that the growth rates of the past won't be realized again in the future, hence the current low interest rate environment. This is clear from long-term economic forecasts provided in Table 8, on page 92 of the U.S. Energy Information Administration's 2013 Annual Energy Outlook. The following table is reproduced for convenience:

Table 8. Comparisons of average annual economic growth projections, 2011-2040

Average annual percentage growth rates

Projection	2011-2015	2011-2025	2025-2040	2011-2040
AEO2013 (Reference case)	2.5	2.6	2.4	2.5

[20] Table B-95 and B-96 attached to the 2013 Economic Report of the President.

[21] "Natural Gas Industry Summary," December 31, 2013, Edward Jones.

AEO2012 (Reference case)[a]	2.7	2.6	2.5	2.6
IHS Global Insight (August 2012)	2.5	2.6	2.5	2.5
OMB (January 2013)[a]	2.2	2.8	--	--
CBO (February 2013)[a]	2.6	2.7	--	--
INFORUM (November 2012)	2.6	2.6	2.4	2.5
Social Security Administration (August 2012)	2.9	2.7	2.2	2.4
IEA (2012)[b]	2.5	2.6	--	2.4
Blue Chip Consensus (October 2012)[a]	2.4	2.5	--	--
ExxonMobil	--	2.5	2.2	2.4
ICF International	--	--	--	2.6
Oxford Economics Group (January 2013)	2.7	2.7	2.6	2.6

-- = not reported or not applicable

[a]OMB, CBO, and Blue Chip forecasts end in 2022, and growth rates cited are for 2011-2022 *AEO2012* projections end in 2035, and growth rates cited are for 2011-2035

[b]IEA publishes U S growth rates for certain intervals: 2010-2015 growth is 2.5 percent, 2010-2020 growth is 2 6 percent, and 2010-2035 growth is 2 4 percent

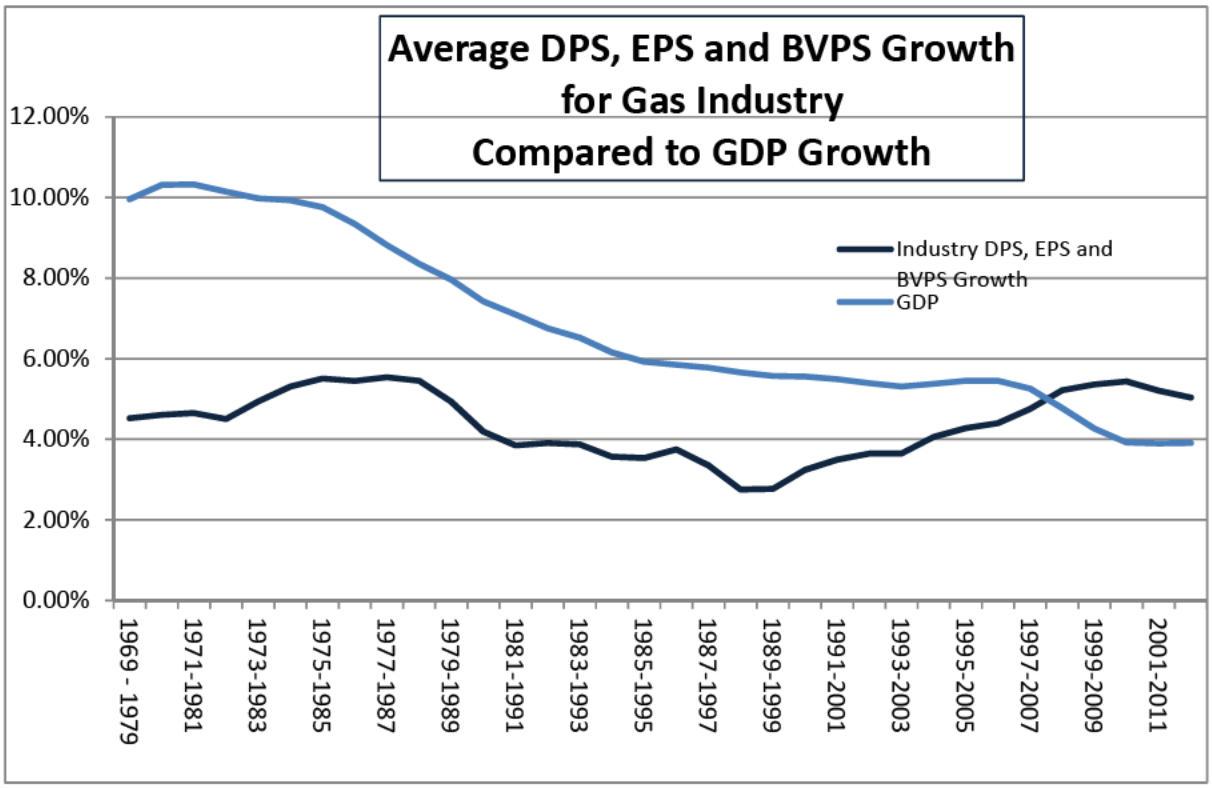
Staff has used the Energy Information Administration, the Congressional Budget Office and the Blue Chip Consensus forecasts for purposes of evaluating projected long-term GDP growth in past rate cases. This table summarized not only these sources, but several other sources that are widely used in evaluating potential GDP growth. For example, the Federal Energy Regulatory Commission (FERC) uses IHS Global Insight for purposes of evaluating GDP growth in gas pipeline rate cases. As can be seen in the above table, these sources provide not only a near-term projected annual compound economic growth rate, but also a projected annual compound growth rate over a very long period, which is of most relevance to a constant-growth DCF growth rate. In fact, some of these sources provide projected annual compound growth rates for the period 2025 through 2040, which provides insight as to the growth rate economists believe are sustainable given the fundamentals of the United States' developed economy. Such "trend" growth rates should be given the most weight to test the reasonableness of long-term growth rates for a mature industry, such as the regulated natural gas distribution industry. Although not included in this table, most economists expect a long-term trend growth rate in the GDP price deflator of approximately 2.0 percent. After multiplying this 2.0 percent inflation rate by a real GDP growth rate of 2.5 percent, this results in a compound growth rate of 4.55 percent for a sustainable, trend growth rate in the U.S. economy. Although some projections may be slightly higher or lower than a 4.55 percent growth rate in GDP, Staff believes this is a reasonable estimate based on the various sources it reviewed.

Although the fundamentals of the natural gas distribution industry do not support a growth rate higher than that of the overall economy, Staff decided it would be prudent to compare historical growth rate patterns for the natural gas distribution industry to that of GDP growth to better understand the relationship between gas industry growth and GDP growth.

In order to evaluate the gas industry's growth compared to GDP growth, Staff had to select a group of natural gas distribution companies that could be considered a good proxy for the natural gas distribution industry for a long, continuous period. Staff started with the entire set of companies that Edward Jones classified as natural gas distribution companies in its September 30, 2013 quarterly publication on the natural gas industry. Staff then researched its library of Value Line Ratings & Reports to determine which of these companies had continuous historical financial data for at least 20 years. The following companies had at least 20 years of continuous financial data: AGL Resources, Atmos Energy, Laclede Group, New Jersey Resources, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries and WGL Holdings.[22] Actually, all of these companies, with the exception of Atmos Energy, had continuous financial data in the Staff's library going back until at least the early 1970s, with most companies having information covering the entire historical period (back to 1968) in which Staff has information available in its library. Staff still included Atmos in its long-term proxy group, but Staff also analyzed trends without Atmos.

Staff's analysis of the proxy group's financial data since 1968 revealed that the actual realized growth of the natural gas distribution industry has averaged in the low 4 percent range, or about 75 percent of average GDP growth of around 7 percent over the same period. Although the natural gas distribution industry grew at a slower rate than GDP, Staff believes it is also important to consider that the growth in the natural gas distribution industry was not highly correlated with GDP growth over this period. Below is a graph of the natural gas distribution industries' average 10-year compound growth rates as they compare to GDP growth for the period 1968 through 2013 (this graph and the supporting data are also contained in Schedules 9-5 through 9-7):

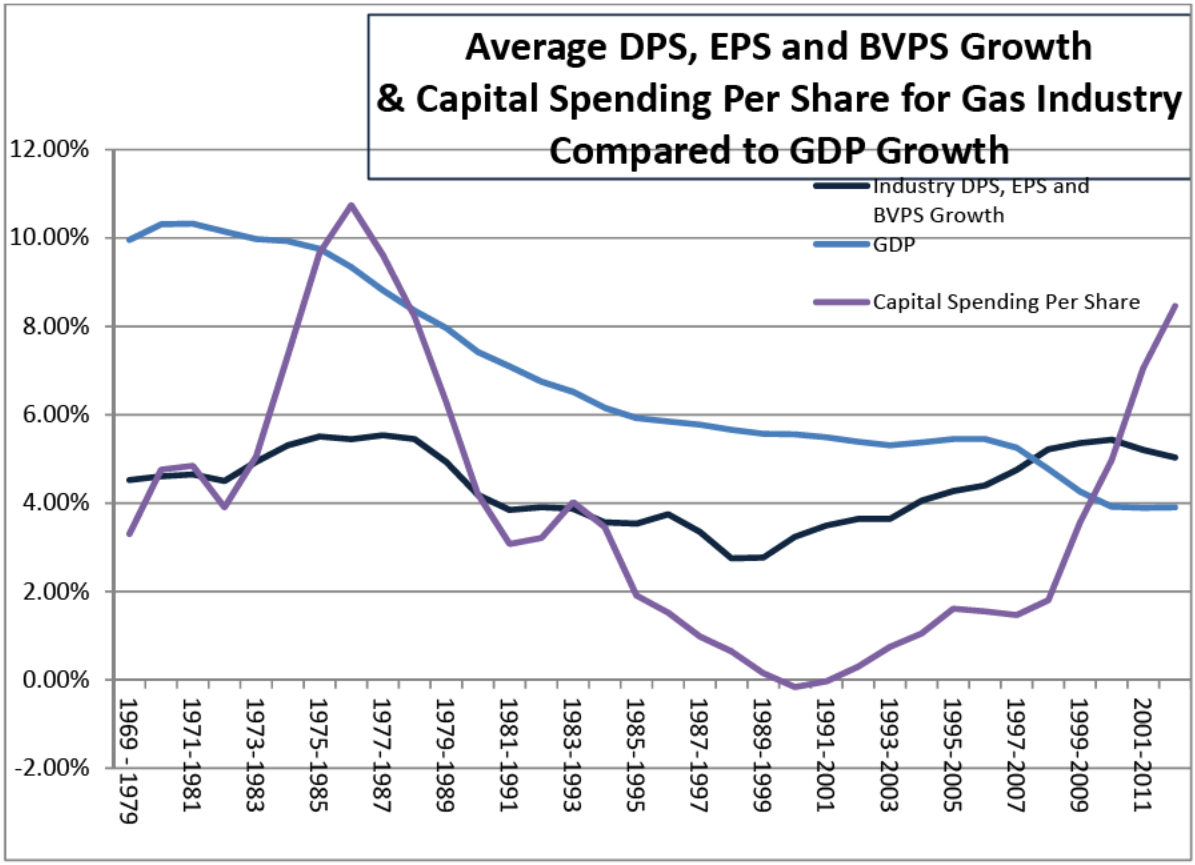
[22] Edward Jones does not classify Southwest Gas Company as a natural gas distribution company. Staff's selection criteria in this case caused it to include Southwest Gas Company in Staff's natural gas proxy group. However, based on Southwest Gas' historical financials, it appears the Company was exposed to volatility not consistent with the other natural gas distribution utilities. Consequently, Staff excluded Southwest Gas from its long-term proxy group.



As can be seen in the above graph, the growth for both the natural gas distribution industry moved inversely to that of GDP for the 10-year periods from 1970- 1980 through 1975-1985 and 1988-1998 through 2001-2011. Consequently, empirical evidence shows that natural gas distribution utility growth has had very little correlation to that of GDP. If this is the case, then a key question for purposes of understanding the reasonableness of constant growth rates used in a DCF analysis is how one should incorporate GDP into evaluating the reasonableness of gas industry growth rates and what are the major factor(s) that will determine the sustainability of gas industry growth rates going forward?

As Staff has already explained, even though natural gas distribution industry growth has not been highly correlated to GDP in terms of growth patterns, it has on average been less than GDP growth. Therefore, long-term GDP growth is at the very least a constraint on the maximum long-term growth potential for the industry even though they don't always move together during shorter intervals. Therefore, considering the fact that average GDP growth is projected to be much lower than it had been over the past 40 years, then it is only logical to expect the long-term compound annual growth rates to be lower for the natural gas distribution industry over the same 40-year period. This supports a long-term constant growth rate of less than 4.55 percent.

The other factors that often determine potential growth for the regulated gas distribution industry are investment and demand/customer growth. Because most regulated natural gas distribution companies have moved to largely decoupled rate designs in which the recovery of the revenue requirement is not a function of usage, but of number of customers, the other major factor should be limited to expansion of the system to serve additional customers. Staffs understanding of the history of the natural gas distribution industry, at least that of the proxy group Staff analyzed, is that customer growth was a key driver of capital investment in the 1980s. In order to understand the relative magnitude of capital investment natural gas distribution companies made in the 1980s, Staff also analyzed the changes in capital spending per share from the period 1968 through the present. Staff, then compared the industry's capital spending to the average growth in DPS, EPS and BVPS and found a fairly high correlation between the two.



As can be seen, there is a higher correlation between capital spending and industry growth, then there is between GDP and industry growth. One would expect capital expenditures

to be fairly highly correlated to GDP growth, but that is not the case for the gas distribution industry. The current rise in capital expenditures is not driven by expected growth in the economy, but in the perceived need to accelerate capital expenditures for infrastructure replacement.

Consequently, growth for existing systems should primarily be a function of investment growth. Staff's understanding of the investment growth in the natural gas distribution industry is that many companies have been and continue to pursue replacement of existing infrastructure in accordance with various infrastructure replacement programs and favorable rate treatment associated with these programs.[23] To the extent there is limited customer growth, this will be the primary driver of growth for the gas distribution industry in general.

Because investors are well aware of the limitations on potential growth for the industry as compared to its historical growth, as Staff discussed above, Staff believes it is important to consider the natural gas distribution industry's actual experienced growth over the long-term, when evaluating whether investment analysts' 5-year EPS growth rates are sustainable. Staff's Schedule 9-4 indicates investment analysts believe the EPS growth over the next 5-years could be around 4 percent. Based on actual historical growth over the long-term, it would appear that this growth rate would be appropriate as a proxy for constant growth.

Schedule 9-5, shows the rolling average 10-year compound growth rates for EPS, DPS and BVPS for the eight natural gas distribution companies Staff analyzed. Staff calculated the historical compound growth rates consistent with Value Line's methodology, which uses a 3-year average for the beginning period and a 3-year average for the ending period. For example, even though the data Staff analyzed dates back to 1968, the 10-year compound growth

[23] Atlanta Gas Light currently has a Strategic Infrastructure Development and Enhancement ("STRIDE") program, which was approved by the Georgia Public Service Commission ("GPSC"). STRIDE is a continuing 10-year infrastructure plan that is updated every three years for review and approval by the GPSC (SNL Energy Financial Focus, February 15, 2013); Approximately 60% of Atmos' 2013 capital expenditures are for infrastructure replacement projects related to safety and compliance with 90% of total capital expenditures targeted for jurisdictions that have some form of alternative ratemaking, e.g. infrastructure riders and charges (SNL Energy Financial Focus, March 28, 2013); Northwest Natural Gas plans to replace all of its bare steel pipeline in Washington by the end of 2014 and will be allowed to recover costs annually rather than waiting for a formal rate proceeding (SNL Press Release, November 11, 2013); In a December 17, 2013, Order the North Carolina Utilities Commission ("NCUC") authorized Piedmont Natural Gas the use of an integrity management rider ("IMR"), which allows the company to track and recover future capital expenditures it expects to incur to comply with federal pipeline safety and integrity requirements (Regulatory Research Associates, Regulatory Focus, December 31, 2013); Maryland and Virginia have approved five-year surcharge mechanisms to allow Washington Gas recovery of accelerated infrastructure replacement programs.

rate is based on the 3-year average of per share data for the period 1968-1970 and 1978-1980. The average rolling 10-year compound growth rates for the period Staff analyzed was 4.42 percent for EPS; the rolling 10-year compound DPS growth rate was 4.20 percent; the rolling 10-year compound BVPS growth rate was 4.50 percent; and the overall average for DPS, EPS and BVPS was 4.37 percent. If Atmos is excluded from these averages, then the results are as follows: 4.18 percent for DPS; 4.51 percent for EPS; 4.45 percent for BVPS; and an overall average of 4.38 percent (see Schedule 9-6).

Because the gas distribution industry only achieved growth in the low 4 percent range during a period of high capital investment and higher economic growth (see Schedule 9-8), Staff believes investors are likely using constant-growth rates closer to 4 percent. However, because some of the more recent growth rates are closer to 5 percent, Staff will use an overall range of 4 percent to 5 percent. This results in a natural gas distribution industry cost of equity estimate of 7.80 percent to 8.80 percent. While Staff believes this is a reliable estimate of the cost of equity for natural gas distribution companies, Staff understands that this is below recent allowed returns for gas distribution companies around the country.

Although Staff's absolute cost of equity estimate in this case is fairly similar to the cost of equity Staff estimated in the recent Ameren Missouri and Kansas City Power & Light Company ("KCPL") rate cases, there is a general perception in the investment community that natural gas distribution company stocks deserve a higher valuation level due to lower risks. Wells Fargo analysts stated the following in a June 4, 2013 equity research report on The Laclede Group when comparing the valuation levels of the regulated electric industry to that of the natural gas distribution industry: "The gas LDC median multiples reflect premiums ranging from 5 percent to 10 percent on 2013-15 estimated EPS, which we believe relates to the **generally lower business risk of gas LDCs versus electric utilities"** (emphasis added).[24]

G. Tests of Reasonableness

Staff has tested the reasonableness of its DCF results, both by use of a CAPM analysis and by consideration of other evidence.

[24] See Wells Fargo June 4, 203 equity research report on The Laclede Group.

1. The Capital Asset Pricing Model

The CAPM is built on the premise that the variance in returns is the appropriate measure of risk, but only the non-diversifiable variance (systematic risk) is rewarded. Systematic risks, also called market risks, are unanticipated events that affect almost all assets to some degree because the effects are economy wide. Systematic risk in an asset, relative to the average, is measured by the Beta of that asset. Unsystematic risks, also called asset-specific risks, are unanticipated events that affect single assets or small groups of assets. Because unsystematic risks can be freely eliminated by diversification, the reward for bearing risk depends on the level of systematic risk. The CAPM shows that the expected return for a particular asset depends on the pure time value of money (measured by the risk free rate), the reward for bearing systematic risk (measured by the market risk premium), and the amount of systematic risk (measured by Beta). The general form of the CAPM is as follows:

$$k = Rf + \beta (Rm - Rf)$$

Where: k is the expected return on equity for a security;

Rf is the risk-free rate;

β is beta; and

$Rm - Rf$ is the market risk premium.

Staff's CAPM is presented on Schedule 13. For inputs, Staff relied on historical capital market return information through the end of 2013. For the risk-free rate (Rf), Staff used the average yield on 30-year U.S. Treasury bonds for the three-month period ending March 31, 2014 – 3.68 percent. For beta (β), Staff relied on estimates directly calculated through an Excel spreadsheet designed specifically to be used with the SNL database of market and financial information. Although Staff is no longer using Value Line's published betas for purposes of its CAPM analysis in its direct testimony, because Value Line is used by many retail investors, Staff still believes Value Line's beta calculation methodology should be considered when performing a CAPM analysis. Because estimating beta is a matter of having access to financial data and performing statistical calculations, unless a financial services provider has a proprietary adjustment they make to their beta calculation, understanding the methodology used by a

financial provider allows an analyst to approximately replicate betas of that provider. Fortunately, this is the case for Value Line's beta calculation methodology. Consistent with Value Line's approach to calculating beta, Staff used 5-years of historical weekly returns of the subject company and the NYSE index. The covariance of the weekly returns on the NYSE index and the weekly returns on the subject company is divided by the variance of the weekly returns on the NYSE index to determine raw beta (unadjusted beta). Staff then adjusted the raw beta using the Blume adjustment formula as used by Value Line: Adjusted Beta= (.35 + .67(Unadjusted Beta)) (*see* Schedule 13).

The average beta for the proxy group was .79. For the market risk premium (Rm – Rf) estimates, Staff relied on the historical difference between earned returns on stocks and earned returns on bonds.[25] The first risk premium was based on the long-term arithmetic average of historical return differences from 1926-2013 – 6.20 percent. The second risk premium was based on the long-term geometric average of historical return differences from 1926 to 2013 – 4.64 percent. The results using the long-term arithmetic average risk premium and the long-term geometric risk premium are 8.59 and 7.36 percent, respectively.

These cost of common equity results support the reasonableness of Staff's cost of equity estimates derived from its DCF analysis. Staff again notes that both U.S. Treasury yields and utility bond yields are quite low (at levels last experienced in the early 1960s) and the spread between them is presently below their long-term average. It is not improbable that investors are only requiring returns on common equity in the 7 to 8 percent range for natural gas utility stocks. In fact, as Staff will explain in its other tests of reasonableness, these cost of equity estimates are consistent with common sense tests.

2. Other Tests

a. The "Rule of Thumb"

A "rule of thumb" method allows estimation of the cost of equity by adding a risk premium to the yield-to-maturity (YTM) of the subject company's long-term debt. Based on experience in the U.S. markets the typical risk premium is in the 3 to 4 percent range.[26]

[25] From Duff & Phelps *2014 Valuation Handbook: A Guide to the Cost of Capital.*

[26] John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of EquityInvestments: Valuation*, Association for Investment Management and Research, 2002, p. 54.

Considering this is based on general U.S. capital market experience and regulated utilities are on the low end of the risk spectrum of the general U.S. market, a risk premium closer to 3 percent seems logical. This is especially true considering that regulated utility stocks behave like bonds. For the months of January, February and March 2014, "A" rated 30-year utility bonds and "Baa" rated 30-year utility bonds had average yields of 4.60 percent and 5.39 percent respectively.[27] Adding a 3 percent risk premium, the "rule of thumb" predicts a cost of common equity between 7.60 percent and 8.39 percent. Adding a 4 percent risk premium, the "rule of thumb" predicts a cost of common equity between 8.60 percent and 9.39 percent.

b. Average Authorized Returns

In the past, the Commission has applied a test of reasonableness using average authorized returns published by Regulatory Research Associates (RRA) to test the reasonableness of its allowed ROE. Because the Commission recently made allowed ROE determinations in the KCPL and Ameren Missouri cases, Staff believes the Commission should utilize the RRA data to test the reasonableness of an allowed ROE for Veolia Kansas City as it compares to KCPL and Ameren Missouri.

According to RRA, the average authorized return on equity in the first quarter of 2014 for natural gas and electric utility companies were 9.54 percent (based on six decisions) and 10.23 percent (based on eight decisions), respectively, which is a difference of 69 basis points. The data does not include a February 20, 2014 New York Public Service Commission steam rate decision for Consolidated Edison Co. of New York that adopted a 9.30 percent ROE. The simple average authorized return on common equity for natural gas and electric utility companies for the four quarters of 2013 was 9.68 percent (based on twenty-one decisions) and 10.02 percent (based on fifty decisions), respectively, a difference of 34 basis points. Although these differences seem to imply that regulators have recognized the lower risk of natural gas utility companies as they compare to electric utility companies, there is a significant difference in the amount of decisions for gas cases compared to electric cases. As a result, Staff reviewed the difference between the annual average authorized ROEs for years prior to 2013.

[27] BondsOnline.com pursuant to a subscription agreement Staff has with BondsOnline.

Staff discovered that beginning in 2007 allowed ROEs for gas utility companies began to consistently be below that of electric utility companies. In 2007 it was only approximately 10 basis points lower, but the difference gradually increased and leveled off at approximately 30 basis points. It actually narrowed to approximately 20 basis points in 2012, but as already noted, it then widened again to 34 basis points in 2013. The difference increased to 69 basis points in the first quarter of 2014. However, there were only 6 natural gas case decisions and 8 electric utility case decisions in the first quarter of 2014.

Staff does not know if this trend will be sustained, but as can be seen in the report published April 9, 2014 allowed ROEs for gas and electric were usually about the same before 2007. The only explanation Staff can readily give for the recent difference is the fact that gas utility stocks have recently been trading at a premium to electric utility stocks. This can be due to many factors, including favorable regulatory ratemaking treatment, levelized capital expenditures, lower elasticity to economic conditions, consistently earning allowed ROE, lower natural gas prices, etc.

H. Conclusion

Using widely-accepted methods of financial analysis, Staff has developed a hypothetical weighted average cost of capital for Veolia Kansas City in the range of 6.82 percent to 7.30 percent (*see* Schedule 14). This rate was calculated by applying a hypothetical embedded cost of long-term debt of 5.27 percent and a cost of common equity range of 8.50 percent to 9.50 percent to a capital structure consisting of 48.00 percent common equity and 52.00 percent long-term debt. Staff urges the Commission to accept its recommendation and allow Veolia Kansas City to earn a fair return on its net rate base of 6.82 percent to 7.30 percent.

Staff Expert/Witness: Shana Atkinson

IV. Rate Base

A. Overview of Plant-in-Service and Accumulated Depreciation Reserve

Staff has included the plant-in-service and accumulated depreciation reserve balances as of December 31, 2013, taken from the Company's Fixed Asset Subledger – Regulated Basis. The Company uses a plant model developed in the early 2000s and used in several past cases filed with the Commission. This plant model identifies Veolia Kansas City's regulated plant and

accumulated depreciation reserve balances for additions and retirement amounts used by the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA) since 1990. The December 31, 2013 account balances are reflected on Accounting Schedule 3 – Plant in Service, and Accounting Schedule 6 – Accumulated Depreciation Reserve. As can be seen on Accounting Schedule 6, there are several depreciation reserve accounts that exceed the plant balances on Accounting Schedule 3.

Staff has calculated the depreciation expense using the December 31, 2013 plant balances and the depreciation rates recommended by Staff witness Arthur W. Rice of the Engineering and Management Services Unit (EMSU). As explained by Mr. Rice later within this report, fully depreciated amounts have depreciation rates of zero. Staff examined the plant and reserve amounts and ensured that these levels tied back to the Company's plant and reserve records. As such, the plant-in-service and accumulated depreciation reserve balances filed by the Company, and adjusted by Staff, are a reasonable representation of the appropriate balances on which the Commission should set rates for the future.

Staff Expert/Witness: V. William Harris

B. History of Veolia Energy Kansas City Inc.'s Plant and Depreciation Reserve Records

In 2004, Veolia Kansas City (then known as Trigen-Kansas City Energy Corporation) filed an asset transfer case, Case No. HM-2004-0618, regarding a pending sale of the Veolia (Trigen) Companies to Thermal North America, Inc. In rebuttal testimony filed in that case, Staff identified numerous problems with Trigen's record keeping system, specifically affecting the Company's plant and depreciation reserve valuations. Staff also recognized that the Company did not use the original cost theory to establish plant-in-service values at the time Trigen acquired the district heating and industrial assets from KCPL in March 1990 (Case Nos. HM-90-4 and HA-90-5). In addition, Staff discovered that Trigen did not use the FERC USOA. Set forth below is information concerning the plant-in-service and the accumulated depreciation reserve for Veolia's Kansas City operations since Trigen purchased the system in 1990.

From the start of its ownership, Trigen set up the books and records incorrectly and was never in compliance with the USOA. Trigen instead recorded the plant balances at the paid purchased price of the property and not the required "original cost" of the property.

This recording of the plant assets was incorrect per the USOA and the incorrect amounts continued to be carried forward annually as additions and retirements were included until 2003 when the Company tried to correct the problem. As part of the review process of the Company's books and records for the asset sale in Case No. HM-2004-0618, Staff made an inquiry into the plant-in-service and accumulated depreciation reserve balances. Staff discovered that Trigen incorrectly recorded the plant-in-service balances at the net book value with the accumulated depreciation reserve starting with a zero balance. Compounding the problem, Trigen added the amount of the premium paid to KCPL for the purchased assets into the plant-in-service balances. This resulted in the plant asset balances being inflated by what is referred to as an "acquisition adjustment". An acquisition adjustment is a premium paid over the net original cost of the assets. The net original cost value is plant less accumulated depreciation reserve. The USOA requires that any acquisition adjustment be accounted for in FERC Account 114 – Electric Plant Acquisition Adjustments. By ignoring net original cost concepts, Trigen in essence accounted for the premium paid to KCPL for the 1990 purchase transaction by spreading the acquisition adjustment to individual plant accounts, which is not permitted by the USOA requirements for plant asset acquisitions.

The FERC USOA for Account 114 states, in part, that:

> This account shall include the difference between (1) the cost to the accounting utility of electric plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (2) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated provisions for depreciation and amortization and contributions in aid of construction with respect to such property.

As such, Trigen's plant and depreciation reserve books and records were incorrect from the very beginning of the Company's ownership of this utility system.

To further compound the issue of what the proper plant valuation should be, the Company never used Commission-authorized depreciation rates to depreciate the utility property. Trigen also did not properly retire plant from its books and records as property was removed from utility service. Trigen did not properly identify and value its plant records using correct capitalization and expense concepts prescribed in the FERC USOA. In some cases Trigen Kansas City's plant was understated or overstated depending on whether costs should be capitalized (i.e. included in plant) or if the costs should have been charged to expense. This

caused plant to not be properly valued in rate base, and since plant in rate base is subject to depreciation, this also caused the accumulated depreciation reserve to be incorrect. As a result of all the errors and improper accounting of the plant assets and resulting depreciation reserve, the Company's asset valuation was incorrect. Also, using improper depreciation rates resulted in an overstatement of depreciation expense that caused an understatement of earnings for most years until the corrections were made. Thus, the need for the correction and restatement of Trigen Kansas City's books and records was recognized, and corrective action was taken by the Company.

During 2000 Trigen initially took an asset impairment write-down of their plant assets under Financial Accounting Standard No. 144 (FAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets. The Company wrote-down the value of the assets on its financial statements and on its FERC Form 1 filing for the 12-months ended December 31, 2000. The Company's Financial Statements and the FERC Form 1 for the years 2000, 2001 and 2002, reflected the plant balances at the written-down values. During the spring of 2003, while completing the 2002 FERC Form 1, the Company requested an extension of time to file. The Company performed an historical analysis of the books and records and determined the need to restate the plant balances starting when the assets were purchased from KCPL. The Company restated the FERC Form 1 balances as if the assets were never written-down under FAS 144, and accordingly reversed its previous write-down.

Case No. HM-2004-0618 resulted in a Commission-approved agreement with Trigen to not reflect in that case any write-down of the assets that the corporate office may have made. As such, in the 2006 rate case, Staff ensured Trigen Kansas City's books and records were restated and corrected to remove any effects of those previous write-downs. Thus, the agreed upon levels of plant did not reflect any amount for the write-down.

Staff Expert/Witness: V. William Harris

C. Staff Review of Plant and Depreciation Reserve Records in this Rate Case - Case No. HR-2014-0066

Staff completed its review of the Company's plant-in-service and accumulated depreciation reserve accounts in this case and determined the Company has not properly recorded all of its plant retirements. In addition, the Company improperly accounted for

several plant investments by recording the investments in accounts other than those required by the FERC USOA. As a result, the Company has been accruing incorrect amounts of depreciation expense.

Staff noted that the Company has made significant strides over the years (and continues to do so) to correct the historical problems discussed in the previous section of this report. However, as noted in the preceding paragraph, several account balances still need to be corrected. Staff witness Rice is recommending adjustments to correct these plant and reserve records. Staff will continue to work with Company personnel to identify and correct existing errors.

Staff Expert/Witness: V. William Harris

D. Truman Medical Center Pipeline

Veolia (then Trigen) came before the Commission in 2006 to request permission to expand its district heating service area to allow the Company to run a steam distribution service line to the Truman Medical Center (Truman) complex. The Commission order authorizing the expansion required Truman to pay for the entirety of construction costs of the service line extension. Truman and Veolia (Trigen) entered into a Highly Confidential agreement providing for ** _____ _____ _____ **.

The Company treated the pipeline construction costs as construction work in progress (CWIP) and transferred the costs to plant in service in June 2008 when Truman began receiving service. Veolia Kansas City (Trigen) recorded the final payment received from Truman in July 2009. Pursuant to the agreement between Veolia Kansas City and Truman, Veolia Kansas City will begin reimbursing Truman for the customer advance in seven equal annual payments beginning April 1, 2014 and ending April 1, 2020. Since Veolia Kansas City has not yet begun to reimburse the customer advance, Staff has included the entire amount of the customer advance paid by Truman as an offset to rate base. The effect of this treatment is to disallow a return on rate base amounts not provided or invested by Veolia Kansas City. Staff also excluded depreciation expense for the Truman pipeline. Staff in subsequent rate proceedings should similarly treat the unreimbursed customer advance balance remaining at that time.

Staff Expert/Witness: V. William Harris

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E. Cargill Pipeline

In 2006, Veolia Kansas City (Trigen) constructed and paid for a distribution pipeline to connect and serve the Cargill Inc., Grain and Oilseed Supply (Cargill). Cargill did not fund the construction of this pipeline.

The Company treated the pipeline construction costs as construction work in progress (CWIP) and transferred the costs to plant in service in 2006 when Cargill began receiving service. Staff has included the Cargill pipeline costs in the plant and depreciation reserve balances, as well as the related depreciation expense in the revenue requirement calculation. Like any other plant investment included in rate base and not offset by a customer advance, Veolia Kansas City will earn a return on this investment.

Staff Expert/Witness: V. William Harris

F. Recommendations Concerning Plant-In-Service and Accumulated Depreciation Reserve

Staff recommends that for regulatory purposes, the Commission adopt the adjusted plant and depreciation reserves reflected on Accounting Schedule 3 – Plant in Service, and Accounting Schedule 6 – Accumulated Depreciation Reserve.

Staff further recommends the Company: (1) continue to maintain its plant and reserve depreciation accounts based on the FERC USOA for electric companies using Commission-approved depreciation rates, as well as continue to maintain new plant additions and retirements according to the USOA Electric Plant Instructions; (2) continue to maintain its books and records in compliance with proper capitalization concepts; (3) continue to maintain its books and records using the plant model that correspondingly ties to the plant general ledger component of the general ledger; and (4) maintain the supporting documentation relating to the modifications and restatement of plant and depreciation reserve balances as part of its regulated books and records should the need arise to review this material in the future.

Staff Expert/Witness: V. William Harris

G. Fuel Inventories

Coal is the only fuel Veolia Kansas City maintains in inventory at the Grand Avenue plant location. The coal is stored by the Company in a plot of land adjacent to the actual steam

production facility. Veolia Kansas City transports coal, via truckload, to the Company fuel yard daily throughout most weeks of the year.

Staff reviewed historical monthly coal stock balances for the period of 2005 through 2013 and determined that a 13- month average (December 2012-December 2013) was the correct methodology to determine the appropriate level of coal inventory to include in Veolia Kansas City's cost of service. A 13-month average reflects the entire year by using the December 31st (January 1, 2013) beginning balance and including each subsequent month-ending balance through the end of the year (December 31, 2013). When inventory levels fluctuate from month to month a 13-month average is used to smooth out those levels. Staff's inventory level for coal is shown in Staff's Accounting Schedule 2 - Rate Base.

Staff Expert/Witness: Karen Lyons

H. Prepayments

Prepayments are amounts for certain costs incurred by the Company and paid in advance of their date payable. Prepayments are treated as an asset investment of the Company and are typically reflected in the rate base of the utility.

During Staff's audit, Staff was able to discern an appropriate balance for the prepayments account, FERC Account 165. Staff reviewed the monthly balances for prepayments for the last several years and determined that a six month (July 2013 through December 2013) average was an appropriate amount to include in rate base for this inventory item. Staff determined a six month average to be appropriate because the prepayment account balances trended downward beginning in July 2013. By using a six month average, Staff was able to capture the downward trend that occurred during the year. The level of prepayments is shown in Staff's Accounting Schedule 2 - Rate Base.

Staff Expert/Witness: Karen Lyons

I. Materials and Supplies

Materials and supplies include spare parts and other miscellaneous items used in daily operations and maintenance activities, such as gauges, casting, paint, conduit, etc. Staff reviewed the monthly balances for materials and supplies for the period of 2008 through 2013. From this review, the Staff determined that a 13-month average (December 2012 -

December 2013) was an appropriate amount to include in rate base for this inventory item. Staff used a 13- month average due to the fluctuations in the account balances from one month to the next and the lack of a discernable trend in the monthly material and supplies inventory account balances. By using a 13-month average, Staff was able to smooth out any of the fluctuations that occurred during the year. The level of materials and supplies is shown in Staff's Accounting Schedule 2 - Rate Base. (Accounting Schedule 2)

Staff Expert/Witness: Karen Lyons

J. Customer Deposits

Customer deposits are the funds required to be provided by certain customers taking steam service from Veolia Kansas City. These funds are deducted from Veolia Kansas City's rate base because these funds are cost-free funds received by Veolia Kansas City. During Staff's review of Veolia Kansas City's books and records Staff determined Veolia Kansas City had only one customer deposit recorded. Based on the Company's response to Data Request 102 in this case, the customer that was required to pay the deposit has maintained a good payment history and therefore steps were taken to return the deposit to the customer. Since Veolia Kansas City required a deposit from one customer and the deposit is being returned to the customer, Staff did not include a customer deposit offset to rate base.

Staff Expert/Witness: Karen Lyons

K. Income Taxes in Rate Base

1. Accumulated Deferred Income Taxes

Veolia Kansas City's deferred income tax reserve (deferred taxes) represents a net prepayment of income taxes by Veolia Kansas City's customers in rates before the actual payment of the income taxes to the IRS is made by Veolia Kansas City. Because Veolia Kansas City is allowed to deduct depreciation expense on an accelerated basis for purposes of calculating its income tax liability to the IRS, depreciation expense deducted for income taxes paid by Veolia Kansas City is considerably higher than depreciation expense used for ratemaking purposes. Since the expense recognized for depreciation is considerably lower for accounting and ratemaking purposes than for income tax purposes, Veolia Kansas City customers are required to pay higher costs for income taxes in rates than the Company will actually pay to the

IRS. The difference in income paid to the IRS and those paid in utility rates are "accumulated" to recognize the future tax liability that will eventually be paid to the IRS. While the Company has retained these tax deferrals they will be used as an offset to rate base. Costs for which different treatment can be applied for financial reporting and income tax purposes, respectively, are referred to as "tax timing differences." Accelerated tax depreciation is almost always the tax timing difference with the greatest impact on a utility's financial reporting and ratemaking.

A utility's use of tax accelerated depreciation for income tax calculation purposes results in creation of a deferral of income taxes to the future until the taxes are paid to the IRS. The net credit balance in the deferred tax reserve represents a source of cost-free funds to Veolia Kansas City. Therefore, Veolia Kansas City's rate base is reduced by the deferred tax reserve balance to avoid having customers pay a return on funds that are provided cost-free to the Company. Generally, deferred income taxes associated with all book-tax timing differences created through the ratemaking process should be reflected in rate base. Staff has taken this approach in calculating the deferred income tax rate base offset amount in this case. These tax deferrals are reflected as an offset on Accounting Schedule 2 – Rate Base.

Staff Expert/Witness: Keith Majors

V. Depreciation

A. Investigation

The basis for Veolia Kansas City's steam production plant depreciation rates originate from Depreciation Authority Order No. 148 issued in an order to a prior owner, KCP&L, in 1986. The current ordered depreciation rates for Veolia Kansas City were ordered in rate Case No. HR-2008-0300 (the 2008 rate case).

In the 2008 rate case, many plant accounts were found to have accumulated excessive depreciation reserves, exceeding the original cost of plant in service including expected future cost of removal. These plant accounts are:

Account Number	Account Description
311.0	Structures and Improvements
312.0	Boiler Plant and Equipment
314.0	Turbogenerator Units
315.0	Accessory Electrical Equipment
316.0	Miscellaneous Power Plant Equipment
361.0	Distribution Structures

As a result of the Stipulation And Agreement in the 2008 rate case, the Commission set the depreciation rates for all the above listed plant accounts to zero. Also, two new subaccounts were created , subaccount 311.1 (Structures) and subaccount 312.1 (Boiler Plant), to allow separate accounting for pre- 2008 plant in service and post 2008 additions to plant in service.

In rate Case No. HR-2011-0241 (the 2011 rate case) no changes were made to the depreciation rates ordered in the 2008 rate case.

For the purpose of depreciation review in the current rate case, Staff reviewed Veolia Kansas City's fixed asset plant record of additions, retirements, depreciation accruals, accumulated reserves, and other book entries to plant and depreciation reserves. Staff's review of Veolia Kansas City's fixed asset plant records revealed multiple record entry discrepancies, including missing retirement book entries since about 2007, additions recorded to incorrect plant accounts, and accumulated reserve deficiencies for accounts other than the accounts listed above.

Staff created a list of discrepancies and estimate of the retirement amounts for apparent missing retirements. Staff worked with the Company to resolve these discrepancies. As a result, the Staff recommended adjustments to the Company's fixed asset record. Staff gathered information from the Company from many sources, including data request responses, a conference call, a site visit, participation in a Technical Conference, and from multiple emails. Adjustments to plant and reserves are shown in the Staff accounting schedules, with individual item adjustments shown in Staff work papers. At the date of this report, Staff has entered estimates for some of the necessary retirement adjustments, but evaluation of the retirement entries is ongoing. All the dollar numbers in this depreciation report section should be considered as an illustration and are provided to indicate the magnitude of the effect on revenue requirement for this rate case.

B. Total Plant and Reserve Adjustments

The reversal of one instance of a duplicate plant addition that was recorded in two different accounts, and the reversal of three items that were recorded to plant but did not represent actual plant placed into service resulted in Staff making a reduction of total plant and rate base of nearly $152,000. Adjustments to depreciation accruals for the timing of these

reversals reduced Staff's accrued depreciation by about $3,000, with a corresponding increase in rate base, compared to the Company's books.

After reviewing these adjustments with the Company, Staff reclassified many plant additions to their proper account classifications. These reclassification adjustments of plant do not change rate base. Staff's reclassifications totaled approximately $715,000.

After reviewing these reclassifications with the Company, Staff made adjustments for missing retirements. These Retirements do not change plant rate base because the same original cost is removed from both the plant in service and the accumulated reserves. These Retirement adjustments totaled approximately $1,500,000.

Staff also made adjustments to depreciation accruals related to the timing of reclassifications and retirements compared to the Company's original bookings. Often the Company failed to record a retirement when the equipment was actually removed from service. These recording omissions caused the Staff to make additional adjustments to reserves. These adjustments reduced accrued depreciation by about $14,000 for the retirements, and an additional reduction of $6,000 attributed to the reclassifications.

In summary, all of the above adjustments to remove plant found not to be in service and the depreciation accrual adjustments associated with reclassifications and retirements resulted in a reduction of the Company's rate base by approximately $129,000.

Overall Plant and Reserve Adjustment Table

Adjustment Type	Plant Adjustment $	Reserves Adjustment $	Net Plant Change $
Reversal Of Entry	-152,000	-3,000	-149,000
Retirement	-1,500,000	-1,500,000	0
Retire Accrual Adjust	0	-14,000	+14,000
Reclassification	net zero		
Retire Accrual Adjust	0	-6,000	+6,000
Sums	-1,652,000	-1,523,000	-129,000

C. Recommended Changes in Deprecation Rates

Staff's investigation revealed two accounts (391 and 392) with negative (under accrued) depreciation reserve, exceeding $100,000 each. Staff recommends corrective action adjustments for each of the two under accrued accounts as follows:

Account 392, Transportations Equipment, is an inactive (abandoned) account showing a negative reserve (under accrual) of $117,147. This account shows zero plant in service and thus cannot be corrected through depreciation accruals. Unless addressed in some manner, this adds an amount of $117,147 to *permanent* rate base. To correct this, Staff recommends a reserve transfer of $117,147 from an over-accrued account in order to zero out the reserves in this account.

Account 391, Office Furniture and Equipment, is an active account with approximately $200,000 of plant in service. This account shows a negative reserve (under accrual) of approximately $104,000. A negative reserve can only result when plant retirements are recorded faster than the depreciation reserve is accruing. Staff's review of the type and nature of the equipment recorded in this account revealed that a predominant amount of the dollars recorded as Office Furniture are not for office furniture but are actually for electronic equipment such as office computers, office electronic equipment, security camera equipment, portable radio equipment, and boiler plant SCADA data collection equipment. The depreciation rate assigned to this account is 4.17 percent, representing a 24 year average service life. Staff concludes that the depreciation rate assigned to the electronic equipment in this account is too low. Therefore, Staff recommends transferring (reclassifying) the electronic equipment currently recorded in account 391 to other accounts and assigning a more appropriate depreciation rate to these plant assets.

Veolia Kansas City currently has an active account for Communications Equipment, account 397, containing $13,664 of office phone equipment with an assigned depreciation rate of 3.7 percent, (average service life of 27 years). Staff recommends reassignment of $40,204 of security video equipment and radio equipment from account 391 to account 397, and assigning a 6.67 percent depreciation rate (15 year average service life) to account 397.

Veolia Kansas City does not currently have a separate plant account for Office Computer and Electronic Equipment. Therefore, Staff recommends that Veolia Kansas City establish new

sub-account number 391.1 for this equipment, and transfer $112,246 of office computer and electronic equipment from account 391 to account 391.1. Staff recommends assigning a deprecation rate of 14.3 percent (7 year average service life) to account 391.1.

Staff recommends that $8,348 of boiler plant SCADA electronic data collection equipment recorded in account 391 be reclassified to account 312.1 (Boiler Plant).

This leaves account 391, Office Furniture, retaining a $39,238 balance that actually represents "furniture".

However, the proposed reclassification of account 391 plant does not address the original problem which is the negative (under accrual) of reserves. The reclassification (transfer) of plant dollars must be accompanied with a transfer of not only the plant dollars, but also the associated reserve amounts which are negative. This results is an under accrual of reserves remaining in furniture account 391 and creates an under accrual of reserves in accounts 391.1 and 397. Staff recommends the transferring of reserves from an over accrued account to all three of these under accrued accounts: $35,000 to account 391; $100,000 to account 391.1; and $25,000 to account 397. These dollar amounts were derived from the approximate amount needed to provide accumulated reserves for each of these accounts so that these amounts represent the average age of the dollars recorded in each account.

Above, multiple recommendations have been made to transfer accumulated depreciation into accounts that have under accrued reserves. There is sufficient over accrued reserves in account 312.0 (Boilers – pre 2008). When the depreciation rate for 312.0 was set to zero in the 2008 rate case, this account had an over accrual of approximately $650,000, (in excess of accruals for cost of removal). This account became an inactive (abandoned) account in 2008 when account 312.1 (Boiler's –post 2008) was created to book all going forward additions for Boiler Equipment. The $650,000 over accrual (excess reserves) in account 312.0 became isolated and remains unchanged. Therefore, Staff recommends using a portion of the excess reserves in account 312 (Boilers pre-2008) as the source to transfer to accounts with under accrued reserves as follows:

continued on next page

Dollar Amount		Reserve Transfer From Acc.	Reserve Transfer To Acc.
$117,147		312.0 Boiler Plant pre-2008	392 Transportation Equip
$35,000		312.0 Boiler Plant pre-2008	391 Office Furniture
$100,000		312.0 Boiler Plant pre-2008	391.1 Office Electronic
$25,000		312.0 Boiler Plant pre-2008	397 Communications Equip
$277,147	Total		

D. Account 370, Meters

Staff's review of the Customer Meters Account 370 shows that this account is over accrued by 6 percent. This means that accumulated reserves equal 106 percent of total plant in service. The current depreciation rate assigned is 4.76 percent which reflects an average service life of 21 years. The average age of the dollars recorded as plant in service in this account is approximately 22 years.

Communications with the Company indicated that the Company continues to refurbish and reuse existing meters. There are no retirements shown since 1997.

Because the meters account is over accrued, and because the Company rebuilds meters and does not record retirements, Staff recommends the Commission order a deprecation rate of zero for account 370, Customer Meters.

E. Recommended Depreciation Rates

The accounting schedules used to determine revenue requirement for this Staff Report uses the depreciation rate for each plant account as shown in the following depreciation rate schedule that Staff's recommends for Veolia Kansas City:

continued on next page

Veolia Energy Kansas City
DEPRECIATION RATES
HR-2014-0066

ACCOUNT NUMBER	ACCOUNT DESCRIPTION		DEPRECIATION RATE % of Plant	AVERAGE SERVICE LIFE (YEARS)	NET SALVAGE % of Plant
311.0	Structures and Improvements (HR-2008-0300)	*	0.00	30.5	-1.0
311.1	Structures and Improvements (additions post-HR-2008-0300)		2.00	30.5	-1.0
312.0	Boiler Plant (HR-2008-0300)	*	0.00	28.6	-4.0
312.1	Boiler Plant (additions post-HR-2008-0300)		2.00	28.6	-4.0
314.0	Turbogenerator Units	*	0.00	32.3	-1.0
315.0	Accessory Electric Equipment	*	0.00	31.3	-1.0
316.0	Miscellaneous Power Plant Equipment	*	0.00	28	2.0
361.0	Distribution Structures	*	0.00	32	-1.0
362.0	Distribution Station Equipment		2.40	42	1.0
366.0	Underground Conduit and Manholes		2.02	50	1.0
369.0	Services		2.50	40	0.0
370.0	Meters	**	0.00	21	0.0
391.0	Office Furniture and Equipment		4.17	24	0.0
391.1	Office Computer & Electronic Equipment	**	14.30	7	0.0
394.0	Tools, Shop and Garage Equipment		3.68	28	3.0
397.0	Communications Equipment	**	6.67	15	0.0
398.0	Miscellaneous Equipment		3.71%	24	11%

Depreciation Rate % = (100 % - Net Salvage %) / Average Service Life
The retirement rate equals the inverse of the average service life.

* In Case No. HR-2008-0300, subaccount 311.1 (Structures) and subaccount 312.1 (Boiler Plant) were created to allow separate accounting for pre 2008 plant in service and post 2008 additions to plant in service. In Case No. HR-2008-0300, the Depreciation rates for accounts 311.0, 312.0, 314.0, 315.0, 316.0, and 317.0 were set to zero due to over accrual of accumulated depreciation reserves. In rate case No. HR-2011-0241 no changes were made to depreciation rates.

** For the current Case No. HR-2014-0066, Staff recommends setting the depreciation rate for account 370 (Meters) to zero, adding a new account 391.1 (Electronic Equipment) with a deprecion rate of 14.3 %, and increasing the depreciation rate for account 397 (Communications Equipment) to 6.67%.

F. Cost of Removal

Dollars for cost of removal is collected from rate payers through the depreciation accrual expense included in customer rates. These collected dollars are included as part of the depreciation accruals to reserves. Whenever plant and equipment is removed or replaced there is often an associated cost to remove the old before the new can be installed. Staff found no ledger entries against accumulated reserves for cost of removal for the review period of 2007 through 2013 even though added plant equipment items were recorded as replacements and evidence of asbestos thermal insulation removal was observed during the site visit.

When cost of removal is included as part of the original project cost, the result is an improper increase in total plant which does not represent original cost of plant. Staff recommends that the Commission order Veolia Kansas City to record cost of removal as a separate entry on capital project work orders and on capital project cost recording, and charge the project's cost of removal against each plant account's accumulated depreciation reserves.

G. Retroactive Depreciation Accruals for Accounts 311.1 and 312.1

On the subject of the depreciation accruals for accounts 311.1 (Structures and Improvements) and 312.1 (Boiler Plant Equipment) between the 2008 and 2011 cases, the Company used a 0 percent depreciation rate. It appears that accounts 311.1 and 312.1 were "officially created" in the 2011 case. The Company fixed asset record does show the separation of 311 and 311.1 (and 312/312.1) starting in 2008, and does not show the Company applying the 2 percent depreciation rate until November 2011. The Stipulation and Agreement for Case No. HR-2011-0241, which was approved in the Commission Order (see below) shows *a 2.0 percent book depreciation rate to be applied prospectively since the effective date of the 2008 rate case*, even though the Stipulation and Agreement was approved in 2011.

HR-2011-0241 Stipulation and Agreement page 3, item 4.

> **Depreciation.** The Commission should order Veolia to adopt depreciation rates as follows: *a 2.0 percent book depreciation rate to be applied prospectively* for Accounts 311 and 312 to be applied only to new plant additions *since the effective date of the* rates implemented in Veolia's *last rate case* (Case No HR-2008-0300). This will be accomplished by establishing a new subaccount of Account 311 and 312.
>
> Filed September 29, 2011

HR-2011-0241: THE COMMISSION ORDERS THAT:

> 1. All pre-filed testimony and accompanying exhibits are entered into the record and such documents already on file, in the Commission's electronic filing and information system, shall suffice for that purpose without the filing of hard copy.
>
> 2. The provisions of the *Stipulation and Agreement* are approved and incorporated into this order as if fully set forth.

Staff did not make an adjustment in Case No. HR-2011-0241 for the additional accruals in these two accounts per the above agreement. Subsequently the Company's equity and rate base have been over stated since the effective date of the 2011 rate case.

Staff computed adjustments in this current rate case by applying the 2 percent depreciation to newly acquired assets for accounts 311.1 and 312.1 for the period between the two rate cases. Staff recommends an adjustment in this current rate case of approximately $15,500 to increase the accrued depreciation for account 311.1, and an adjustment of approximately $178,000 to increase the accrued depreciation for account 312.1.

Staff recommends that the Commission order Veolia Kansas City to correct the Company's books and records to account for the additional depreciation accruals for account 311.1 and 312.1, reflecting depreciation accruals using a 2 percent depreciation rate as of the effective order date of Case No. HR-2008-0300.

Staff Expert/Witness: Arthur W. Rice

VI. Income Statement

A. Weather Normalization

1. Weather Variables

Steam usage and revenue vary from year to year based on weather conditions. The temperature pattern in the update period (12-months ending December 31, 2013) is the primary determinant for weather-sensitive customer steam usage and the Company's revenue. Each year's weather is unique, so rates for weather-sensitive customer classes must be based on annualized and normalized usage and revenues adjusted to a level commensurate with "normal" weather conditions, rather than actual usage and revenue.

Staff obtained weather data from the Midwest Regional Climate Center (MRCC).[28] Kansas City International Airport ("MCI") weather data was used for Veolia Energy Kansas City, Inc. ("Veolia Kansas City" or "VEKC"). The weather data sets consists of actual daily maximum temperature ("T_{max}") and daily minimum temperature ("T_{min}") observations. Staff used these daily temperatures to develop a set of normal mean daily temperature ("MDT")[29] values.

Historical Data Used to Calculate Normal Weather Variables – According to the National Oceanic and Atmospheric Administration ("NOAA"), a climate "normal" is defined as the arithmetic mean of a climatological element computed over three consecutive decades.[30] In developing climate normal temperatures, the NOAA focuses on the monthly maximum and minimum temperature time series to produce the serially-complete monthly temperature ("SCMT") data series.[31]

Staff utilized the SCMT that was published in July 2011 by the National Climatic Data Center ("NCDC") of the NOAA. For the purposes of normalizing the update period steam usage and revenues, Staff used the NOAA's three consecutive decade convention of observed T_{max} and T_{min} daily temperatures for the 30-year period of January 1, 1981 through December 31, 2010, at MCI. This is the same location and period the NOAA used for its calculation of the SCMT.

There may be circumstances under which inconsistencies and biases in the 30-year time series of daily temperature observations occur, e.g. if the weather instruments were relocated, replaced, or recalibrated. Changes in observation procedures or in an instrument's environment may also occur during the 30-year period. The NOAA accounted for documented and undocumented anomalies in calculating its SCMT. The meteorological and statistical procedures used in the NOAA's homogenization for removing documented and undocumented anomalies from the monthly maximum and minimum temperature series is explained in a peer-reviewed publication.[32]

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[28] http://mrcc.isws.illinois.edu/CLIMATE/.

[29] By National Climatic Data Center convention, MDT is average of daily maximum temperature (T_{max}) and daily minimum temperature (T_{min}) e.g. MDT = (T_{max} + T_{min}) /2.

[30] Retrieved on January 17, 2014, http://www ncdc noaa.gov/oa/climate/normals/usnormals.html.

[31] Retrieved on January 17, 2013, http://www1.ncdc noaa.gov/pub/data/normals/1981-2010/source-datasets/. The SCMT, computed by the National Climate Data Center of the NOAA, includes adjustments to make the time series of daily temperatures homogeneous.

[32] Menne, M.J., and C.N. Williams, Jr., (2009) Homogenization of temperature series via pairwise comparisons. *J. Climate*, 22, 1700-1717.

HDD and CDD - Steam sales are predominantly influenced by "ambient air temperature,"[33] so MDT and the derivative measures, heating degree days ("HDD")[34] and cooling degree days ("CDD")[35], are the measures of weather used in adjusting steam sales. HDD and CDD were originally developed as a weather measure that could be used to determine the relationship between temperature and energy usage. HDDs are based on the difference of the MDT from a comfort level of 65°F. HDDs are calculated as the difference between 65°F and the MDT when the MDT is below 65°F, and are equal to zero when the MDT is above 65°F. The Staff calculates CDD as the MDT minus 65 when the MDT is above 65 °F, and is equal to zero when the MDT is below 65 °F.

Calculation of Daily Normals - Subsequent to determining the homogenized monthly temperature time series described above, the NOAA calculates monthly normal temperature variables based on a 30-year normal period, e.g. maximum, minimum, average temperatures, HDDs and CDDs. These monthly normals are not directly usable for Staff's purposes, because the NOAA daily normal temperatures and HDD and CDD values are derived by statistically "fitting" smooth curves through these monthly values. As a result, the NOAA daily normal HDD and CDD values reflect smooth transitions between seasons and do not directly relate to the 30-year time series of MDT as used by Staff. However, in order for Staff to develop adjustments to normal HDD and CDD for steam usage, Staff must calculate a set of normal daily HDD and CDD values that reflect the actual daily and seasonal variability. Therefore, Staff developed a series of normal MDTs by adjusting the update period's actual daily average temperature data based on the 30 years of MDTs, such that the monthly average of the adjusted normal MDTs for a month is consistent with the NOAA's SCMT. Using these adjusted MDTs, Staff calculated HDD and CDD for each day of the 30-year period history. Staff calculated daily normal HDD and CDD as the average of the adjusted daily actual HDD and CDD for each calendar date in the update period. For example, Staff averaged the 30 observations of the adjusted daily actual HDD for January 1 of each year for years 1981 through 2010, to determine the normal HDD for January 1.

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[33] Ambient air temperature is the outside temperature of the surrounding air without taking into account the humidity or wind in the air.

[34] Where MDT < 65°F, HDD = 65 – MDT; otherwise, HDD = 0.

[35] Where MDT > 65°F, CDD = MDT - 65; otherwise, CDD = 0.

The following chart presents calendar month summaries of adjusted daily actual and normal HDD and CDD during the update period for MCI. The HDD and CDD comparison indicates that the update period (January 1, 2013 – December 31, 2013) in MCI was cooler than normal by approximately 9.4 percent in heating season and 3.4 percent in cooling season. This information was made available to calculate the weather normalization adjustment factor.

Case HR-2014-0066
Veolia Service Area - Kansas City International Airport
Heating Degree-Days (HDD) and Cooling Degree-Days (CDD)
For The 12 Calendar Months Beginning January 01, 2013 And Ending December 31, 2013

		TOTAL HDD BY MONTH			TOTAL CDD BY MONTH		
YEAR	MONTH	OBSERVED TOTALS HDD	NORMAL TOTALS HDD	**ADJUSTMENT ACTUAL TO NORMAL**	OBSERVED TOTALS CDD	NORMAL TOTALS CDD	**ADJUSTMENT ACTUAL TO NORMAL**
2013	1	998	1121	123	0	0	0
2013	2	912	882	(30)	0	0	0
2013	3	844	648	(196)	0	3	3
2013	4	467	334	(133)	13	26	13
2013	5	162	104	(58)	86	87	1
2013	6	19	9	(10)	271	264	(7)
2013	7	0	0	0	359	414	55
2013	8	0	2	2	339	376	37
2013	9	21	64	43	217	159	(57)
2013	10	334	293	(41)	28	26	(2)
2013	11	723	642	(80)	0	1	1
2013	12	1143	1040	(103)	0	0	0
12 MONTHS		**5622**	**5140**	**(482)**	**1312**	**1358**	**46**

Staff Expert/Witness: Seoung Joun Won, PhD

2. Weather Normalization Factors

Weather data shows that the update period of the test year in this case (January 1, 2013 – December 31, 2013) had a cold winter and a cool summer, compared to normal temperatures. Colder than normal temperatures in heating season often result in increased energy consumption

because consumers use more energy for space heating. Colder than normal temperatures in cooling season often result in decreased energy consumption due to lower than normal cooling usage.

In order to weather-normalized energy usage[36] Staff prepared three regression analyses for a heating model, a cooling model, and a heating and cooling model. The Staff generated the regression analyses by using the data that includes monthly billed tariff steam sales and actual monthly HDDs and CDDs. The monthly actual and monthly normal HDDs and CDDs are discussed in the Weather Variables section of this cost of service report. The regression equation develops quantitative measures that describe the relationship between monthly HDDs and CDDs and steam usage.

The estimated slope from the regression produced a coefficient that the Staff multiplied by the monthly HDD and CDD difference, and then multiplied by the Company's customer count for each month to obtain the monthly adjustment. The monthly adjustment was then added to or subtracted from the actual monthly usage. The Staff then took this normalized usage amount and divided it by the actual usage amount to arrive at the monthly weather normalization factors.

Staff Expert/Witness: Seoung Joun Won, PhD

3. Weather Normalization of Sales

The Company has three tariff rate schedules - Standard Commercial Service (SCS), Large Commercial Service (LCS), and Interruptible Heating Service (IHS). Staff weather normalized each individual customer in all three classes. The Staff adjusted all customers, with the exception of Veolia Missouri and TMC, to reflect normal HDDs. Because Veolia Missouri only uses VEKC service for cooling purposes, the Staff adjusted its usage to reflect normal CDDs. TMC uses VEKC service for both cooling and heating; therefore Staff normalized its usage to reflect normal CDDs and normal HDDs.

In summary, Staff weather-normalized steam sales to correct for deviations from normal weather conditions during the update period ending December 31, 2013. Staff applied the weather normalization factors to actual monthly usage to calculate the adjustment. The

[36] To "Weather normalize" energy usage means to adjust energy usage to correct for deviations from normal weather conditions.

adjustment was then added to or subtracted from the actual usage to obtain the normalized usage. The Staff provided the revenue adjustment associated with these calculations to Staff witness Keith Majors for calculation of the revenue requirement. The Staff also provided the adjusted billing units to Staff witness Brad J. Fortson for use in the Rate Design portion of this case.

Staff Expert/Witness: Seoung Joun Won, PhD

B. Commercial Customer Adjustments

Staff annualized monthly usage and the associated rate revenues for the test year, 12-months ending June 2013, updated through December 2013 for Veolia Kansas City commercial customers.

Commercial customers are billed based on the three customer classes established in, Case No. HR-2008-0300. The customer classes consist of LCS, SCS and IHS.

Revenue annualization adjustments are made to account for changes to Veolia Kansas City's revenues, typically due to tariff customers discontinuing steam service, beginning to take steam service or switching customer class rate structures through the update period. For the 12-months ending December 2013, Veolia Kansas City had two customers discontinue steam service, and had one customer begin steam service. Staff made an adjustment in its annualized revenue analysis to reflect the changes of these customers. Staff also applied the weather normalized usage adjustment for each customer class, provided by Staff witness Seoung Joun Won.

Staff Expert/Witness: Robin Kliethermes and Brad J. Fortson

C. Annualization of Special Customer Revenues

Veolia Kansas City serves two large industrial steam customers, Ingredion (formerly National Starch & Chemical Company) and Cargill. Ingredion and Cargill have entered into contractual agreements with Veolia Kansas City. As such, the revenues received from Ingredion and Cargill are based on their respective agreements with Veolia Kansas City. Because Ingredion and Cargill are billed on a contract rate, Staff annualized the revenues associated with Ingredion and Cargill separately. Staff analyzed actual loads for Ingredion for the calendar years 2006-2012, the test year ending June 30, 2013, and the update period ending December 31, 2013. As a result of this analysis, Staff calculated a two-year average of the

Ingredion steam volumes using the most recent billed steam price and used this average as a representative level of revenues received by Veolia Kansas City. Staff calculated the revenues received from Ingredion by pricing the annualized load times the average price of steam billed to Ingredion during the 2013 calendar year.

Similar to Ingredion, Staff analyzed Cargill's actual steam loads for the calendar years 2006-2012, the test year ending June 30, 2013, and the update period ending December 31, 2013. As a result of this analysis, Staff calculated a two-year average of the Cargill steam volumes at the most recent billed price and used this average as a representative level of revenues received by Veolia Kansas City. Staff calculated the revenues received from Cargill by pricing the annualized load times the average price of steam billed to Cargill during the 2013 calendar year.

Staff's Special Customer adjustments are Rev-8.1, Rev-8.2, Rev-9.1, and Rev-9.2 on Staff Accounting Schedule 10.

Staff Expert/Witness: Keith Majors

D. Grand Avenue Space Leased/Allocated to Veolia Missouri

Veolia Kansas City currently leases approximately ** _____ ** square feet of industrial space in its Grand Avenue production facility (Grand Avenue) to its non-regulated affiliate, Veolia Missouri. Veolia Missouri produces and distributes chilled water service to several customers located within Veolia Kansas City's service territory. With Grand Avenue's operations manager serving as tour guide, Staff recorded physical measurements and calculated approximately ** _____ ** square feet of actual space currently used for Veolia Missouri operations. Currently, Veolia Kansas City leases this space to its affiliate at the rate of ** _____ ** per square foot per month. Based on an analysis of data obtained from an extensive database of real estate brokers, Staff believes that ** _____ ** per square foot per month is a more appropriate amount for Veolia Kansas City to charge its affiliate for the leased space. Staff believes this increased rate is more representative of an amount Veolia Missouri would have to pay if it were located at a different industrial building within the downtown Kansas City area.

Staff believes other factors also demonstrate significant benefits of the Grand Avenue space and serve as justifications to increase the lease rate being charged to Veolia Missouri including:

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1) Grand Avenue is the ideal location for the Veolia Missouri non-regulated operations because it is the headquarters of Veolia Kansas City and thus provides opportunity for management oversight and assistance that would not be available in another building location.

2) The net benefits of having shared labor (the work force outside of management oversight) already on site to monitor, maintain and operate the chilled water service provided by Veolia Missouri.

3) Veolia Missouri must be located within the Veolia Kansas City steam service territory in order to receive steam service. Available industrial space within the steam service territory is increasingly being converted to residential space to meet the rising demand for lofts and other living quarters in downtown Kansas City. Staff found only three available locations within the steam service area – one in the River Market area (near Grand Avenue) and two in the Hospital Hill area. None of the three locations had sufficient space available to accommodate the operations of Veolia Missouri. Veolia Kansas City is fully aware of the lack of available options. On page 4-1 of its 2004 (then Trigen) *Cost Allocation Manual* filed with its *Annual Report to the Commission*, the Company states "The Grand Avenue Station is a unique industrial facility situated in the downtown Kansas City area, for which no relevant market price comparisons are believed to be possible."

4) By being located at Grand Avenue, Veolia Missouri does not have to construct a steam line to connect its facilities to the steam service and does not require a separate structure/building for its chilled water operations – a significant savings to the non-regulated operations of Veolia Missouri.

Staff's adjustment for the revenue associated with the lease of Veolia Kansas City's production facility to their non-regulated affiliate, Veolia Missouri is shown on Staff's Accounting Schedule 9, Adjustment Rev-13.1.

Staff Expert/Witness: V. William Harris

E. Grand Avenue Station's Production Expenses

1. Fuel Expense

The annualized fuel costs are determined by making adjustments to reflect Staff's annualized load and current fuel prices. Staff's methodology used to calculate fuel expense starts with the customer sales in units of Mlbs, referred to as "loads", provided by Staff witness Keith Majors, and includes the following inputs:

1) Distribution system losses;
2) Station use and auxiliaries;
3) Plant heat rate;
4) Fuel mix for coal and natural gas fuels;
5) Fuel heat rate for coal and natural gas;
6) Delivered coal price per ton;
7) Coal hauling and disposal factor;
8) Ash hauling and disposal per ton; and
9) Delivered cost of natural gas per Mmbtu.

Staff examined several years of data for the various cost components of fuel using actual costs and compared those actual costs to the production plant's steam output—the actual amount of steam produced at Grand Avenue.

The fuel components are based on categories of costs, such as the delivered fuel costs for coal and natural gas—the two fuel sources used to produce steam at Grand Avenue. The fuel components also include water and sewer costs. A significant amount of water is needed to produce steam. When the steam is converted back to water, the condensate goes to the city sewer system. Staff's treatment of Veolia Kansas City's water and sewer costs are addressed by Staff witness V. William Harris later in this report.

Another fuel component is the chemicals used to treat the water used to make steam. These chemicals are referred to as "consumables." The analyses for all these fuel inputs are based on actual information of one to five years, depending on the consistency of the historical values for that input.

Specifically, the various fuel components are based on:

- the distribution system losses—referred to as line loss, station use and auxiliaries—the energy it takes to operate and heat the Grand Avenue plant site-- are based on a three year average 2011-2013
- the plant heat rate is based on the calendar year 2013
- the fuel heat rate for coal is based on the 2013 calendar year average level of actual Btu's in the coal per pound deliveries determined by the actual coal Btu's purchased from the coal supplier
- the coal hauling and disposal factor is based on the August 2013 contract price
- the ash hauling and disposal per ton is based on calendar year 2013

The fuel mix input reflects the percentage of fuel that is coal and the percentage that is natural gas. Staff reviewed several years of data and determined a two year average of 2012-2013 is the appropriate fuel mix to use in calculating Veolia Kansas City's fuel expense.

The fuel prices used for the delivered coal price per ton and the delivered cost of natural gas cost per Mmbtu are based on Staff's analysis of coal and natural gas prices for the period of 2009 through 2013. Veolia Kansas City entered into a new coal contract effective December 2013. Staff used Veolia Kansas City's average coal heat rate for the 12-month period ended December 2013 and the current contract price to determine the delivered coal price per ton. Veolia Kansas City's actual historical gas prices have fluctuated over the past several years. Since there was no apparent trend, up or down, Staff used a three year average, 2011-2013, to calculate the delivered cost of natural gas cost per Mmbtu.

In addition to delivered coal and natural gas expense, Veolia Kansas City incurs costs to dispose of coal ash and to maintain the coal pile located at the Grand Avenue station. Veolia Kansas City pays a contractor to haul and properly dispose of ash produced from the Grand Avenue plant. Fly ash and bottom ash is a waste product of burning coal. The costs Staff included in Veolia Kansas City's cost of service to dispose of fly ash and bottom ash is based on actual costs for 2013. Veolia Kansas City entered into a new contract for coal handling in August 2013. Staff calculated coal handling costs using the August 2013 contract price.

Staff's fuel adjustments included in Veolia Kansas City's cost of service are shown on Staff's Account Schedules E-17.1 E-18.1, E-19.1, and E-21.1.

Staff Expert/Witness: Karen Lyons

2. Consumables Expense Adjustments

Veolia Kansas City purchases treated water from Kansas City's Water Department (Water Department) for the production of steam at its Grand Avenue Station. The steam system does not have a dedicated system to return the water that is left when the steam cools and condenses back to water. Therefore, Veolia Kansas City must pay the Water Department to dispose of the water through the sewer lines. Water expense is unique to Veolia Kansas City in that it is a variable cost based on the amount of actual steam produced. Therefore, annual water expense is calculated similarly to the calculation of other direct consumables such as fuel. In Veolia Kansas City's case, its sewer cost is also a variable cost resulting from the municipality's billing procedures.

Staff examined the actual Water Department bills, including storm water and primacy charges, for the period of July 2012 through December 2013. In order to reflect the most recent costs, Staff based its water and sewer expense adjustments on the actual Water Department bills for the 12-months ended December 2013. Staff also annualized water expense to reflect the May 2013 rate increase. Since water rates are increasing again this month, Staff will continue to monitor water expense throughout this case. The total water and sewer costs were included as part of operational expenses and also included in the calculation of fuel expense.

Staff also examined the costs of other consumables, such as ammonia and salt. In order to reflect the most recent costs of other consumables, Staff based its other consumables expense adjustments on the actual account balances as of the known and measurable update period ended December 31, 2013. The other consumables costs were included as part of operational expenses and also included in the calculation of fuel expense. Staff's adjustments are reflected in Staff's Accounting Schedule 9, E-23.1, E-24.1, E-27.1, E-28.1, E-29.1, E-30.1 and E-31.1.

Staff Expert/Witness: V. William Harris

3. Purchased Power and Electric Expense

In order to meet its own energy needs to operate the Grand Avenue Station, Veolia Kansas City must either generate electricity using a small five-megawatt steam turbine generator located at the plant, or purchase electricity from KCPL. When it purchases electricity from KCPL, that transaction is considered purchased power. The largest percentage of Veolia Kansas City's purchased power (electricity) is used to power the equipment at the Grand Avenue

Station, which is required to operate the steam production facility. Veolia Kansas City also receives power to operate equipment for three other locations within its service territory (Baltimore, Wyandotte, and Truman and Cherry). The annualized expense is included in the total fuel and energy costs calculation, which is treated as part of total cost of service.

Whenever the opportunity presents itself, Veolia Kansas City sells any excess electricity it produces to KCPL at an agreed upon rate. There is a significant difference between the rates KCPL charges Veolia Kansas City for electricity and the amount Veolia Kansas City charges KCPL for electricity. The selling of power (electricity) to KCPL is taken into account in the revenues calculation of Staff witness Keith Majors. The electricity sold back to KCPL is treated as an increase in revenues for Veolia Kansas City.

KCPL also has plant equipment to operate its electric system that requires electricity. This power is delivered to the Grand Avenue Station through separate metering. The KCPL electric bill for Veolia Kansas City considers this electricity. Staff examined these bills to ensure none of the electricity used at Grand Avenue to operate the KCPL system were included in the Veolia Kansas City costs.

Staff has reviewed the electric bills from KCPL to determine the annualized amount of electricity expense to include in the current rates. Staff annualized this expense using a five year average (2009-2013) of kilowatt hour usage for Veolia Kansas City's Grand Avenue station and applied the most current Commission approved tariffed electric rate to the average to determine an annualized level of electricity. For the other three locations receiving power, Staff reviewed monthly usage for the period of 2009 through 2013 and determined the 12-month period ended December 31, 2013 is representative of an ongoing level of usage. Staff's adjustment for purchased power is reflected in Staff's accounting schedules, Adjustment E-20.1.

Staff Expert/Witness: Karen Lyons

4. Environmental Fees

Staff included a level of environmental expense in Veolia Kansas City's cost of service. Staff reviewed actual environmental costs for the period of 2011 through 2013. Staff determined the actual costs incurred during the 12-month period ended December 31, 2013 represents an appropriate level of environmental expense to include in Veolia Kansas City's cost of service. This level excludes costs related to the Kansas Department of Health and Environment (KDHE)

that is discussed later in this report. Staff's adjustment is shown in Staff's Accounting Schedules, Adjustment E-33.1.

Staff Expert/Witness: Karen Lyons

F. Payroll, Related Benefits, and Payroll Taxes

Staff based its revenue requirement calculation of payroll, payroll related benefits and payroll taxes on the Company's current employee levels and current wage rates. Utilizing the most current wage rates provided by the Company, Staff adjusted the Company's payroll, payroll tax, and related benefits to annualized payroll levels to reflect the most current level of expense in the revenue requirement calculation.

Staff Expert/Witness: Matthew Young

1. Base Payroll

Base payroll was calculated by multiplying each hourly employee's last known wage rate by 2,080 hours and adding the most recent salaries of all active salaried employees. Staff then multiplied the annualized amount by a payroll Operation and Maintenance (O&M) expense factor to the total payroll to identify the expense portion of payroll—this is sometimes referred to as the "capitalization ratio." The calculation of the capitalization ratio is discussed in a later section. This annualized amount does not include corporate wages and allocations which are annualized separately. The corporate allocation of wages is discussed further by Staff witness Keith Majors in the section on corporate allocations.

Staff also reviewed costs for premium pay in the Company general ledger for the years of 2011 through 2013, and reviewed the Company's work papers for hours charged to premium pay from 2011-2013. Premium pay includes overtime, double time, call-out pay, and on-call pay. Staff determined that the number of hours charged to premium pay decreased each year during this three year period. Since premium pay was trending downward from 2011-2013, Staff utilized the number of hours charged to the individual types of premium pay during 2013, adjusted by Staff's capitalization ratio, for inclusion in Base Payroll. (Accounting Adjustments E-9.1, E-10.1, E-14.1, E-16.1, E-23.2, E-32.1, E-37.1, E-38.1, E-41.1, E-44.2, E-45.2, E-52.2, E-56.2, E-57.2, E-71.1 and E-72.1)

Staff Expert/Witness: Matthew Young

2. Allocation between Veolia Kansas City and Veolia Missouri

Staff reviewed Veolia Kansas City employee timesheets from January 2011 to December 2013 to determine the employees who had identified time worked between Veolia Kansas City's steam operations and Veolia Missouri's chilled water operations, a non-regulated affiliate of Veolia Kansas City. Veolia Missouri provides non-regulated chilled water services to customers using steam purchased from Veolia Kansas City. The two companies have common employees, causing the need for each employee to allocate a portion of time between the non-regulated Veolia Missouri and the regulated Veolia Kansas City operations. Each employee is required to document and allocate his/her time on a weekly basis between these two entities. Employee time dedicated to Veolia Missouri should not be included in rates charged to the steam customers, since this is a non-regulated affiliate of Veolia Kansas City.

During the examination of the timesheets during the period 2011 – 2013, Staff discovered that the total time charged to Veolia Kansas City per employee has been steadily decreasing. Therefore, Staff calculated the allocation factor for each individual employee using the time actually charged to the regulated steam operations of Veolia Kansas City during the calendar year 2013. Staff then applied each individual's allocation factor to their last known wage rates. The same allocation factors were used to develop an appropriate amount of payroll taxes and premium pay to include in the payroll annualization.

Staff Expert/Witness: Matthew Young

3. Allocation between Expense and Construction

In general, public utilities are capital intensive entities where ongoing construction activity is necessary to meet the energy needs of current and future customers; therefore, construction is a significant and on-going activity of a utility company. Construction activity not only involves actual physical construction projects, but also the planning, budgeting, monitoring and record keeping activities associated with construction projects. Utility management provides oversight of the construction activities of a public utility, including the approval of all construction projects. Even construction projects performed by outside contractors require Veolia Kansas City management oversight and, therefore, time spent on these projects. Some of these activities can be directly identifiable with specific construction projects, while some of these activities cannot be directly identified with a specific project. The fact that the activity

cannot be directly identified with a project does not mean that the activity was not performed in support of the construction. Where construction activities take place and funds are expended, some portion of indirect administrative and general (A&G) costs should also be charged to construction. The payroll expense ratio should reflect a proper allocation of total payroll cost between operations and maintenance activity (expensed in the current year) and construction activity (capitalized to plant in service).

Executive management has oversight responsibility for all of Veolia Kansas City's operations, including construction. Although the Company does not have any large projects scheduled in the near future, the Company still incurs some construction costs going forward, which would include payroll related costs. Staff developed a ratio using hours related to capital projects to total payroll hours during the years of 2011 through 2013, and found the ratios to be fluctuating. Consequently, Staff used an average of those three years in its payroll annualization. Staff applied the expense allocation percentage to the total payroll costs to include the expense levels in the revenue requirement calculation. The amount related to construction activity will be included in future plant balances.

Staff Expert/Witness: Matthew Young

4. 401K, Defined Contribution Plan and Group Benefits

Veolia Kansas City offers a 401K Retirement Plan, Defined Contribution Plan, comprehensive medical, dental, life, and disability coverage for their employees. Staff reviewed the employer costs for each benefit and included the actual expenses for current employees during the 12-month period ending December 31, 2013.

Staff also obtained the amount each employee was contributing to their 401K accounts as of December 31, 2013, as well as the formula the Company uses to match employee contributions. The employer 401K expense was annualized using the last known employee contributions applied to the Company's matching policy. Staff annualized the Company's expense based on the number of existing employees at the end of the update period, December 31, 2013, to include in the cost of service for the remaining employee benefits. Finally, Staff applied the same O&M expense factor to 401 K as it did for the payroll expense to capitalize a portion of these costs. (Accounting Adjustments E-80.1 and E-81.1)

Staff Expert/Witness: Matthew Young

5. Payroll Tax

The adjustments made to payroll taxes serve to ensure that Staff included in rates the appropriate level of Social Security (FICA) and Medicare taxes associated with the Staff's annualized payroll. The Staff's calculation used the current tax rates for the individual tax components. Staff applied the same O&M expense factor to payroll taxes as it did for the payroll expense to determine the expense portion for these taxes. Applying these rates to the current annualized level of payroll expense produces the best available allowance for payroll taxes on a going forward basis. (Accounting Adjustment E-98.1)

Staff Expert/Witness: Matthew Young

6. Bonus Compensation

During the test year, Veolia Kansas City incurred costs related to bonus compensation earned by participation in the Company's two types of incentive programs. The two programs are titled Operations & Maintenance Incentive Plan (OMIP) and the Management Incentive Plan (MIP). Staff made adjustments to remove the cost of all bonus compensation from the test year because these types of costs are typically excluded from the cost of service. These adjustments were also proposed by the Company in their direct filing. (Accounting Adjustments E-11.1, E-39.1, and E-73.1)

Staff Expert/Witness: Matthew Young

7. Contract Labor

Veolia Kansas City utilizes contract labor to meet the maintenance requirements of the production plant that cannot be addressed with in-house labor. Staff examined the contract labor expense incurred by the Company for the years of 2011 through 2013 and found the costs to be increasing. Staff found it appropriate to include in rates the expense incurred at the end of the known and measurable period, December 31, 2013, in the cost of service to ensure the company is able to fund its future contract labor needs. (Accounting Adjustments E-15.1 and E-42.1)

Staff Expert/Witness: Matthew Young

8. Corporate Allocated Costs

Corporate allocated costs are A&G costs that are directly assigned or allocated from various Veolia entities, including the parent corporation Veolia North America Holdings, Inc. ("VENAH"), to its subsidiaries for various supporting services. Thermal North America, Inc. ("TNAI") and Veolia Energy North America, LLC ("VENA LLC"), provide executive management and centralized support services to the Veolia district heating and cooling companies ("Veolia Companies"). These services are provided to the Veolia Companies on an allocated basis and include executive management, accounting and tax, finance and treasury, human resources, information technology, legal and other general corporate services. VENA LLC, a management services company, provides management oversight and A&G services to Veolia Kansas City and Veolia Missouri from corporate headquarter locations (Chicago, Boston, Indianapolis, and Milwaukee), on an allocated cost basis.

VENA LLC allocates all of its costs either directly to individual district heating and cooling subsidiaries, including Veolia Kansas City, or back to its parent company VENAH. The A&G costs of VENA LLC that are charged back to VENAH along with A&G costs of TNAI ultimately are allocated to each Veolia district heating and cooling subsidiary including Veolia Kansas City. In past cases, Staff believed these corporate costs were excessive and contributed in part to ** _____ **. In the past two rate cases and in this third rate case, Staff has examined the corporate costs Veolia Kansas City is being charged from the various Veolia entities providing management oversight. The costs directly incurred for the local management, maintenance and operations of district heating and cooling in Kansas City—either provided by Veolia Kansas City or its affiliate, Veolia Missouri—are not an issue. The directly assigned costs have been included in Staff's revenue requirement calculation either as payroll, payroll benefits or operation and maintenance costs.

The costs that have been a concern in the past relate to TNAI, VENAH, and VENA LLC's A&G costs that are allocated to each Veolia Company subsidiary based on sales of each entity in relation to the total sales of VENAH. The percentage derived from Veolia Kansas City's sales to VENAH's total sales is applied to A&G costs resulting in its allocated share of the costs. The allocation process ensures that each entity receives its allocated share of the total

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A&G costs. The following table identifies Veolia Kansas City's allocated share of A&G costs from 2006-2013:

Year	Allocation Percentage for Veolia Kansas City
2006	** _____ **
2007	** _____ **
2008	** _____ **
2009	** _____ **
2010	** _____ **
2011	** _____ **
2012	** _____ **
2013	** _____ **
Source: Data Request 80, Case Nos. HR-2011-0241 & HR-2014-0066	

One factor contributing to increased corporate costs is an increased allocation percentage used to calculate Veolia Kansas City's share of corporate costs. Although VENA LLC used the same approach to allocate corporate costs for the last several years, Veolia Kansas City's allocated share has increased from ** _____ ** in 2006 to ** _____ ** in 2012, and ** _____ ** in 2013.

However, the most significant factor causing the increase in corporate costs allocated to the Company is the substantial increase in the amount of total corporate costs since the 2007 corporate ownership change from Trigen to Veolia. In December 2007, Thermal North America was acquired by Veolia Environnement. S.A., that caused a difference in how corporate costs were allocated to Veolia Kansas City. The following table is a list of the total pool of allocated corporate costs to the Veolia Companies:

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Year	Total Pool of A&G Corporate Costs	Corporate Ownership
2007	** _____ **	Trigen Companies
2008	** _____ **	Veolia Companies
2009	** _____ **	Veolia Companies
2010	** _____ **	Veolia Companies
2011	** _____ **	Veolia Companies
2012	** _____ **	Veolia Companies
2013	** _____ **	Veolia Companies
Source: Data Request 80, Case No. HR-2011-0241 & HR-2014-0066		

Although VENAH allocates its A&G costs to each entity as described above, it retains some of its corporate costs. The Company is not seeking reimbursement of these retained costs in this current rate case, and has also recommended adjustments to the remaining allocated costs because some of these costs may be considered controversial for ratemaking purposes. Veolia Kansas City witness Steve Carver, the Company's consultant, addresses this point in his direct testimony at pages 31-32:

> In the normal course of business, certain cost center expenses are retained and not allocated to the various operating entities. In addition, other cost center expenses were removed for regulatory purposes and not allocated to VEKC for purposes of this rate case. The voluntary removal of certain common costs initially allocated to VEKC was undertaken with the intention of conservatively eliminating elements of expense that are sometimes controversial in the rate setting process.
>
> [footnotes omitted, Carver Direct Testimony, HR-2014-0066]

The Company's Adjustment C-14, as described in the Direct Testimony of Steve Carver, removes several categories of expenses such as marketing, officer's salaries, and bonuses. The summary of that adjustment is in the table below:

continued on next page

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Company Adjustment C-14 Summary	
Test Year Total VENA/TNAI A&G Costs	** _____ **
Test Year Allocation to Veolia Kansas City	** _____ **
Company Proposed Adjustments	** _____ **
Adjustment to Test Year Booked Corporate Allocations	** _____ **

The Company proposed similar adjustments in the last two prior rate cases. The following table details the test year corporate costs and the Company's adjustment to the corporate costs for rate recovery for Case No. HR-2008-0300, HR-2011-0241, and the current rate case:

Rate Case	Test Year Corporate Costs	Company Adjustment	Net Corporate Costs
HR-2008-0300	** _____ **	** _____ **	** _____ **
HR-2011-0241	** _____ **	** _____ **	** _____ **
HR-2014-0066	** _____ **	** _____ **	** _____ **

Staff examined the annual reports to the Commission filed by Veolia Kansas City. In the case of Veolia Kansas City, these reports are filed using FERC Form 1. The following chart identifies corporate costs assigned to Veolia Kansas City:

Veolia Kansas City Corporate Allocations as reported on FERC Form 1		
Year	**Corporate Allocations**	**Percentage Change From Previous Year**
2006	$ 198,114	N/A
2007	$ 238,392	20%
2008	$ 273,377	15%
2009	$ 508,331	86%
2010	$ 782,994	54%
2011	$ 598,157	-24%
2012	$ 583,059	-3%
2013	$ 462,973	-21%
Source: FERC Form 1, Page 323, Account 930.2		

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It should be noted there are some relatively small differences in corporate costs the Company identified in a data request response and those reported in the annual report submission to the Commission (the FERC Form 1). As can be seen by the information in this table, after peaking at $782,994 in 2010, Veolia Kansas City has reduced the amount of corporate allocations from that peak by 41 percent through 2013. Staff views this as positive event which directly influences the profitability of the Veolia Kansas City steam system.

While Staff concluded in its review of corporate costs that VENA LLC distributed corporate costs consistently to all Veolia Companies using the percentage of sales method, Staff has not concluded those corporate functions are entirely necessary to the operations of Veolia Kansas City; that Veolia Kansas City could provide some or many of those functions at a local level more effectively; or that the overall levels of corporate costs allocated to Veolia Kansas City were necessary to the regulated operations or proper as to the overall amount allocated. The amount of corporate costs allocated from VENA LLC and assigned to Veolia Kansas City may simply be excessive considering the size of the Company's Kansas City regulated operations. In other words, while the corporate services may be worthwhile, and even necessary, Veolia Kansas City may simply not be able to afford the Veolia corporate structure with its many layers of management.

In comparison to operating revenues, Veolia Kansas City's total A&G expenses, including corporate allocations and locally incurred A&G expenses have decreased in the past two calendar years:

Veolia Kansas City A&G Expenses Compared to Operating Revenues			
Year	**Total A&G Expenses**	**Total Revenues**	**A&G Expenses Per Dollar of Operating Revenue**
2007	$1,247,787	$13,428,036	$0.0929
2008	$1,695,449	$16,507,327	$0.1027
2009	$1,414,648	$19,417,923	$0.0729
2010	$2,247,172	$19,474,373	$0.1154
2011	$2,674,958	$19,640,245	$0.1362
2012	$1,556,509	$18,821,159	$0.0827
2013	$1,753,972	$19,640,442	$0.0893
Source: FERC Form 1, Page 323, Line 197			

As a condition of the Stipulation and Agreement in Case No. HR-2011-0241, Veolia Kansas City agreed to an internal review of the corporate allocations to Veolia Kansas City. The relevant section is below:

> **7. Corporate Cost Study.** Veolia agrees to conduct an internal review of the charges to individual corporate cost centers (or cost pools), assess the anticipated beneficiaries of the underlying services and consider alternative methods and approaches to the allocation of such costs to all Veolia entities. Veolia will document the study results and will discuss those results with Staff representatives. Veolia will complete the study within twelve (12) months from the date the tariff rates from the pending case go into effect.
>
> [Stipulation and Agreement, Case No. HR-2011-0241, page 4]

Veolia Kansas City provided the study, attached as Appendix 3, Schedule KM-1, dated October 31, 2012. While brief, the study does specifically identify the services provided to Veolia Kansas City by its corporate affiliates and is useful for that purpose.

While Staff believes Veolia Kansas City's share of corporate costs is excessive with respect to the size and scope of the Veolia Kansas City operations, the reductions over the past two years have positively affected the profitability of the Veolia system. Staff believes that Veolia Holdings and Veolia Energy North America needs to review the corporate costs allocated to Veolia Kansas City, including the types of corporate activities charged to Veolia Kansas City. While the current allocation process using the revenues (sales) methodology seems to be appropriate, the review of the total corporate costs should include the appropriateness of the ultimate amount of total allocated costs being made to Veolia Kansas City.

Based on Staff's analysis, Staff has concluded that the Company's recommended adjustment reduced Veolia Kansas City's share of corporate costs to a more appropriate level. Staff is recommending the adjusted level of corporate allocated cost of ** _____ ** be included in the cost of service in this case. (Accounting Adjustment E-86.1)

Staff Expert/Witness: Keith Majors

9. Profitability of the Veolia System

Veolia Kansas City has had ** _____ ** in every year since the beginning of its operations when the system was purchased from Kansas City Power & Light Company in 1990. According to the Company, and the response to Data Request 80 in Case No.

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HR-2011-0241, Veolia Kansas City has ** _____ ** since taking over the operations of the district heating system in 1990 and through 2011 (Data Request No. 113, HR-2011-0241). Even with the rate increases from the 2008 and 2011 Rate Cases, Veolia Kansas City has ** _____ _____ **

The table below details Veolia Kansas City's Operating Income (Income before Interest, Taxes, and Other Allocated Costs) and Net Income:

Year	Veolia Kansas City Operating Income	Veolia Kansas City Net Income
2006	** _____ **	** _____ **
2007	** _____ **	** _____ **
2008	** _____ **	** _____ **
2009	** _____ **	** _____ **
2010	** _____ **	** _____ **
2011	** _____ **	** _____ **
2012	** _____ **	** _____ **
2013	** _____ **	** _____ **
Source: Data Request No. 80		

The amount of corporate allocations has an effect, but is not the only factor in Veolia Kansas City's ** _____ ** Two other factors that Staff has identified that have an effect are the legal and consulting rate case expenses incurred by the company and the variability of fuel and consumable expenses.

Rate case expenses related to the current case are addressed by Staff Witness Matthew Young elsewhere in Staff's Cost of Service report. In future rate cases, Veolia Kansas City should consider filing under the MPSC Small Utility Rate Case process in an effort to limit these expenses, as reducing rate case expense would contribute to ** _____ **. In the current case, rate case expense represents a proportionally large part of Veolia Kansas City's rate increase compared to other utility rate cases. In the current cPage 65 HCase, Veolia Kansas City has estimated approximately ** _____ ** for rate case expense, and has requested an approximate $1.0 million rate increase, a ratio of ** _____ **. In Veolia Kansas City's 2011

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rate case, the Company incurred ** _____ ** of rate case expense for a rate request of $1,379,000, for a ratio of ** _____ **. Veolia Kansas City's rate case expense as a percentage of rate increase requested is excessive and clearly outside the norm for rate case expense.

The variability of fuel and consumable expenses has been addressed by the Company in its direct filing in the form of a proposed "Production Adjustment Clause". Staff will address the applicability and appropriateness of a separate adjustment mechanism for fuel and consumable expenses in Staff's May 15, 2014 Class Cost of Service filing.

Staff Experts/Witnesses: Keith Majors and Cary G. Featherstone

G. Non-Labor Operations and Maintenance Expense

O&M expenses reflect costs to operate and maintain Veolia Kansas City's Grand Avenue production facilities, as well as the steam distribution plant. Veolia Kansas City incurs two types of production and distribution expenses: labor costs to pay employees for performing O&M activities and non-labor costs for the materials and supplies needed for the employees to perform the duties. Staff witness Matthew Young is responsible for the payroll (labor) component of O&M expenses. Fuel and consumables expenses used in the operation of the production facilities are discussed elsewhere in this report. This section will address non-labor O&M distribution and production expenses, other than fuel and consumables expenses.

Staff analyzed non-labor O&M production and distribution costs by FERC account for the period 2008 through the test year and the known and measurable (K&M) update period ended December 31, 2013 to identify any significant trends or fluctuations in account balances. Staff calculated and compared the 3-year and 6-year account balance averages to the test year and the update period balances. Staff concluded that the proper normalized expense level of the Company's future O&M costs were best reflected by the update period balances.

Staff's adjustments to reflect the normalized level of non-labor O&M expenses are: E-44.1, E-45.1, E-46.1, E-51.1, E-52.1, E-53.1, E-56.1, E-57.1 and E-58.1.

Staff Expert/Witness: V. William Harris

NP

H. Outside Services and Rate Case Expense

1. Outside Services

Outside services are amounts paid to consultants and non-Veolia Kansas City employees hired by the Company to perform specific tasks and functions. Staff utilized Company records and responses to data requests to determine the correct amount of Outside Services expense for inclusion in rates. The Company uses the law firm of Bryan Cave to review many of its legal disputes. The hourly rates of some of the legal costs for these disputes as well as legal costs incurred for processing the rate case are higher than in other Missouri comparable cases. While Staff made no adjustment to disallow these costs the Company does need to manage these costs on a reasonable basis. After reviewing the Company's historical data and invoices provided through data requests, Staff calculated an average Outside Services expense over a four year period to include in this case. Staff used this approach because the Outside Services expense fluctuates yearly.

2. Rate Case Expense

Rate case expenses are costs incurred by the Company in preparation and performance of its filing for rate relief. Rate case expenses typically are end-loaded—that is, the Company incurs significant costs to process the rate case towards the end of the process with activities such as the production of testimony, participation in the settlement conferences and the hearing process, including the production of briefs. As the Company incurs additional rate case costs for this case, Staff will include actual costs deemed to be reasonable and prudent to develop an amount of on-going rate case expense level that it will recommend for recovery in rates.

To determine if the Company's rate case expense is being prudently incurred, Staff went to the law offices of Bryan Cave located in Jefferson City and examined the un-redacted invoices submitted to Veolia Kansas City for legal services. While the Company has a right to legal counsel and representation during a rate case, Staff is concerned with the level of total costs to process this case and the hourly rates Bryan Cave is charging the Company for legal services. Besides Bryan Cave, the Company has also engaged other consultants in this case for consulting services and representation in a variety of rate case matters. Staff has not removed any of these costs but would like to explore the feasibility of Veolia Kansas City using the small company

rate case procedure to see if the costs to process future rate cases can be reduced. The costs to process the rate case contribute to the lack of profitability of Veolia Kansas City.

Staff has determined that the Company should be allowed to recover its prudently incurred and verified rate case expenses at an on-going and recurring level normalized over a four-year period of time. (Accounting Adjustments E-77.1 and E-85.2)

Staff Expert/Witness: Matthew Young and Keith Majors

I. Missouri Public Service Commission Assessment Expense

The Commission assessment is an amount levied on every regulated utility in Missouri for the recapture of expenses incurred by the Commission for providing the regulation of public utilities under its jurisdiction. Staff annualized the Commission Assessment to reflect an average of the three most recent assessments. The Staff adjusted the test year Commission Assessment to a calculated three year average based on records from the Commission. (Accounting Adjustment E-85.1)

Staff Expert/Witness: Matthew Young

J. Insurance Expense

Insurance expense is the cost of protection obtained by utilities provided by third parties, who protect against the risk of financial loss associated with unanticipated events or occurrences. Utilities, like non-regulated entities, routinely incur insurance expense in order to minimize their liability associated with unanticipated losses. Likewise, certain forms of insurance reduce ratepayer's exposure to risk. Premiums for insurance are normally pre-paid by utilities; i.e., payment is made by the utility to the insurance vendor in advance of the policy going into effect. Since insurance policies are normally pre-paid, Staff typically includes in rate base the unamortized balance of the pre-paid insurance account. In this case however, the insurance policies are procured by VENAH, a parent company of Veolia Kansas City, and the costs of those policies are allocated to the various subsidiaries of VENAH on a monthly schedule. As Veolia Kansas City receives those monthly allocations, it charges the cost to an expense resulting in a permanent zero balance of pre-paid insurance in rate base.

During the audit, Staff reviewed the Company's insurance policies for the following forms of insurance; General Liability, Worker's Compensation, and Automobile and

Property Insurance. Staff looked at coverage dates from 2011 through 2014. Based on the information provided by the Company, the Staff calculated an annualized insurance amount by using the insurance premiums that will be in effect through 2014, which the Company provided in the insurance policies. While reviewing Company documents, Staff became aware that Veolia Kansas City does not allocate insurance costs to Veolia Missouri, the non-regulated affiliate of Veolia Kansas City, for the Automotive and Worker's Compensation insurance premiums. An amount of insurance has been allocated to Veolia Missouri. Therefore, Staff's insurance annualization excludes Veolia Missouri's share of the insurance premiums and only reflects amounts for Veolia Kansas City steam operations. (Accounting Adjustments E-78.1, E-78.2, E-79.1, and E-79.2)

Staff Expert/Witness: Matthew Young

K. Injuries and Damages Expense

Injuries and damages expense represents the portion of legal claims against a utility that are not subject to reimbursement under the utility's insurance policies. Injuries and damages expense normally consists of the following components:

- General Liability
- Auto Liability
- Worker's Compensation

General liability claims tend to be the largest component of injuries and damages expense, and the part that can give rise to the most controversy in rate proceedings. Generally Accepted Accounting Principles (GAAP) normally requires companies to book injuries and damages claims on an accrual basis. This means the expense is based upon estimated future claims payout amounts, rather than the actual cash payments made. However, for ratemaking purposes, Staff generally takes the position that injuries and damages expense should be measured on a "cash" basis, which means they should be based upon actual cash payouts by the utility for claims made against it. This approach results in the actual payments forming the basis for the amount allowed in utility rates for recovery, instead of the accrued book expense.

For injuries and damages, Staff examined the cash payouts by Veolia Kansas City and Veolia Missouri during the years 2008 through 2013. An analysis of the historical data shows the

annual cash expense fluctuates from year to year indicating a six year average is the best representation of actual injuries and damages expense.

Since Veolia Kansas City and Veolia Missouri share common employees, Staff allocated a portion of injuries and damages expenses that were incurred by worker's compensation claims to Veolia Kansas City. To find the proper allocation percentage, Staff examined the employee timecards supplied by the company to find the number of hours charged to Veolia Kansas City compared to the hours charged to all business units. This allocation is consistent with the wage allocation discussed in the Payroll section of this report. Multiplying the normalized worker's compensation expense by this allocation percentage ensures that Veolia Kansas City is not held responsible for all costs related to employee claims when the employees do not spend 100 percent of their time on steam operations. The allocation of employee time between Veolia Kansas City and Veolia Missouri is discussed in detail in the payroll section of this report.

Staff then made an adjustment to the test year balance in Account 925 to include the normalized expense of all injuries and damages claims. (Accounting Adjustment E-79.3)

Staff Expert/Witness: Matthew Young

L. Miscellaneous Non-Recurring Expenses

In Case No. HR-2011-0241, Staff was informed of two non-recurring events that impacted Veolia Kansas City's operating expenses. In the 2011 rate case, the Company made an adjustment in its direct filing to remove costs related to these events. Although both events have been resolved, Staff reviewed the costs to ensure costs booked during the test year were excluded in Veolia Kansas City's cost of service.

In February 2010, Veolia Kansas City received a Responsible Party Notification Letter from the Kansas Department of Health and Environment (KDHE). KDHE identified Veolia Kansas City as a potentially responsible party in connection with an environmental investigation. As a result of the investigation, Veolia Kansas City was held responsible for a portion of the remediation costs. In December 2013, Veolia Kansas City received a letter from KDHE indicating the remediation requirements were satisfactorily completed. The Company did not seek recovery of these costs in the 2011 rate case and as such made an adjustment in its direct filing to remove the estimated accrued costs of remediation from expense. Likewise, the

Company is not seeking recovery of any expense related to the KDHE issue in this current case. The Company made an adjustment to reverse the accrual that was initially recorded in 2010. Staff reflected this adjustment in its Accounting Schedules, Adjustment E-33.2. Staff also identified costs related to KDHE in Account 923 - Outside Services. Staff included a normalized level of expense less all costs related to KDHE for Account 923 - Outside Services. Staff's treatment of outside services expense is addressed by Staff witness Matthew Young.

In July 2008, Missouri Gas Energy (MGE) notified Veolia Kansas City of an issue with MGE's gas meter that resulted in an alleged under-billing of Veolia Kansas City's natural gas service for the period of 2003-2008. Veolia Kansas City disputed the costs MGE identified as a result of the meter issue. This issue was settled in April 2012. The Company did not seek recovery of any costs in its direct filing for this rate case. Staff did not include any of these costs in its case.

Staff Expert/Witness: Karen Lyons

M. Property Taxes

Each year, the jurisdictional taxing authority bills Veolia Kansas City for the Company's property taxes. Tax bills for the year are based (assessed) on the property that Veolia Kansas City owns exclusively on January 1 of that calendar year. The property taxes assessed on January 1 of each year are typically not due to the taxing authorities until December 31 of that same year.

Since the update period for this case is December 31, 2013, Staff determined the annualized property taxes based on the Company's taxable property January 1, 2014. Staff used the relationship of 2013 property taxes (paid December 31, 2013) to January 1, 2013 plant balances. This property tax ratio, based on actual 2013 property tax payments, applied to January 1, 2014 plant balance provides the amount of annualized property taxes the Staff expects the Company to pay for future years.

For this rate case, Staff obtained from the Company the total amount of taxable property owned on January 1, 2014 and applied the tax rate assessed to the Company in 2013. Staff calculated the property tax rate assessed in 2013 by dividing the total amount of property tax paid by the total cost of the taxable property owned on January 1, 2013. Staff believes that the level of property tax expense arrived at in this manner is the best available information, since it

relies on the January 1st, 2014 balance of the Company's property, uses the most recent, known tax rate (2013), and considers the most recent tax assessment of property values without attempting to estimate any change in the rate of taxation for 2014 that is not known as of the update period. Staff's approach is consistent with positions taken in previous cases the Commission has ruled on, including KCPL's 2006 rate case. In the Report and Order issued in Case No. ER-2006-0314, the Commission states the following:

> Staff recommends that the Commission calculate property tax expense by multiplying the January 1, 2006 plant-in-service balance by the ratio of the January 1, 2005 plant-in-service balance to the amount of property taxes paid in 2005…the Commission finds that the competent and substantial evidence supports the Staff's position, and finds this issue in favor of Staff.

Based on the methodology addressed earlier, Staff's adjustments include an annualized amount for property taxes. (Accounting Adjustments E-96.1 and E-97.1)

Staff Expert/Witness: Matthew Young

VII. INCOME TAXES

Staff calculated the revenue requirement in this case for income taxes using two components for the income statement and one component for the rate base.

A. Income Taxes in the Income Statement

1. Interest Expense Deduction

Staff calculated the interest expense deduction using a method it has used since the early 1980's called "interest synchronization." Staff first utilized this methodology in KCPL's 1980 electric rate case, Case No. ER-80-48. Staff has consistently used, and the Commission has consistently adopted, this approach since that rate case.

This method identifies the interest expense amount utility customers pay in rates through the rate of return calculation. The rate of return developed by Staff witness Shana Atkinson includes a debt component. When applied to the recommended rate base, that debt component provides the Company with an amount to pay interest on its debt service. Since this is the amount customers are responsible for in the cost of service, this interest expense is also used as the income tax deduction to the calculated income tax expense amount for ratemaking purposes.

The interest expense deduction is calculated by taking the weighted cost of debt multiplied by the recommended rate base. This is the amount shown as a deduction on Schedule 10 - Income Taxes of the revenue requirement model. This methodology assures that the amount of interest expense used in the calculation of income tax expense, for ratemaking purposes, equals the interest expense the ratepayer is required to provide the Company in rates. Because Staff's calculates its recommended revenue requirement in part on a rate of return computation, the interest synchronization method allows an interest deduction consistent with the rate of return computation that is applied to rate base.

Staff Expert/Witness: Keith Majors

2. Depreciation Expense Deduction for Income Taxes Purposes

Staff calculated the deduction for depreciation for income tax expense using the amount of annualized book depreciation expense determined on a straight-line basis. The amount identified in Schedule 11 - Income Taxes as the "Add to Net Income Before Taxes" for depreciation was also used as the deduction for income tax purposes, found in Schedule 11 - Income Taxes.

Staff used the "Add Back" amount for the depreciation deduction since the Company was essentially treated as a new company, for income tax basis purposes, after the 2005 purchase by Thermal North America. As such, Veolia Kansas City no longer had any tax basis differences that the Staff would normally need to consider in the calculation of the depreciation deduction used in the income tax calculation. Typically, any income tax deduction previously taken cannot be taken again, so the Staff excludes those amounts from the tax basis of the property used in calculating the straight-line depreciation deduction for ratemaking purposes. In addition, since the Company essentially started over as a new company in 2005, all accumulated deferred income tax reserves were reduced to zero and, consistent with this treatment, no basis differences existed for tax depreciation. Staff has used the annualized book depreciation expense that is calculated on a straight line basis using the proposed rates recommended by Staff witness Arthur W. Rice. Staff's annualized depreciation amount is being used as the tax deduction for depreciation found on Schedule 11, without reflecting any basis differences for prior years deductions. There is a question as to whether there has been any basis differences at all based on prior tax treatment of timing differences. Staff believes that to the extent timing differences were

identified by the Company, the Company never took a current income tax deduction; in other words, those deductions for the timing differences were very likely normalized. KCPL was one of two utilities in the state that used normalization treatment of its timing differences. The "normalization" method (which was not typically used in determining utility rates in this state in the past) provided for a deferral of the deduction of the timing differences in the ratemaking process. While the companies were able to deduct certain costs currently to determine the amount of income taxes owed to the Internal Revenue Service, the normalization method did not reflect those current deductions in the ratemaking process. Under normalization, the Company deferred deductions and took them over the life of the assets. Generally, because of these deferred deductions, income tax expense was higher for ratemaking purposes under the normalization method than it would have been under the flow-through method.

Staff has reflected the tax deduction for tax timing differences consistent with the period used for recognizing the cost as an expense for financial reporting purposes, referred to as the "normalization" method. (Accounting Schedule 11)

Staff Expert/Witness: Keith Majors

Appendix 1 – Staff Credentials

Appendix 2 – Support for Staff Cost of Capital Recommendation – Shana Atkinson

Appendix 3 – Veolia Kansas City study – Keith Majors

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF SHANA ATKINSON

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Shana Atkinson, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Shana Atkinson

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF CARY G. FEATHERSTONE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Cary G. Featherstone, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Cary G. Featherstone

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF BRAD J. FORTSON

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Brad J. Fortson, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Brad J. Fortson

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF V. WILLIAM HARRIS

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

V. William Harris, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

V. William Harris

Subscribed and sworn to before me this 15th day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF ROBIN KLIETHERMES

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Robin Kliethermes, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Robin Kliethermes

Subscribed and sworn to before me this 1st day of May, 2014.

Notary Public

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF KAREN LYONS

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Karen Lyons, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Karen Lyons

Karen Lyons

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF KEITH MAJORS

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Keith Majors, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Keith Majors

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF ARTHUR W. RICE, PE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Arthur W. Rice, P.E., of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Arthur W. Rice

Arthur W. Rice P.E.

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D. Suzie Mankin

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF SEOUNG JOUN WON PHD

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Seoung Joun Won, PhD., of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Seoung Joun Won PhD.

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City, Inc for Authority to File Tariffs to Increase Rates	)))	Case No. HR-2014-0066

AFFIDAVIT OF MATTHEW YOUNG

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Matthew Young, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Matt Young
Matthew Young

Subscribed and sworn to before me this 1st day of May, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin
Notary Public