BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

STAFF'S POST-HEARING REPLY AND TRUE-UP BRIEF

Kevin A. Thompson
General Counsel

Steven Dottheim
Nathan Williams
Sarah Kliethermes

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-6514 (Telephone)
(573) 751-9285 (Fax)
kevin.thompson@psc.mo.gov

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STAFF'S POSTHEARING REPLY AND TRUE-UP BRIEF

On November 5 and 6, 2007, parties in this case filed posthearing briefs. On November 9, 2007, the Commission held a true-up hearing where parties adduced evidence on changes factual changes from March 31, 2007 to September 30, 2007. There were three contested issues during the true-up hearing. The Staff characterized them the same as they were described in the list of issues for the October 1-5, 9-12, 2007 evidentiary hearing, but numbered them differently. The issues list the Staff provided for true-up follows:

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

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

3. **KCPL Experimental Regulatory Plan Additional Amortization**
   What, if any, additional amortization is required by KCPL's Experimental Regulatory Plan approved by the Commission in Case No. EO-2005-0329?

The Staff's listing of true-up issues corresponds to the October evidentiary hearing issues list as follows:

October hearing issue no.	True-up issue no.
2.	1.
14.a.	2.
24.	3.

As it did with its initial posthearing brief filed November 6, 2007, the Staff has organized this brief following the issues list for the October hearing, regardless of whether the argument is in reply or for the true-up; therefore, to the extent the Staff presents true-up argument, it is presented in this brief under issue nos. 2., 14.a. and 24.

INTRODUCTION

The Staff has no disputes with KCPL regarding the true-up; however, Public Counsel does. Since it has no disputes with KCPL regarding the true-up, the Staff believes the significance of the issues it disputes with KCPL remain as the Staff set them out in its November 6, 2007 post-hearing brief.

The Staff's post-hearing reply and true-up argument follows.

REVENUE REQUIREMENT

Rate of Return

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

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

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

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

Hope and Bluefield – the Constitutional Parameters:

Staff will not waste the Commission's time by repeating at length what it has already stated in its initial brief. In that brief, Staff pointed out that the constitutional parameters[1] that must guide the Commission's award of a return on equity ("ROE") to KCPL are as follows:

(1) An adequate return is commensurate to the returns realized from other

[1] Derived from the two leading decisions of the United States Supreme Court, *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943) and *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

businesses with similar risks;

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

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

The first of these principles unmistakably requires a comparative analysis, as this Commission has clearly stated.[2] KCPL must be compared to a group of other businesses, whose returns on equity are known or may be calculated, and which proxy group is assembled on the basis of risk comparable to that of KCPL itself. All of the financial analysts who testified as experts in this case have purportedly performed such an analysis. The second principle derived from *Hope* and *Bluefield* refers to KCPL's own credit rating. A return "sufficient to maintain the utility's credit" is a return that will not cause the utility's credit rating to be impaired or damaged. The third principle, which requires a return "sufficient to assure confidence in the financial integrity of the utility," may operate to require a return that actually improves a utility's credit rating, in those situations in which it is already unduly low.

In applying the *Hope* and *Bluefield* principles, the Supreme Court has stated that "there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which [the General Assembly] has required it to reconcile."[3] *Hope* and *Bluefield* set both the floor and the ceiling for a just and reasonable rate. An appropriate ROE is one that is high enough to satisfy the *Hope* and *Bluefield* principles, *but not higher.* At that point of balance, the Commission has indeed reached a "fair" rate: "fair to the public, and

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[2] *In the Matter of The Empire District Electric Company,* 13 Mo.P.S.C.3d 350, 373-4 (*Report & Order,* issued March 10, 2005.

[3] *In re Permian Basin Area Rate Cases,* 390 U.S. 747, 770, 88 S.Ct. 1344, 1361, 20 L.Ed.2d 312, ___ (1968).

fair to the investors."[4]

How are the *Hope* and *Bluefield* principles to be integrated? Simple – the average ROE of the properly-constructed proxy group *is* the ROE of the company under consideration unless either the second or third of the *Hope* and *Bluefield* principles requires an upward adjustment to maintain creditworthiness or financial integrity. The Commission should keep that in mind when considering "adders" such as that proposed by KCPL's expert witness, Dr. Samuel Hadaway.

The "Zone of Reasonableness":

In its initial brief, Staff also discussed the "Zone of Reasonableness" ("ZOR") analysis used by this Commission in setting ROEs for the past several years. The ZOR compares the recommendations of the expert witnesses to the national average of the ROEs awarded in the industry in question over some recent interval. It is a type of benchmarking analysis and it is a way of implementing the principle of the "commensurate return" described by the Supreme Court in *Hope* and *Bluefield.*[5] In the present case, as Staff pointed out in its initial brief, the ZOR is of limited utility because all of the expert recommendations fall within it.

Dr. Hadaway's Proposed "Adder":

Another important issue addressed in Staff's initial brief is the 50 basis point "adder" the forms part of Company expert witness Dr. Sam Hadaway's recommendation. Staff pointed out that the use of an "adder" is unacceptable in at least two ways:

First, the use of an "adder" for a higher level of construction risk violates the principle of the "commensurate return" described by the Supreme Court in *Hope* and *Bluefield.* If the proxy group is truly comparable in risk to KCPL, then the average return for the proxy group *is*

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[4] *St. ex rel. Washington University et al. v. Pub. Serv. Comm'n*, 308 Mo. 328, 344-45, 272 S.W. 971, 973 (banc 1925).

[5] The United States Supreme Court has itself endorsed a "Zone of Reasonableness" analysis. *See Permian Basin Area Rate Cases, supra,* 390 U.S. at 767, 88 S.Ct. at 1360, 20 L.Ed.2d at ___; *Federal Power Commission v. Natural Gas Pipeline Co.,* 315 U.S. 575, 585, 62 S.Ct. 736, 743, 86 L.Ed. 1037, ___ (1942).

KCPL's ROE and no "adder" is either necessary or permissible. Indeed, as pointed out above, *Hope* and *Bluefield* permit upward adjustment *only* in two circumstances: to maintain creditworthiness and to maintain financial integrity. Staff considers the use of an "adder" by the Commission for any other reason to greatly increase the risk of reversal on appeal.

Second, in this particular case, Dr. Hadaway admitted on cross-examination that the magnitude of the "adder" that he recommended – 50 basis points – was simply snatched out of the air.[6] If the concept of an "adder," to account for some greater risk faced by the subject utility when compared to the proxy group, is accepted in principle, then the "adder" must represent some sort of rational quantification of that greater risk. Staff considers the use of an irrational adder, such as that proposed by Dr. Hadaway, to be arbitrary and capricious and to greatly increase the risk of reversal on appeal.

The Recommendations of the Experts:

With these points in mind, the Commission must now turn to a comparative analysis of the recommendations of the expert witnesses in order to determine the "just and reasonable" ROE award for KCPL. There are two points that the Commission must consider:

First, was the proxy group analyzed by each of the experts properly constructed in terms of the *Hope* and *Bluefield* principles? In other words, does the group reflect companies subject to the same level of risk as KCPL? If not, then the analysis cannot yield the required "commensurate return."

Second, was the methodology used by each of the experts reasonable? In other words, does it appear that any of the experts has manipulated the methodology employed in order to yield a desired result, whether higher or lower than it would otherwise be? The Commission, as trier-of-fact, may believe some, all or none of the expert testimony adduced at the hearing:

[6] Tr. 6:266.

"Evaluation of expert testimony is left to the Commission which 'may adopt or reject any or all of any witnesses' [sic] testimony.'"[7]

The Proxy Groups:

Hope and *Bluefield* require that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[8] This is the principle of the "commensurate return."[9] Its logical validity is dependent on the proper composition of the proxy group, for if the selected enterprises do not accurately reflect the "risks and uncertainties" of KCPL, then the ROE developed by the analysis of the proxy group will not be the appropriate ROE for KCPL.

Each of the three analysts that testified in this case used a fairly large proxy group

Barnes	Gorman	Hadaway
Alliant	--	Alliant
Ameren	--	Ameren
AEP	AEP	AEP
--	--	Central Vermont
--	--	CH Energy
Cleco	Cleco	Cleco
--	--	Con Ed
DPL	--	--
--	--	DTE
		Duquesne Light*
--	Edison Int'l	--

[7] *State ex rel. GS Technologies Operating Co., Inc. v. Public Service Com'n of State of Mo.,* 116 S.W.3d 680, 690 (Mo. App. W.D. 2003); *Associated Natural Gas,* 37 S.W.3d 287, 294 (Mo. App., W.D. 2000) (quoting *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n,* 706 S.W.2d 870, 880 (Mo.App.1985)).
[8] *Hope Natural Gas, supra,* 320 U.S. at 603, 64 S.Ct. at ___, 88 L.Ed. at ___ (citations omitted).
[9] In its restatement of this principle in *Hope,* the Supreme Court did not repeat the modifying language that it used earlier in *Bluefield,* that the commensurate return should be "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[.]" *Bluefield, supra,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183. It is not clear whether the omission was intended to be significant. In any event, while the temporal restriction continues to be valid, Staff suggests that the geographic restriction is no longer relevant, given the fact that utilities now compete for capital in a national – if not international – market.

Barnes	Gorman	Hadaway
Empire	Empire	Empire
--	--	Energy East
Entergy	--	--
First Energy	--	--
FPL	--	--
		Green Mountain*
Hawaiian	--	Hawaiian
IDACORP	IDACORP	IDACORP
--	--	MGE
--	N Source	N Source
--	--	N Star
--	--	NE Utilities
--	OGE	--
--	--	PPL
--	PG&E	--
--	Pepco	--
Pinnacle West	Pinnacle West	Pinnacle West
PNM Resources	PNM Resources	--
Progress Energy	Progress Energy	Progress Energy
--	--	Puget
--	SCANA	SCANA
Southern Co.	Southern Co.	Southern Co.
--	Vectren	Vectren
Westar Energy	--	--
--	Wisconsin	--
--	Xcel	Xcel

drawn from the universe of Value Line electric utilities.[10] The chart below places the three experts' proxy groups side-by-side. They are much the same. Barnes used a group of 16 companies, Hadaway used 26, and Gorman used a group of 17 companies of his own composition plus Hadaway's group, with two companies – Green Mountain and Duquesne Light

[10] The universe includes 66 companies. Barnes Direct, 15.

Holding -- excluded.[11]

As stated, the proxy groups must be constructed on the basis of comparable risk to KCPL or the logical validity underlying the "commensurate return" analysis required by the United States Supreme Court is lost. There are two primary sorts of risk to be considered: business risk and financial risk.

Business risk is the uncertainty inherent in projections of a company's future rate of return on assets. Business risk arises as a result of such factors as demand variability, sales-price variability, input-cost variability, ability to adjust output prices for changes in input costs, ability to develop new products in a timely, cost-effective manner, and the extent to which costs are fixed. Comparable business risk is assured, in the first instance, because all of the companies included in the various proxy groups are also regulated electric utilities, which necessarily face the same risks as KCPL to the extent that those risks are inherent in that line of business. Additionally, Standard & Poor's has developed a ten-point ranking system for assessing business risk in the electric energy business, where "1" indicates the lowest business risk and "10" the highest business risk. Standard & Poor's has assessed KCPL's business position to be "6" and GPE's as "7".[12]

Financial risk is the additional risk a company faces as a result of using debt financing. "Debt brings increased financial risk to the equity owners of a corporation. The existence of fixed interest expense means that returns to equity owners in a firm with debt . . . are more variable than they might otherwise be."[13]

[11] A total of 37 companies were used by the experts in the three lists. Seven companies appear on all three lists and eight others appear on two of the lists. Dr. Hadaway's group included the largest number (12) of companies not used by either of the other experts. None of the experts limited his proxy group to Midwestern utilities.
[12] Gorman Direct (Ex. 201), 4.
[13] D.E. Logue, *Handbook of Modern Finance,* 27-2 (1984).

Matt Barnes' direct testimony included this excerpt from Standard & Poor's June 25, 2004, GPE Research Report:[14]

> Kansas City, Mo.-based Great Plains Energy Inc.'s ratings are based on the consolidated financial and business risk profiles of its family of companies. Through its subsidiaries, Great Plains is involved in vertically integrated electric operations through its main subsidiary, KCP&L, and in retail energy marketing and power supply coordination through its majority interest in Strategic Energy. Because there are no regulatory mechanisms or other structural barriers in Missouri and Kansas that sufficiently restrict access by the parent to the utility's cash flow, Standard & Poor's views the default risk of KCP&L and Great Plains as the same.

Thus, the bond ratings assigned by rating agencies such as Standard & Poor's are based on an analysis of *both business and financial risk.* Barnes testified that the present ratings of both GPE and KCPL are "BBB" with a stable outlook.[15] The "BBB" rating is two notches above junk status and is thus investment grade.[16] Each of the three expert financial analysts formed his group of proxy companies on the basis of comparable bond ratings.[17] There is no reason, therefore, to doubt that each expert constructed his proxy group appropriately.

The Experts' Methods:

Three principal methods have emerged for determining the cost of common equity, the "market-determined" approach, the "comparable earnings" approach and the risk premium method.[18] The market-determined approach relies upon stock market transactions and estimates of investor expectations.[19] Examples of market-determined methods are the Discounted Cash Flow method ("DCF") and the Capital Asset Pricing method ("CAPM").[20]

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14 Barnes Direct (Ex. 105), at 10.
15 *Id.;* Gorman Direct (Ex. 201), 4.
16 *Id.*
17 Barnes: "at least investment grade credit rating," Direct (Ex. 105), at 16; Gorman: S&P BBB or A rating, Moody's Baa or A, Direct (Ex. 201), at 10; Hadaway: "at least a triple-B (investment grade) bond rating," Direct (Ex. 11), 4.
18 Hadaway Direct (Ex. 11), 14; C.F. Phillips, Jr., *The Regulation of Public Utilities,* 394 (1993).
19 Phillips, *supra.*
20 *Id.*

The comparable earnings approach is a comparative method and relies upon the concept of "opportunity cost," that is, the return the investment would have earned in the next-best alternative use.[21] The comparable earnings approach requires a comparative study of earnings on common equity in both regulated and unregulated enterprises of similar risk.[22] None of the analyses performed in the present case utilized the comparable earnings approach.

The third method is the Risk Premium method. This method requires that the analyst "(1) determine the historic spread between the return on debt and the return on common equity, and (2) add this risk premium to the current debt yield to derive an approximation of current equity return requirements."[23]

Matt Barnes employed a traditional constant-growth DCF model as his principle analytical tool, applied to his proxy group of sixteen companies and checked against two CAPM analyses and a company-specific, constant-growth DCF model. Barnes' recommendation of 9.72% was the midpoint of the results of his DCF results. Michael Gorman used a constant-growth DCF, a two-stage DCF, a Risk Premium analysis and a CAPM analysis, applied both to his own proxy group of seventeen companies and to Hadaway's proxy group of 26 companies (adjusted by excluding two). Gorman's recommendation of 10.10% was the average of all of his results. Hadaway used a traditional constant-growth DCF, a constant-growth DCF using the GDP as the growth rate, and a two-stage DCF, applied to his proxy group of 26 companies and checked against three Risk Premium analyses. Hadaway's base recommendation of 10.75% was the midpoint of the range yielded by his constant-growth DCF analysis using the GDP as the growth rate (10.7% - 10.8%).

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[21] *Id.,* at 397.
[22] *Id.,* at 397-98.
[23] *Id.,* at 399.

The DCF model is based on the assumption that stock prices represent the present or discounted value of all future dividends that investors expect to receive.[24] It is the most widely used regulatory cost of equity estimation method and one of the simplest.[25] In essence, it is simply the sum of the expected dividend yield and the expected long-term dividend (or price) growth rate.[26] Dr. Hadaway noted that, while dividend yields "are easy to obtain, estimating long-term growth is more difficult."[27] Hadaway testified that the constant-growth DCF model is unreliable where "growth rates are expected to fluctuate or when future growth rates are highly uncertain[.]"[28] Both Hadaway and Gorman used a two-stage DCF model. Because the growth-rate input is difficult to determine, the results of the DCF analyses will necessarily reflect the differing assumptions and opinions of the analysts. This point explains how Gorman and Hadaway achieved significantly different results using the same proxy group.

The CAPM is another market-determined method. Matt Barnes characterized the CAPM as describing "the relationship between a security's investment risk and its market rate of return. This relationship identifies the rate of return which investors expect a security to earn so that its market return is comparable with the market returns earned by other securities that have similar risk."[29] The CAPM requires an estimate of the market risk-free rate, the company's beta, and the market risk premium.[30] Each of these inputs must be selected by the analyst and each of them, consequently, is subject to subjective manipulation by the analyst.

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[24] Hadaway Direct (Ex. 11), 17.
[25] *Id.,* at 16.
[26] *Id.*
[27] *Id.*
[28] *Id.,* at 17.
[29] Barnes Direct (Ex. 105), E-1.
[30] Gorman Direct (Ex. 201), 25.

The Risk Premium method is "based on the assumption that equity securities are riskier than debt and, therefore, that equity investors require a higher rate of return."[31] Dr. Hadaway noted that[32]

> In regulatory practice, there is often considerable debate about how risk premium data should be interpreted and used. Since the analyst's basic task is to gauge investors' required returns on long-term investments, some argue that the estimated equity spread should be based on the longest possible time period. Others argue that market relationships between debt and equity from several decades ago are irrelevant and that only recent debt-equity observations should be given any weight in estimating investor requirements. There is no consensus on this issue. Since analysts cannot observe or measure investors' expectations directly, it is not possible to know exactly how such expectations are formed or, therefore, to know exactly what time period is most appropriate in a risk premium analysis.

As Dr. Hadaway's testimony indicates, the Risk Premium method is the subject of controversy. Consequently, each analyst will express his or her particular opinions and assumptions in the inputs selected for this model.

In summary, it is clear that each of the methods used by the experts in this case is subject to uncontrolled subjective manipulation, whether purposeful or not. This basic methodological unreliability has undoubtedly been a factor in this Commission's increasing reliance on more objective benchmarking analyses such as the "Zone of Reasonableness" discussed above. Staff suggests that, while the "Zone of Reasonableness" may not provide the answer in the present case, benchmarking may still provide the Commission with both a just and reasonable ROE for KCPL and a measure of objective certainty.

A Just and Reasonable ROE:

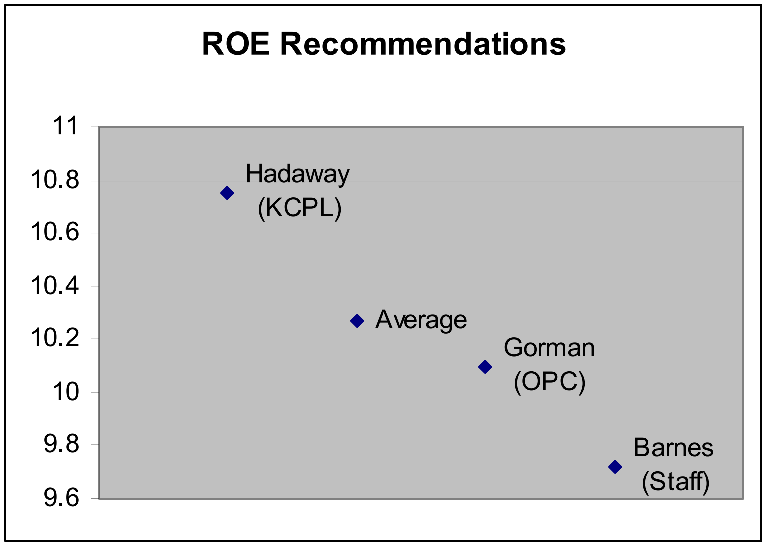
With respect to KCPL's risk, Mr. Gorman testified as follows:

> KCPL has an investment bond rating of "BBB" and business profile score of '6' from S&P. For integrated utility companies, S&P's business profile scores

[31] *Id.,* at 20.
[32] *Id.,* at 21.

> typically fall within the range of '4' to '6’. KCPL's investment grade bond rating and business profile score are generally comparable to the risk of a typical integrated electric utility company.[33]

“Typical” risk is average risk. In its initial brief, Staff presented a chart similar to the chart below, which graphically displays the recommendations of the three experts compared to the average value for ROEs awarded to regulated electric utilities in 2007:



Staff suggests that, since KCPL’s risk level is average, that it should be awarded an ROE close to the average.

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

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

[33] Gorman Direct (Ex. 201), 4.

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

These figures are based upon the actual capital structure, and the actual embedded costs of its components other than common equity, of Great Plains Energy ("GPE"), KCPL's parent, as of the true-up date. No one has denied that these figures are accurate.

However, OPC expert witness Michael Gorman continues to argue that the Commission should use a hypothetical capital structure rather than the actual capital structure of GPE. Gorman makes this suggestion because, in his view, GPE's capital structure is "excessively weighted with common equity[.]"[34] Gorman goes on to explain that an excessive amount of equity in the capital structure "unnecessarily increases the utility's claimed revenue deficiency because common equity is the most expensive form of capital[.]"[35] In Gorman's opinion, a hypothetical capital structure should be used containing only 53.43% common equity.[36] Gorman supports his opinion by reference to the practices of the bond rating agencies. KCPL's business profile of "6", according to Gorman, would support a debt level of 48% to 58% without an adverse impact on its bond rating.[37] Finally, Gorman notes that KCPL itself agreed, in its Experimental Regulatory Plan, that a 51% level of debt "would be supportive of its credit rating

[34] Gorman, True-up Rebuttal, at 2.
[35] *Id.*
[36] *Id.,* at 3.
[37] *Id.*

during its major construction program through 2012."[38]

It is Staff's practice to use actual figures in ratemaking rather than hypothetical, estimated or *pro forma* figures. Actual figures, after all, are known and measurable and their use is fair to all parties. In setting rates, the Commission is required to be fair to both the Company's investors and the Company's ratepayers. In what way, one wonders, is Mr. Gorman's hypothetical capital structure fair to the shareholders? What legal justification is there – for neither Public Counsel nor Mr. Gorman has cited any – for the Commission to disregard the reality of GPE's capital structure on the appointed true-up date? Just as Dr. Hadaway's "adder" is a transparent device used to inflate the Company's ROE, and thus its revenue requirement, so Gorman's hypothetical capital structure is a transparent device used to deflate the Company's revenue requirement. Both should be rejected.

EXPENSE ISSUES

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

In its brief at pp. 19-20, KCPL mischaracterizes the Staff's position on this issue. The Staff is not advocating that the benefits of the subrogation proceeds should be shared between KCPL shareholders and ratepayers because there is indication that KCPL was earning a reasonable rate of return after the outage. The Staff presented evidence indicating that after the outage KCPL was earning a reasonable return as well as that KCPL did not seek special accounting treatment due to the outage and that KCPL did not file a rate case seeking to increase its rates. Each of these facts supports the reasonableness of the Staff's position it should be

[38] *Id.* Mr. Gorman does not suggest that the Experimental Regulatory Plan *binds* KCPL to 51% debt in its capital structure, and, indeed, it does not.

presumed KCPL had already recovered the expenses incurred due to the explosion in the rates it charged its customers.

Because receipt of the Hawthorn 5 subrogation proceeds was an extraordinary event tied to an earlier generating facility outage, the Staff is looking to who bore the burden of the outage for who should reap the benefit of the proceeds. The evidence is that it was KCPL's customers who bore the burden of the outage, not KCPL's shareholders. Accepted ratemaking theory assumes that if a utility company does not seek a rate increase for an extended period of time, then its existing rates must be allowing it to recover all of its expenses plus a reasonable rate of return. KCPL has provided no evidence in this case that overcomes this assumption.

At page 19 of its brief, KCPL erroneously states that the only evidence in the record concerning the adequacy of KCPL's earnings during the 1999-2001 outage is the following testimony from Mr. Giles: "The two years where we really struggled were '99 and 2000 and part of 2001." Staff witness Hyneman testified at page 7 of his surrebuttal testimony that KCPL agreed to reduce its rates by $14.7 million on March 1, 1999. If a utility company voluntarily agrees to reduce its rates, it follows that utility must be earning at least a "reasonable" return on equity. Mr. Hyneman provided additional evidence at page 7 of his surrebuttal testimony. There he testified that in the Stipulation and Agreement in Case No. ER-99-313, KCPL agreed to a rate moratorium until September 1, 2001. Under the specific terms of that Stipulation and Agreement, KCPL could have terminated the rate moratorium due to extraordinary events such as the Hawthorn 5 boiler explosion, but it chose not to do so. This is additional evidence that KCPL's earnings during this period were more than adequate for its shareholders.

KCPL's assertion on page 20 of its brief that for the Staff's argument to prevail the Commission would have to determine what a reasonable rate would have been during 1999-2001 outage and set prospective rates accordingly is predicated on KCPL's mischaracterization of the Staff's position. The Staff is not asking the Commission to engage in retroactive ratemaking, explicitly or tacitly. As stated above and in its initial brief, it is the Staff's position the Hawthorn 5 subrogation proceeds are a reimbursement received in the test year for costs which KCPL's customers paid through rates. KCPL argues in its brief that when KCPL received the subrogation proceeds was happenstance and that the proceeds have nothing to do with KCPL's on-going operations. These two characteristics of the Hawthorn 5 proceeds are common to all extraordinary cost and extraordinary revenue events. As stated at page 9 of Staff witness Hyneman's surrebuttal testimony, as a result of the Commission's order in KCPL's 2006 rate case, KCPL is currently recovering an annual level of $4.5 million for ice storm costs that it incurred in 2002. The test year in the 2006 rate case was 2005. When that major ice storm occurred was happenstance, and the costs of the ice storm in 2002 had nothing to do with KCPL's ongoing operations in 2005. Yet, with these identical characteristics, KCPL sought and the Commission granted it rate recovery of these ice storm costs.

The crux of the Staff's position is that KCPL's customers paid for the costs from the Hawthorn 5 explosion. The Staff has provided substantial evidence to the Commission that KCPL's customers paid these costs. KCPL has provided no evidence its shareholders paid these costs. Because KCPL's customers have paid the Hawthorn 5 explosion costs in rates and KCPL received reimbursement of these costs during the test year, it is appropriate that the benefit be shared by KCPL's customers and shareholders.

As the Staff stated at page 22 in its initial brief, it is the Staff's position that, when a utility recovers from a third party for expenses it incurred to provide service to the utility's customers, but the utility already recovered for those expenses in the rates it charged its customers, the utility's customers should share in the benefit of the recovery.

The Staff proposes a sharing of the benefits of the subrogation proceeds by proposing the amount KCPL recovered be straight-line amortized over a period of five years and the resulting annual amount be included in KCPL's cost of service. (Ex. 108, Staff witness Hyneman Direct pp. 4-5; Ex. 109, Staff witness Hyneman Surrebuttal pp. 4-5). A proposal also made by DOE. (Ex. 802, DOE witness Dittmer Direct p. 14).

While the Staff believes they are not overly material to this issue, the Staff notes that KCPL stated facts in its brief that are not supported in those portions of the record to which it cites. While they may be true, with the exception that KCPL received a payment in 2006, the following statements of fact at pp. 18-19 in KCPL's brief are not supported by the portions of the record to which KCPL cites:

> In 2003 and 2004, KCPL settled and received settlement payments from all but one of the defendants. Following a jury trial against that defendant in early 2004, the court found in favor of KCPL and its insurers. The defendant appealed that judgment. In 2006, the Missouri Court of Appeals, Western District affirmed the lower court's decision. As a result of that decision, the remaining defendant paid KCPL in 2006.

Further, KCPL's statement on p. 19 that it does not expect to receive any additional subrogation proceeds is also unsupported by the citation to the record KCPL provides. The citation to Tr. 176, lines 16-18 only supports that KCPL does not anticipate receiving any subrogation proceeds in 2007.

In this case the Commission should presume ratepayers paid for the expenses KCPL incurred for the Hawthorn 5 boiler explosion, a financial return on the destroyed plant as well as depreciation and property taxes and, therefore, the Staff recommends the Commission treat the $23.1 million (total company) of Hawthorn 5 boiler explosion insurance subrogation proceeds

KCPL received in 2006 in the same manner as it treats extraordinary expenses it allows to be recovered from ratepayers in rates by straight-line amortizing the $23.1 million over five years ($4.6 million total company per year) and including the amount of $2.5 million (Missouri jurisdictional) in KCPL's cost of service for purposes of setting rates in this case.

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

The Staff believes that it adequately addressed the Long-Term Incentive Compensation issue in its initial brief. By not filing a section on this issue in its Reply/True-Up brief, it should not be misconstrued as the Staff yielding any ground on this issue.

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

The Staff believes that it adequately addressed the Short-Term Incentive Compensation issue in its initial brief. By not filing a section on this issue in its Reply/True-Up brief, it should not be misconstrued as the Staff yielding any ground on this issue.

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

KCPL erroneously asserts that KCPL's and Staff's different views on whether KCPL should recover from its customers the costs of its talent assessment program severance costs arises from a "fundamental difference in management philosophy." The Staff's position that KCPL's customers should not bear the costs of this program is based on KCPL's failure to demonstrate any benefit to those customers from that program.

KCPL agrees it was providing safe and adequate utility service before it initiated this program, and KCPL presented no evidence it needed the program to enable it to provide safe and adequate utility service in the future.

According to KCPL the purpose of the talent assessment program was to ascertain whether its non-officer management employees had the "skills, ability, and desire" to assist KCPL in reaching its "strategic objectives." KCPL has utterly failed to define what those strategic objectives are. When pointedly asked to identify the strategic objectives during the hearing in this case, KCPL's witness on this issue, Ms. Lora Cheatum, testified as follows:

> Q. Can you provide me -- specifically state the objectives that are directly related to the Talent Assessment Program?
>
> A. I can certainly set the stage for you, and I think that I -- in my testimony we stated that we undertook a -- a initiative in the company to ensure that we had the right skills and abilities of our folks to move us into a comprehensive energy plan, for one.
>
> We were undertaking things, obviously building our coal-fired plant, our wind, and looking at some energy efficiency projects. It wasn't the typical regulated utility industry standard that we had done in the past.
>
> And so because of that, we felt it was necessary that we were honest with our employees, told them what the expectations were to ensure that as we moved in the future towards building this new company and strategic plan, that they understood what our expectations were and that we could help them if, in fact, there were any gaps that were identified in terms of helping us achieve our strategic intent.
>
> Q. Let me try it this way: What specific strategic objectives were furthered by the Talent Assessment Program?
>
> A. What specific strategic objectives?
>
> Q. Yes.
>
> A. Well, again, back in 2004 when we – we embarked on a new direction within KCP&L to build a coal-fired plant, we knew that -- I believe it had been almost 30 years since we had, you know, built a coal-fired plant or built wind energy, and certainly, the skills, talents, abilities and background of folks to

> do that was something that we didn't – we didn't at the time know if we had those skills.
>
> So certainly, in order for us to achieve those objectives, we felt as though it was necessary to find out if we had the appropriate staff, if we had the willingness of the staff to help move us into the next millennium, if you will.

(Vol. 7, Tr. 402-04).

Because KCPL cannot define the "strategic objectives" its Talent Assessment Program was to further, it cannot show any benefit to KCPL customers from that program.

Further, the only benefit KCPL even attempted to demonstrate was based on J.D. Powers & Associates survey results. As the Staff has shown in its initial brief, the abrupt change in KCPL's rankings from 2006 to 2007 can logically be attributed to weather, not its Talent Assessment Program.

Additionally, since KCPL's customer service personnel were not evaluated under the program and KCPL's payroll did not decrease due to the program, the direct link between the J.D. Powers & Associates survey results and KCPL's Talent Assessment Program that KCPL advances does not exist. (Cheatum Vol. 7, Tr. 406-07).

Despite KCPL's assertion to the contrary, the Staff does not believe a utility company should be satisfied with minimum levels of service, and the Staff has made no such assertion in this case. At pages 26-27 of its brief, KCPL correctly describes the Staff's position that before it initiated the Talent Assessment Program, KCPL provided exemplary performance and performed well as a regulated utility as evidenced by the many awards it received for its performance. It is the Staff's position that KCPL, with its high performance level, did not need to replace a significant part of its management and incur $8.9 million in employee termination costs.

At page 27 of its brief, KCPL asserts that how it has treated this program for its incentive compensation plan is irrelevant to whether the program was justified. If the Talent Assessment

Program was justified, why did KCPL's management decide to exclude the expense from the earning per share calculation which drives management incentive compensation? In other words, why should KCPL's customers bear the cost of this program when KCPL's management is not held responsible for the cost of this program. This type of one-sided treatment of severance costs by KCPL was addressed by the Commission in its *Report and Order* in KCPL's 2006 rate case. There the Commission said it sees no equity in allowing KCPL to recover costs from its customers when its own management excludes the same costs from its earnings-per-share (EPS) calculation, to the enrichment of its executives via the incentive compensation plan. While it had the opportunity to address this Commission concern, KCPL did not.

Because the record evidences no benefit to KCPL's customers from the $8.9 million in severance and associated costs KCPL incurred in carrying out its talent assessment program in 2005 and 2006 and for all the other bases advanced by the Staff in its initial brief, the Staff recommends the Commission exclude those costs from KCPL's cost of service used for setting rates in this case.

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

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

As the Staff pointed out in its initial brief, this issue is worth about $0.5 million (total company). (Ex. 108, Staff witness Hyneman Direct p. 5; Ex. 2, KCPL witness Cheatum Rebuttal p. 2).

It is the Staff's position, as stated in its initial brief, that KCPL paid these severance costs solely to protect shareholders and that they are not recurring costs of the type KCPL's customers should bear. These severance payments did not decrease KCPL's payroll, and there is no indication they will provide any benefit to KCPL's customers. (Ex. 108, Hyneman Direct pp. 4-5, 7-8).

This very same issue was before the Commission just a few months ago in KCPL's 2006 rate case. Nothing affecting this issue has changed and KCPL has not attempted to provide any new evidence to show why this cost should be recovered from its customers. Because the Commission rejected including in cost of service these types of employment severance costs in KCPL's 2006 rate case, Case No. ER-2006-314, because they provided no benefit to KCPL's customers and were designed to protect KCPL against such issues as sexual harassment or age discrimination, and because KCPL has provided no new basis for including them in its cost of service in this case, the Staff recommends the Commission exclude them from KCPL's cost of service in this case. (Ex. 108, Staff witness Hyneman Direct pp. 5-6; Ex. 109, Staff witness Hyneman Surrebuttal pp. 20-21).

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

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

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

The Staff believes that it adequately addressed the Off-System Sales Margin issue in its initial brief. By not filing a section on this issue in its Reply/True-Up brief, it should not be misconstrued as the Staff yielding any ground on this issue.

15. <u>Department of Energy Nuclear Fuel Overcharge Refund</u>: Should the Department of Energy Nuclear Fuel Overcharge Refunds for 1986 through 1993 KCPL

> received during the test year in this case be included in KCPL's cost of service for setting KCPL's rates?

As the Staff stated in its initial brief, during calendar year 2006, the ordered test year in this case, KCPL received $427,150 in litigation proceeds for claims that the Department of Energy had in earlier years overcharged KCPL for nuclear fuel enrichment services provided for fuel purchased from 1986 to 1993. (Ex. 9, KCPL witness Giles Rebuttal p. 6; Ex. 109, Staff witness Hyneman p. 12). KCPL asserts at page 35 of its posthearing brief, "For Staff's position to prevail, the Commission would have to determine that KCPL had excess profits between 1986 and 1993 and conclude that KCPL should, in essence, refund those alleged profits in this case by including the settlement in its cost of service." As it was with the Hawthorn 5 issue that is similar in nature, KCPL is wrong and mischaracterizes the Staff's position. The Staff's position is not predicated on KCPL having earned excess profits in the past; instead, the Staff's position is that KCPL recovered the overcharges in the rates it charged its customers at the time KCPL was being overcharged and, therefore, KCPL's customers should share in the settlement received during the test year in this case.

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

CLASS COST OF SERVICE / RATE DESIGN

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

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

As regards Staff's proposal to shift inter-class revenue responsibility to more closely approximate parity between the costs recovered by the company from each class and the costs, including return on investment, incurred by the company in serving each class, no party presented any evidence that these shifts are not warranted. It is Staff's position that significant disparities were identified between class cost recoveries and class costs of service in the nine Class Cost of Service Studies utilized in KCPL's last rate filing, ER-2006-0314, and that it is appropriate to continue to adjust class revenue responsibilities in the directions identified by the presence of these disparities. It is true that OPC's studies in that case revealed less of a disparity as regards the residential class than did any other study, but even OPC's "Average and Peak" study revealed a 5.66% disparity, and OPC's "Time of Use" study revealed a 2.41% disparity. [Ex.111 Staff Witness Pyatte Surrebuttal, p 5]. In that last case the Commission adopted a 2% shift to the residential class, and that leaves, at minimum, a .41% disparity to be addressed. [Ex.111 Staff Witness Pyatte Surrebuttal, p 5]. The eight studies identify disparities ranging from 25.19% to OPC's 2.41% between the revenues of the residential class, and the cost allocated to serving the residential class, which can similarly be adjusted by arithmetically applying the 2% shift implemented in the last case – leaving a consensus among the studies from the last case that the Residential class continues to underpay in the range of .41% - 22.19%. [Ex.111 Staff Witness Pyatte Surrebuttal, p 5]. Not coincidentally, these studies, including

OPC's, also identified that several classes, notably the Medium General Service class (MGS), were paying more than cost allocations indicate are appropriate, ranging from Staff's low end 8.75% up to 11.91%, as calculated by the DOE. Adjusting arithmetically for the change adopted in the last case leaves the MGS class bearing 8.30% (8.75% - 0.45% = 8.30%) to11.46% (11.91% - 0.45% = 11.46%) extra revenue responsibility. [Ex.111 Staff Witness Pyatte Surrebuttal, p 5]. OPC claims that the presence of regulatory amortizations create significant problems with "updating" the results of cost studies performed before the rate increase in the last case, yet presents no evidence or argument as to why the un-updated results of the studies filed in the last case would no longer be valid. Furthermore, on page 40 of its Post Hearing Brief, KCPL states since the last case, ER-2006-0314, there have not been dramatic changes in the underlying costs. The shifts Staff proposes are supported by OPC's own studies in the last case, and no party has presented any evidence to refute Staff's observation of the remaining disparities in class revenue responsibility and class cost of service.

KCPL provides no basis for its assertion that a change to rate structure is any change that causes customers to make decisions about their choice of rate schedule, nor does it present any evidence or argument regarding the propriety of Staff's proposed inter-class shifts. (KCPL Initial Post Hearing Brief, page 48). OPC states at page 15 of its brief that it will address the propriety of inter-class shifts, separate and apart from the issue it has made as to whether those shifts are available under the S&A. It then goes on to quote testimony dealing with OPC's attempt to bind a party to an agreement which that party did not sign – this has no apparent relation to the policy decision of whether or not the proposed inter-class shifts are appropriate. Neither OPC nor KCPL at any point present arguments or evidence to refute the results of their own class cost of service studies performed for ER-2006-0314, as arithmetically adjusted to account for the inter-class revenue shifts implemented by the Commission in that case.

On page 14 - 15 of its brief OPC alleges that the basis for the Staff's proposed inter-class revenue responsibility shifts is supported solely by evidence which it alleges to be either privileged or parol. Staff's inter-class revenue responsibility shifts are entirely supported by evidence that has not been subject to privilege or parol evidentiary objections. As discussed at some length above, Staff's proposed shifts are fully supported by Ms. Pyatte's Surrebuttal testimony, which presents a summary of the results of each party's Class Cost of Service studies admitted in ER-2006-0314, including OPC's studies. [Ex.111 Staff Witness Pyatte Surrebuttal, p 5].

Further, Staff's position that the KCPL Experimental Regulatory Plan Stipulation and Agreement ("S&A") does not prohibit inter-class shifts in revenue responsibility, discussed at some length in the motions and corresponding responses concerning the limitation or striking of the testimonies of OPC witness Barbara Meisenheimer and Staff witness Janice Pyatte, is supported by competent evidence not asserted by any party to be privileged or barred by the parol evidence rule – the Commission's own use and understanding of the disputed language, and the Commission's own use and observation of language used to accomplish the effect that OPC and KCPL seek to impose upon the words actually used in the S&A.[39] Further, Praxair, and the MIEC and Ford interpret the prohibition of "changes to rate structures" consistent with the definition of the term "rate structure" that Staff provided in its direct case. (See Initial Posthearing Brief of Praxair, Inc., at page 5, and MIEC and Ford witness Brubaker in Ex 602, at

[39] See pages 3-4 of the INITIAL POSTHEARING BRIEF OF PRAXAIR, INC., and footnote 5, page 9 of STAFF'S RESPONSE TO THE MOTIONS TO STRIKE OF THE OFFICE OF PUBLIC COUNSEL AND KANSAS CITY POWER & LIGHT COMPANY, AND STAFF'S MOTION TO LIMIT THE TESTIMONY OF OPC WITNESS BARBARA MEISENHEIMER for instances in which the "equal percentage" language was used to implement or refer to equal percentage changes.

page 3.) No party should be allowed to contort the language of an agreement to receive a greater benefit then they bargained for initially. OPC and KCPL should not be permitted to play grammatical slight-of-hand with a Commission-approved stipulation and agreement in order to receive a benefit they never bargained to receive.

To clarify a point alluded to by the DOE/NNSA in its Post-Hearing Brief, the Staff does not advocate its proposed Inter-class Shifts on the basis of the anticipated inclusion of Iatan 2 in KCPL's rate base. Staff would ask the Commission to take administrative notice of RSMo. § 393.135, and to make any inter-class revenue shifts it may order solely on the basis of known and measurable information, specifically the Class Cost of Service studies performed for ER-2006-0314.

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

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

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

In the MIEC and Ford's brief at pages 4 – 5, the MIEC and Ford misquote the testimony of their witness Brubaker. At pages 5 - 6 of his prefiled surrebutal testimony, MIEC and Ford witness Brubaker states that, with reference to his understanding of the parties' intended effect of the agreement entered into in the S&A, that "[i]t was **not** my understanding that the parties were agreeing not to propose interclass revenue allocations that were different from equal percent across-the-board changes." [Emphasis added.] (Ex. 602, p 5 – 6).

The MIEC and Ford mischaracterize the Staff's position on the Large Power Service [LPS] issue. Staff does not assert that the LPS tariff does not adequately and fairly recover costs.

Staff does not believe that sufficient evidence has been introduced to warrant a revision of the manner in which the LPS charges are collected. However, Staff has prepared a concessionary proposal that would reallocate a portion of the recovery of costs between the energy and demand charges, should the Commission agree with the MIEC and Ford's assertion that the present LPS rates do not appropriately recover those costs.

In the MIEC and Ford's brief at pages 5 – 6 they state that Staff's concessionary proposal for the LPS proposal could constitute a change to rate structure, in that it postulates the elimination of rate blocks. A similar claim is made by Praxair at page 17 of its brief. However, Staff has testified that the effective elimination of a rate block can be accomplished by pricing that block equal to the proceeding block, and that such a modification does not constitute a change to rate structure. [Vol. 13 Tr.1028].

Praxair makes several references to recent Commission decisions in natural gas distribution cases where a "straight fixed variable" rate design was adopted for the residential class, and to one case where a straight fixed variable rate design was adopted for the small general service class. Praxair has not pointed to any cases where a straight fixed variable rate design has been applied to a large-customer class, and Staff is not aware of any such case. Rate design policy decisions made in gas distribution cases are not directly applicable to the rate design of a vertically integrated electric utility, such as KCPL. There has been no evidence presented that KCPL's LPS customers share the homogeneity of facilities and usage attributable to residential gas customers. There has been no demonstration that it is appropriate for the customers of a vertically integrated electric utility, such as those of KCPL, to be saddled with all of the risk attributable to the company's recovery of costs. Although Praxair argues at page 11 of its brief that Mr. Brubaker's proposal for the LPS would "(1) remove disincentives for utilities to encourage and assist customers in making conservation and efficiency investments; and (2) reduce the effects of weather on utility revenues and customers [sic] bills," Praxair produces no evidence that there are existing disincentives for utilities to encourage LPS customers' improvements of conservation and efficiency, and Praxair certainly produces no evidence that LPS customers are even weather-sensitive in the first instance, much less that it is appropriate to saddle customers with all weather-related risk.

There has been no demonstration that the "fixed costs" of a vertically integrated (production, transmission, and distribution) electric utility are comparable to the "fixed costs" of a distribution-only gas utility. While Mr. Brubaker frequently glibly refers to "fixed" and "variable" costs, it has not been demonstrated that electric utility rate design is so black-and-white. Also, while Praxair and the MIEC and Ford make many assertions that high load factor customers are cheaper to serve, on average, they do not produce any evidence that the existing LPS tariff does not already account for the economy of serving high-load factor customers. In particular, the Facilities Charge accounts for the differences in the equipment that is required to serve customers at each voltage level and the hours-use energy charges account for the lower average cost of serving customers that use relatively more electricity in the off-peak hours.

As regards Praxair's assertion on page 13 of its brief that Staff's opposition to Praxair's LPS proposal is "half-hearted," Staff heartily asserts that this is not the case. Further, Staff takes affront at Praxair's assertion on page 13 of its brief that dedication of "a mere two pages of rebuttal testimony" to discussion of an issue is indicative of the significance that Staff attributes to an issue.

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

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

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

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

d.

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

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

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

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

Regarding the assertion of KCPL on page 42 of its Post Hearing Brief that the proposals concerning the General Service All-Electric and Space Heating rates constitute a change to rate structure, "even under Staff's definition," Ms. Pyatte agreed only that elimination of a rate schedule all together would be a rate structure change. She did not testify that beginning the phase out of a rate schedule would be a change in rate structure. [Vol.13 Tr. 1030.] Staff's proposal in this case is to begin the phase-out of these rates, not to entirely eliminate those rates. In its admission on page 52 of its brief, KCPL acknowledges that its electric heating customers would likely turn to natural gas or steam if they were required to pay KCPL's full cost of serving them, thus acknowledging that these customers do not currently pay KCPL's full cost of serving them. At some point, if not in this case, the Commission will need to decide whether or not these electric heating rates are unduly preferential.

24. KCPL Experimental Regulatory Plan Additional Amortization: What, if any, additional amortization is required by KCPL's Experimental Regulatory Plan approved by the Commission in Case No. EO-2005-0329?

REGULATORY PLAN ADDITIONAL AMORTIZATIONS

Short-Term Debt Interest Expense

This issue developed late even in the course of the true-up, requiring the Staff and OPC to react almost immediately to a material event presented to them by KCPL. (Ex. 130, Traxler True-Up Direct, p. 7, ls.10-11).

The True-Up Reconcilement / Reconciliation, Exhibit 123, filed by the Staff on November 5, 2007 shows the following revenue requirements with and without the regulatory plan additional amortization for KCPL, the Staff and OPC:

PARTY	REV. REQ. W/ REG. PLAN ADDITIONAL AMORTIZA.	REG. PLAN ADDITIONAL. AMORTIZA. REV. REQ	REV. REQ. W/ REG. PLAN ADDITIONAL AMORTIZA.
KCPL	$33,162,887	$14,155,968	$47,318,855[40]
Staff	$ 8,469,315	$30,886,516	$39,355,831
OPC	$ 1,669,107	$23,074,630	$24,743,737

In his True-Up Direct testimony KCPL witness Michael W. Cline stated that there is a "change" in methodology used by KCPL in calculating the amount of the additional amortization requested by KCPL in the instant case. The "change" is shown on Schedule MWC-9 attached to Mr. Cline's True-up Direct Testimony, Exhibit 36. He explained that "Line 27b in Schedule MWC-9 has been added to reduce Funds from Operations by the after-tax impact of short-term interest payments." (Ex. 36, Cline True-Up Direct, p. 3, ls. 20-21; the caption for Line 27b is as follows: "less Short-term Interest Expense net of tax"). He stated that this "change" in methodology was necessary because of an omission by KCPL and how Standard & Poor's (S&P) calculates the metrics on which the additional amortization is based:

> The calculation of Funds from Operations by Standard & Poor's is net of interest payments on both short-term and long-term debt. Previously, in the calculation reflected in Schedule MWC-9, line 27 deducted only the long-term interest from the Operating Income shown on line 26. . . .

Id. at 4, ls. 2-5). Mr. Cline identified Line 27b "less Short-term Interest Expense net of tax" in Schedule MWC-9 to his True-Up Direct Testimony as the prior omission that KCPL was now addressing. He testified that the prior omission of Line 27b, i.e., the prior omission of the

[40] At the True-Up hearing on November 9, 2007, representatives for KCPL stated that even though its revenue requirement with the Regulatory Plan additional amortizations exceeds the increase in rates that it has filed for, which is approximately $45.3 million, KCPL is not seeking to be authorized to recover in rates more than what it has filed for. (Vol. 15, Tr. 1287, ls. 4-25, and Tr. 1344, ls. 6-21).

deduction of short-term debt interest from operating income, had been an oversight by KCPL in its rate increase case last year (Case No. ER-2006-0314) and in the Regulatory Plan case (EO-2005-0329). There has been no change by S&P regarding its applicable credit metrics. (Vol.15, Tr. 1220, ls. 4-15). Counsel for OPC asked Mr. Cline how he knew that the omission of the deduction of short-term debt interest from operating income was an oversight and not intentional. Mr. Cline responded as follows:

> Because, you know, I'm aware of the individuals who calculate the schedules for Kansas City Power & Light and can assure you that the intent all along has been to include short-term debt interest. It was only in this case where it was a material amount that it became obvious.

(Vol. 15, Tr. 1179, ls. 17-22). Thus, Mr. Cline indicated that KCPL discovered its error when the amount of short term debt became material. The amount of KCPL short-term debt at September 30, 2007 is $259 million total KCPL, $136.3 million Missouri jurisdictional KCPL,[41] which Mr. Cline indicated is a material amount to KCPL. (Ex. 130, Traxler True-Up Direct, p. 7). Mr. Cline said that Missouri jurisdictional KCPL short-term debt at September 30, 2006, the end of the true-up period of KCPL's preceding rate case, was $43.7 million. (Vol. 15, Tr. 1182, ls. 8-11). Mr. Cline testified that including short-term debt interest in the Funds From Operations calculation would not have changed KCPL's additional amortization calculation in its filing on February 1, 2007. (Ex. 36, Cline True-Up Direct, p. 4, ls. 10-15).

Mr. Steve M. Traxler is the Staff witness on Regulatory Plan additional amortizations. He was the Staff's witness on Regulatory Plan additional amortizations in KCPL's preceding rate increase case, Case No. ER-2006-0314. He stated that he was not specifically involved in the direct negotiations in Case No. EO-2005-0329. He identified Robert E. Schallenberg as the main representative of the Staff in the negotiations in Case No EO-2005-0329 and stated that he

[41] Exhibit 36, Schedule MWC- 9, Line 4 and Exhibit 214, Line 4, Missouri jurisdictional allocator: 52.71%.

has discussed the development of the Regulatory Plan and additional amortizations with Mr. Schallenberg. (Vol. 15, Tr. 1210, ls. 8-16 and Tr. 1215, ls.2-16).

Staff witness Mr. Traxler related that the $30.9 million increase in the Regulator Plan additional amortization as of the September 30, 2007 true-up was higher than the Staff had anticipated for two reasons. One reason is KCPL advised that it planned to issue hybrid debt by September 30, 2007 and this financing was reflected in KCPL's projected capital structure during the course of this case. Mr. Traxler explained that this financing not occurring had a significant effect on the Regulatory Plan credit metric, which requires FFO to be 25% of total debt. KCPL supplied an updated calculation of the Regulatory Plan additional amortization with the workpapers supporting its cost of service calculation as of the September 30, 2007 true-up date. Subsequently, and this is the second reason, several days before the November 5, 2007 date for filing true-up direct testimony, KCPL advised the Staff that the materials that KCPL had provided should have considered in the additional amortization calculation the $136.3 million in Missouri jurisdictional short-term debt but due to an oversight had not done so. (Ex. 130, Traxler True-Up Direct, p. 7, ls. 3-13; Ex. 36, Cline True-Up Direct, Sched. MWC-9, Line 37).

Mr. Cline testified that KCPL's February 1, 2007 rate increase case filing projected a $250 million long-term debt financing by KCPL to occur by September 30, 2007 that was supplanted during the pendency of this case by a projected hybrid debt financing in an amount greater than $250 million by KCPL. (Vol. 15, Tr. 1158, ls. 9-17 and Tr. 1189, l. 4 – Tr. 1191, l. 6). He said that one of the intended purposes of the hybrid debt issuance was to retire KCPL's short-term debt and the existence of $259 million in short term debt, total KCPL, at September 30, 2007 is a direct result of the hybrid debt not being issued. Thus, if the hybrid debt transaction had occurred by September 30, 2007, the amount of the additional amortization requested by KCPL would have been reduced from the present amount. (Vol. 15, Tr. 1192, ls. 7-14; Tr. 1193, ls. 3-8; and Tr. 1193, l. 23 – Tr. 1194, l.8).

One of the benefits of the hybrid debt transaction that KCPL desired to enter into by September 30, 2007, rather than a long-term debt transaction, is that it reduces the amount of interest expense and total debt that must be covered by FFO in the credit metrics used by S&P to determine KCPL's credit rating because the hybrid receives a certain degree of equity treatment from the credit rating agencies. (Vol. 15, Tr. 1158, l. 18 – Tr. 1159, l. 8 and Tr. 1194, l. 4 – Tr. 1195, l. 1). The $259 million in short-term debt on KCPL's balance sheet as of September 30, 2007, total KCPL ($136.3 million Missouri jurisdictional KCPL), is treated as 100% debt in the credit metric assumptions instead of being treated as only 50% debt in the credit metric assumptions had KCPL engaged in the hybrid debt transaction by September 30, 2007. (Ex. 130, Traxler True-Up Direct, p. 7, l. 22 – p. 8, l. 3).[42]

Mr. Cline testified that KCPL still has plans to complete the hybrid debt transaction at some point when it is prudent for KCPL to do so. (Vol. 15, Tr. 1152, l. 20 – Tr. 1153, l. 4).

OPC is opposed to the interest on short-term debt being recognized in the calculation of the Regulatory Plan additional amortizations. OPC witness Russell W. Trippensee in his True-Up Rebuttal Testimony cites the Commission to certain language in the Regulatory Plan Stipulation And Agreement. The Staff has proceeded mindful of the following language in the Regulatory Plan Stipulation And Agreement filed on March 28, 2005, as amended by the Commission's August 23, 2005 Order Approving Amendments To Experimental Regulatory

[42] The Staff does not want to leave a mistaken impression respecting its view of the projected hybrid transaction. Mr. Traxler's True-Up Direct Testimony states that KCPL's decision whether to engage in additional financing and what form of additional financing should be pursued should be based on the need to finance and the lowest cost financing available, not based upon the existence and operation of the Regulatory Plan additional amortization. A hybrid debt issuance with a higher cost than alternative financing would likely be imprudent in the Staff's view and would be addressed by the Staff when the opportunity arose, for example, the next KCPL rate case. (Ex. 130, Traxler True-Up Direct, p. 8, ls. 6-11).

Plan in Case No. EO-2005-0329:

> **III.B.1.i. Additional Amortizations to Maintain Financial Ratios**
>
> . . . .
>
> The non-KCPL Signatory Parties commit to work with KCPL to ensure that based on prudent and reasonable actions, KCPL has a reasonable opportunity to maintain its bonds at an investment grade rating during the construction period ending June 1, 2010. As part of this commitment, the non-KCPL Signatory Parties agree to support the "Additional Amortizations to Maintain Financial Ratios", as defined in this section and related appendices, in KCPL general rate cases filed prior to June 1, 2010. The accumulated "Additional Amortizations to Maintain Financial Ratios" amounts will be treated as increases to the depreciation reserve and be deducted from rate base in any future KCPL rate proceedings, beginning with the first rate case after the 2006 Rate Case. The "Additional Amortization to Maintain Financial Ratios" will only be an element in any KCPL rate case when the Missouri jurisdictional revenue requirement in that case fails to satisfy the financial ratios shown in Appendix E through the application of the process illustrated in Appendix F. The non-KCPL Signatory Parties reserve the right to recommend "Additional Amortizations to Maintain Financial Ratios" amounts in each rate case such that these amounts in aggregate do not exceed the expected cost savings from the amortization mechanism and the lower costs of capital resulting from the investment grade ratings.

KCPL Regulatory Plan Stipulation And Agreement, p. 19, as amended by *Re Kansas City Power & Light Co.*, Case No. ER-2005-0329, Order Approving Amendments To Experimental Regulatory Plan, p. 3, (August 23, 2005).

. . . .

> The Signatory Parties agree to support an additional amortization amount added to KCPL's cost of service in a rate case when the projected cash flows resulting from KCPL's Missouri jurisdictional operations, as determined by the Commission, fail to meet or exceed the Missouri jurisdictional portion of the lower end of the top third of the BBB range shown in Appendix E, for the Funds from Operations Interest Coverage ratio and the Funds from Operations as a Percentage of Average Total Debt ratio. The Signatory Parties agree to adopt an amortization level necessary to meet the Missouri jurisdictional portion of these financial ratios.

KCPL Regulatory Plan Stipulation And Agreement, p. 20.

In his True-Up Rebuttal Testimony, Mr. Trippensee noted that KCPL in the True-Up is reducing FFO by the Missouri jurisdictional amount of $4,783,218 for interest on short term debt shown on Line 27b of Mr. Cline's True-Up Direct Schedule MWC-9, the impact of which is to increase the Regulatory Plan additional amortization amount to be recovered from ratepayers by $7,811,886 shown on Line 38 "Short-term Debt Interest" of Mr. Cline's Schedule MWC-9. Line 37 "Short-term Debt Balance" and Line 38 "Short-term Debt Interest" appear in the area of Schedule MWC-9 for which there is the heading "Additional financial information needed for the calculation of ratios." (Ex. 212, Trippensee True-Up Rebutttal, p. 3, ls. 1-8; Ex. 36, Cline True-Up Direct, Sched. MWC-9; *See also* Ex. 213, Line 37 and Line 38). Although there is not a line item for the equivalent of Line 27b "less Short-term Interest Expense net of tax" on Appendix F-3 to the Regulatory Plan Stipulation And Agreement, which is Attachment No. 1 to the July 28, 2005 Report And Order in Case No. EO-2005-0329, there are line items "Short-term Debt Balance" and "Short-term Debt Interest" in the area of Appendix F-3 for which there is the heading "Additional financial information needed for the calculation of ratios." Mr. Cline testified that the information on the lines for "Short-term Debt Balance" and "Short-term Debt Interest" should be included in the calculation of the metrics for the Regulatory Plan additional amortizations. (Vol. 15, Tr. 1202, l. 5 – Tr. 1203, l. 9).

Mr. Trippensee states in his True-Up Rebuttal Testimony: at page 5, lines 20-22 and page 6, lines 14-17 that:

> . . . Based on my thirty years of regulatory experience, I can state that it is unusual to have a utility finance its rate base with short-term debt, or stated another way, to have more short-term debt than it has CWIP [construction work in progress] . . . .
>
> . . . .
>
> . . . According to Mr. Cline's testimony and schedules, KCPL has approximately $259 M. of short-term debt. It is my understanding that the balance of CWIP as of September 30, 2007 is in excess of $380 M. Thus all short-term debt is needed to support CWIP and will be included in the calculation of AFUDC. Therefore it is not appropriate to include any short-term debt in the capital structure used to determine the revenue requirement in this case.

(Ex. 212, Trippensee True-Up Rebutttal, p. 5, lines 20-22, p. 6, ls. 14-18, and p. 7, ls. 9-12). As a consequence, the CWIP not being supported by short-term debt must be supported by KCPL's long-term debt, common stock and preferred stock, and OPC is not proposing that KCPL not recover the portion of the Regulatory Plan additional amortization assignable to this long-term debt interest expense reducing FFO. Mr. Traxler identified short-term debt financing as common practice for a utility engaged in construction activity as a bridge between permanent or long-term financing. (Vol. 15, Tr. 1213, ls. 10-25).

The language in the Regulatory Plan Stipulation And Agreement in Case No. EO-2005-0329 relating to additional amortization is clear as to the intent to meet two of the three financial ratios used in determining the rating agency investment grade credit rating for KCPL: "The 'Additional Amortizations to Maintain Financial Ratios', is designed to satisfy two of three financial ratios shown in Appendix E 'Credit Ratio Ranges & Definitions.'" (KCPL Regulatory Plan Stipulation And Agreement, pp. 19-20, which is Attachment No. 1 to July 28, 2005 Report And Order in Case No. EO-2005-0329). Mr. Cline testified that S&P deducts interest on short-term debt in determining FFO available to meet the credit metrics. (Ex. 36, Cline True-Up Direct, p. 4, ls. 2-3). Recognition of interest on short-term debt in the calculation of FFO is consistent with the intent of the Regulatory Plan Stipulation And Agreement in Case No. EO-2005-0329.

There are various examples of short-term debt being proposed as a part of an electric utility's capital structure or the Commission accepting short-term debt as part of an electric utility's capital structure. There are several rate increase cases involving what is now Aquila and the most recent Union Electric Company, d/b/a AmerenUE (AmerenUE) rate increase case. In *Re Missouri Public Service, a division of UtiliCorp United Inc*., Case Nos. ER-90-101 et al., 30 Mo.P.S.C.(N.S.) 320, 352-54, 118 P.U.R.4th 215, 241-42 (1990)(emphasis supplied), the

Commission stated as follows:

Staff/Public Counsel recommend the following capital structure for Company.

Capital Component	*Amount (000)*	*Ratio*
Short-term Debt	$ 52,102	5.41%
Long-term Debt	436,428	45.30%
Preference Stock	97,362	10.11%
Common equity	377,503	39.18%

Total	$ 963,395	100.00%

This is UtiliCorp's capital structure as of December 31, 1989. Staff/Public Counsel state that they have included **short-term debt** in this capital structure because UtiliCorp's **short-term debt** outstanding as of December 31, 1989, exceeds its construction work in progress (CWIP) by the amount of $52,102,000. Staff/Public Counsel explain that **short-term debt** is not generally included in the capital structure since it is typically completely accounted for by the amount spent for CWIP. Staff/Public Counsel have included **short-term debt** in their recommended capital structure because UtiliCorp is using the **short-term debt** exceeding CWIP for purposes other than CWIP.

Company opposes Staff/Public Counsel's capital structure as nonrepresentative because MPS has a different risk profile than the other divisions and subsidiaries comprising UtiliCorp. Company contends that a consolidated capital structure will not shield MPS's ratepayers from risk as promised by MPS at the time UtiliCorp was formed. Company maintains that the capital included in the consolidated capital structure is not available to finance MPS's construction and is a hypothetical capital structure which is merely the sum of the capital structures assigned to the various divisions and subsidiaries of UtiliCorp. Further, Company argues that Staff/Public Counsel's capital structure improperly includes **short-term debt**. Company states that this is a departure from the Commission's usual practice which recognizes that **short-term debt** will shortly be refinanced into long-term debt which will be part of the capital structure during the time when the new rates are in effect.

Finally, Company argues that the equity ratio chosen by Staff/Public Counsel is too different from the median common equity ratio for the 98 electric utilities followed by Value Line in 1989 (45.7 percent) as well as the median equity ratio forecasted by Value Line for these companies for 1990 (45.8 percent).

The Commission determines that the capital structure proposed by Staff/Public Counsel, as modified hereinafter, should be adopted in this case. In ratemaking, establishing the correct capital structure is part of the process of setting the rate of return on the Company's facilities. The goal of selecting a rate of return is to attract sufficient capital for the company's needs in financing its facilities. It is important that the rate of return established realistically reflect the assessment of prospective investors in that Company. The Commission finds that it is more reasonable to use the consolidated capital structure for MPS than it is to assign a hypothetical capital structure to MPS. As noted by Staff/Public Counsel, MPS has no capital structure of its own and its stock is not traded on the stock market. Investors cannot invest in MPS but can invest in UtiliCorp. It is the capital structure of UtiliCorp that prospective investors will examine when contemplating an investment. It is UtiliCorp which must attract capital for the use of its divisions and subsidiaries including MPS.

The Commission determines that the use of a consolidated capital structure in this instance will not, per se, expose MPS's ratepayers to any adverse consequences arising from UtiliCorp's other activities any more than the use of a hypothetical, assigned capital structure will insulate them from these consequences. As stated by Staff/Public Counsel's witness, the present capital structure of UtiliCorp is not harmful to MPS's ratepayers. However, an adjustment would need to be made in future rate cases should UtiliCorp develop a capital structure that would subject MPS's ratepayers to adverse consequences arising from UtiliCorp's other activities.

The Commission further determines that it is not germane to the establishing of an appropriate rate of return that the consolidated capital structure is unavailable to finance MPS's future construction. As pointed out by Staff/Public Counsel's witness, only new capital is available to MPS for new construction. Since UtiliCorp raises the capital for MPS's use, it is UtiliCorp's capital structure which is the more important in raising capital from investors to finance MPS's construction program.

The Commission finds that it is inappropriate to include **short-term debt** in Company's capital structure. The Commission notes that it is the nature of **short-term debt** that it will soon be converted into long-term debt. Since rates are set prospectively, the Commission finds that it is unreasonable to base these rates in part on a capital structure which will not be representative of Company's future capital structure. Therefore, the Commission determines that **short-term debt** should be removed from the capital structure suggested by Staff/Public Counsel and that the effect of that removal should be distributed equally among the other forms of capital. The Commission finds that this will result in the following capital structure for Company.

Capital Component	*Amount (000)*	*Ratio*
Long-Term Debt	$436,428	47.89%
Preference Stock	97,362	10.68
Common Equity	377,503	41.42

Total $911,293 100.00%

Finally, the Commission determines that the equity ratio represented in Staff/Public Counsel's modified capital structure is reasonably within the range of ratios for common equity in comparable companies. Staff/Public Counsel's ratio for common equity is 41.42 percent when adjusted for the removal of **short-term debt**. Company proposes a common equity ratio of 49.07 percent. Ninety-eight electric utilities followed by Value Line had an average equity ratio in 1989 of 44.9 percent. Therefore, the Commission concludes that the capital structure proposed by Staff/Public Counsel, as modified above, should be used in establishing Company's rate of return in this case.

In *Re Missouri Public Service, a division of UtiliCorp United Inc*., Case Nos. ER-97-394, et al., Report And Order, 7 Mo.P.S.C.3d 178, 181-83 (1998)(emphasis supplied), the Commission stated as follows:

. . . MPS is an operating division of UtiliCorp, however, and issues neither its own stock nor its own debt. All of the MPS capital comes from its parent UtiliCorp; therefore, a capital structure must be imputed to MPS.

There is substantial difference in theory, and some resulting variance in numbers, in the capital structures proposed by UtiliCorp, the Staff and the OPC. UtiliCorp proposes a capital structure allocated to MPS by UtiliCorp. UtiliCorp refers to this as its 'per books' capital structure and uses a capital structure as of December 31, 1996, the end of the test year. The resulting debt to equity ratio is 52.69 percent debt to 47.31 percent equity.

. . . .

The Staff maintains that a capital structure based on the actual overall cost of capital to the parent is more reasonable. The Staff proposes applying the UtiliCorp consolidated capital structure as of December 31, 1996, including consideration of **short-term debt** (adjusted to remove construction work in progress), resulting in a debt-to-equity ratio of 56.14 percent debt to 43.86 percent equity. . . .

The OPC also takes the position that the UtiliCorp consolidated capital structure should be used, but prefers the consolidated structure on June 30, 1997. This results in a debt-to-equity ratio of 57.63 percent debt to 42.37 percent equity. . . .

Based on substantial evidence of record, the Commission finds that the

> consolidated capital structure as proposed by the Staff accurately reflects the correct capital structure of UtiliCorp itself, and therefore MPS, during the actual test year.
>
> The Commission adopts the Staff-proposed capital structure of 56.14 percent debt to 43.86 percent equity.

In response to applications for rehearing, the Commission stated as follows in *Re Missouri Public Service, a division of UtiliCorp United Inc*., Case Nos. ER-97-394, EC-98-126, Order Denying Applications For Rehearing, Granting In Part And Denying In Part Application For Reconsideration, Granting Motion For Clarification And Approving Tariff (1998)(emphasis supplied):

> Company requests reconsideration or rehearing of this issue because it asserts that the Commission's March 6 decision does not contain adequate findings and is not based on competent and substantial evidence because Missouri Public Service does not use **short-term debt** to finance its plant and is not kept on a going forward basis. This debt is used by Aquila Southwest.
>
> This argument is not new and was considered by the Commission in rendering its decision on March 6. The evidence clearly supports the Commission's finding that UtiliCorp has consistently maintained a significant percentage of its debt as **short-term debt** rather than long term debt, and that the lower cost of this **short-term debt** should be reflected in the cost of debt to be applied to Missouri Public Service. The Commission has already determined that rate of return issues should be determined on a UtiliCorp wide basis and then modified as appropriate to fit Missouri Public Service as the regulated portion of UtiliCorp's operation. Therefore, whether the debt is actually used by Aquila Southwest or some other subsidiary or operating division of UtiliCorp is irrelevant. Company's request for reconsideration or rehearing should be denied.

In *Re Union Electric Co., d/b/a AmerenUE*, Case No. ER-2007-0002, 257 P.U.R.4th 259, Report And Order (2007)(emphasis supplied), AmerenUE's recent rate case, the Commission adopted a capital structure including short-term debt:

> For purposes of determining an appropriate rate of return, AmerenUE has proposed to use its actual capital structure, which is the following:

Type	*Amount (Millions)*	*Percent of total*	*Cost*

Long-Term Debt	$2,522	44.964%	5.473%
Short-Term Debt	$ 45	0.795%	5.360%
Preferred Stock	$ 115	2.017%	5.189%
Common Equity	$2,964	52.224%	TBD
Total	$5,675	100%	

> . . . Public Counsel, however, proposed a 'double leverage' adjustment to account for its assertion that a portion of AmerenUE's equity is actually debt held at the parent company level. Public Counsel would adjust the capital structure as follows:

Long-Term Debt	47.3%
Short-Term Debt	0.8%
Preferred Stock	2.0%
Common Equity	49.8%

Id. at 33-34, 257 P.U.R.4th at 279-280; Footnotes omitted.

> Hill points out AmerenUE's proposed capital structure nets **short-term debt** against average construction work in progress (CWIP) balances. Hill acknowledges that what AmerenUE has done is standard regulatory practice in Missouri. . . . .

Id. at 35, 257 P.U.R.4th at 280; Footnotes omitted.

> The Commission rejects Public Counsel's proposed double leverage adjustment because double leverage does not exist in AmerenUE's capital structure. The following capital structure shall be used as the capital structure of AmerenUE:

Long-Term Debt	44.964%
Short-Term Debt	0.795%
Preferred Stock	2.017%
Common Equity	52.224%

Id. at 36, 257 P.U.R.4th at 281.

There is at least one KCPL rate increase cases where short-term debt is addressed in the Commission's Report And Order. In *Re Kansas City Power & Light Co.*, Case Nos. ER-81-42 and ER-80-48, Report And Order, 24 Mo.P.S.C.(N.S.) 386, 422-23, 43 P.U.R.4th 559, 595-97 (1981)(emphasis supplied) on the issue of minimum and compensating bank balances, the Commission stated as follows:

4. *Minimum and compensating bank balances*. Company proposes that $4,413,000 be included in its cash working capital allowance, representing minimum and compensating bank balances. Company is required to keep minimum and compensating balances in each bank at which the Company has a line of credit. On a total-Company basis, KCPL maintains a total of $6,925,000 of minimum and compensating balances in 11 banks to secure an open line of $57 million in short-term credit, and to avoid bank service charges. Company asserts that these lines of credit enable it to sell commercial paper at favorable discount rates and provide the Company with additional flexibility in planning its long-term financings. Company believes that these lines of credit will play a crucial role in meeting its financial commitments during the period 1980 to 1982, including Company's construction program, long-term debt refundings, net changes in fuel inventories, operations needs, and other items.

Staff and GSA do not argue that the maintenance of minimum and compensating balances is not a sound business practice. However, Staff and GSA assert that those balances should not be added to Company's cash working capital requirements. Rather, Staff and GSA argue that such balances should be included in the calculation of Company's rate for allowance for funds used during construction (AFUDC), because they are used to finance construction.

The Staff and GSA position is based in large part on Federal Power Commission (now Federal Energy Regulatory Commission) Order No. 561, which treats **short-term debt** as the first source of construction funds. Construction work in progress (CWIP) must be excluded from rate base under §393.135, RSMo 1978. Thus, it is asserted, the minimum and compensating balances which support CWIP should be treated in the same manner as CWIP (which is through AFUDC).

. . . internally generated funds were not nearly sufficient in 1980, and will not be in 1981 or 1982, to meet Company's construction expenditures, without the use of the short-term credit secured by Company's minimum and compensating balances.

The Commission concludes that minimum and compensating balances are a business necessity of providing service to the ratepayer, and require the use of investor-supplied funds. Since **short-term debt** is the first source of construction funds, the Commission further finds, however, that KCPL’s minimum and compensating balances support the Company's construction program, and should not be included in Company's rate base. Rather, such balances should be taken into account in KCPL’s AFUDC rate calculations.

In so holding, the Commission distinguishes the facts of this case from those in *Re: St. Joseph Light & Power Company*, Case No. ER-81-43, decided June 9, 1981. There, the Commission found that St. Joseph Light & Power's **short-term debt** did not support CWIP, because Company's internally generated funds as a percentage of construction expenditures equaled 135.94 per cent for 1980.

> In Case No. ER-80-48, the Commission ordered that portions of this Company's minimum and compensating balances should be included in the AFUDC formula. The specified portions were $667,510 directly attributable to minimum balances, and a percentage of the compensating balances based on the ratio of such balances to the credit actually utilized as a result of such balances. The Commission directs in the instant case that the inclusion of minimum and compensating balances in the AFUDC formula shall be consistent with the method of calculation utilized by Company since the Commission's decision in Case No. ER-80-48. However, since the Commission has now found minimum and compensating balances to be a business necessity of providing service to the ratepayer, the full amount of such balances shall be included in the formula rather than the specified portion of same.
>
> . . . .
>
> 5. Summary. Based on the Commission's findings above, the lead-lag study performed by Staff should be applied in this case. In addition, the Company's $4,413,000 of Missouri jurisdictional minimum and compensating balances shall be included in its AFUDC computation formula, as set out above, and not added to rate base.

Finally, the Staff would note *Re Kansas City Power & Light Co.*, Case No. ER-78-252, Report And Order, 23 Mo.P.S.C.(N.S.) 1, 6 (1979), where the Commission addressed the issue of Materials and Supplies and CWIP:

> The Public Counsel, supported by intervenors Jackson County and National Welfare Rights Organization, contends that a portion (57%) of Company's materials and supplies "relate to" CWIP, and thus should be excluded from rate base pursuant to the terms of section 393.135, V.A.M.S. [statute omitted]
>
> . . . .
>
> In Case No. ER-78-29, <u>In the matter of Missouri Public Service Company of Kansas City, Missouri</u>, 7/5/78, this Commission was faced with an identical proposal, at that time a part of staff's case. The allowance was disallowed in that case because there was no evidence to indicate that the materials and supplies in question were distinguishable from the entire inventory of maintenance supplies, and were not specifically identified with any construction or expansion. The evidence in this case is the same, as must be the result.
>
> The Commission finds that no portion of the materials and supplies inventory of Company are properly chargeable to CWIP, and the proposed adjustment to rate base is disallowed.

The Staff assumes that Mr. Trippensee in his Rebuttal True-Up Testimony at page 7, lines 7-14 where he states in part – "As this Commission is well aware, the statutes of this state do not allow CWIP to be used in the determination of the jurisdictional revenue requirement." – is presaging a Section 393.135 RSMo 2000 argument by OPC. This is a matter of first impression. The Staff will respond below with legal discussion.

The Staff would first note that as part of the KCPL Regulatory Plan, there is an offset for the additional amortization. This particular language appears in the section of the Regulatory Plan Stipulation And Agreement quoted above and now repeated:

> . . . The accumulated "Additional Amortizations to Maintain Financial Ratios" amounts will be treated as increases to the depreciation reserve and be deducted from rate base in any future KCPL rate proceedings, beginning with the first rate case after the 2006 Rate Case. . . .

Thus starting with the rates that go into effect as a result of KCPL's next rate case, which KCPL has indicated it will file in spring of 2008, KCPL's rate base will be reduced/offset by the full amount of the additional amortization that is determined by the Commission in this case.

It should be remembered that Missouri courts have approved the standard that the Commission applies for granting interim or emergency rate relief.[43] That standard which

[43] To be eligible, a utility must show that: (1) it needs the additional funds immediately, (2) that the need cannot be postponed, and (3) that no other alternatives exist to meet the need but rate relief. "Although the Commission has, on occasion, granted interim rate relief in a nonemergency situation, those instances are few and in response to particular pressing circumstances." *Re Missouri Power & Light Company*, Case Nos. GR-81-355 and ER-81-356 (1981). In 1983, the Commission noted that "[t]hat the Commission has traditionally granted interim relief *only* in response to emergency or near emergency conditions." *Re Gas Service Company*, Case No. GR-83-207, 25 Mo.P.S.C.(N.S.) 633, 637 (1983; emphasis added). Thus, the historical standard applied by the Commission since 1949 has consistently required a showing of some emergency or immediate need for rate relief. This standard was first enunciated in a nascent form in *Re Southwestern Bell Telephone Company*, Case No. 11,634, 2 Mo. P.S.C. (N.S.) 131 (1949).

Judicial recognition of the Commission's authority first occurred in *State ex rel. Laclede Gas Co. v. Public Serv. Comm'n*, 535 S.W.2d 561, 567 (Mo.App. K.C.Dist. 1976) where the Western District Court of Appeals held that the Commission has the authority to grant interim rate increases within the broad discretion implied from the Missouri file and suspend statutes and from the practical requirements of utility regulation. Regarding the Commission's standard for interim or emergency rate relief, the Court stated, in part, as follows:

> All of the distracting preliminary issues now having been cleared away, there are finally laid bare the real, substantive issues in this case: (1) What is the proper test to be applied for the allowance

requires that a utility cannot obtain funds for operations other than by a rate increase historically has occurred when Missouri utilities are engaged in major construction projects involving generating units. As an example, the Staff would note that on November 16, 1976, St. Joseph Light & Power Company (SJLP) filed with the Commission an application for emergency/interim rate relief with revised tariff sheets designed to increase annual revenues by approximately $2.5 million on an annual basis.[44] *Re St. Joseph Light & Power Co.*, Case No. ER-77-93, Report And Order, 21 Mo.P.S.C.(N.S.) 356 (1977). SJLP contended that without emergency/interim rate relief, it would default on the Iatan project because no other alternatives for meeting its construction commitments were available. SJLP further contended that default on Iatan would jeopardize its ability to provide adequate service, which would compromise SJLP's status as an independent electric utility and possibly require SJLP to merge with a larger electric utility. The Commission stated that "the pivotal issue in this case is Company's need for the

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> of an interim rate increase? (2) Has Laclede proved facts bringing this case within the appropriate test?
>
> A majority of the Commission follows the principle that the purpose of a special hearing concerning interim rates is to ascertain whether emergency conditions exist which call for especially speedy relief, and the Report and Order expresses the view that an interim increase should be granted only 'where a showing has been made that the rate of return being earned is so unreasonably low as to show such a deteriorating financial condition that would impair a utility's ability to render adequate service or render it unable to maintain its financial integrity.' Laclede admits that if this be the proper test to be applied, then the ruling in this case must be against it. . . .

Id. at 568-69.

. . . .

> It may be theoretically possible even in a purposefully shortened interim rate hearing for the evidence to show beyond reasonable debate that the applicant's rate structure has become unjustly low, without any emergency as defined by the Commission having as yet resulted. Although some future applicant on some extraordinary fact situation may be able to succeed in so proving, Laclede has singularly failed in this case to carry the very heavy burden of proof necessary to do so.

Id. at 574.

[44] Subsequently on December 20, 1976, as a result of the enactment of Section 393.135 (Proposition No. 1) by voters on November 6, 1976, SJLP filed revised tariff sheets effective as of February 1, 1977 reducing rates by $1.4 million by removing CWIP from rate base. As a consequence, SJLP's requested emergency electric rate increase was for $3.9 million over the rates on file and in effect as of February 1, 1977.

additional generating capacity which Iatan will provide and the secondary issue is how will Company finance its participation in Iatan with or without the emergency rate relief requested in this case." 21 Mo.P.S.C.(N.S.) at 358.

On March 4, 1977 in Case No. ER-77-93, 21 Mo.P.S.C.(N.S.) at 368, 373, the Commission approved emergency/interim rate relief for SJLP contingent upon, among other things, SJLP entering into a binding agreement disposing of 57 to 67 megawatts (MWs) of its 157 MW entitlement to Iatan 1 capacity by the effective date of the final Report And Order issued in connection with SJLP's permanent rate case, *Re St. Joseph Light & Power Co.*, Case No. ER-77-107, Report And Order, 21 Mo.P.S.C.(N.S.) 466 (1977).[45] The Commission authorized emergency/interim rate relief in the amount of an increase of annual gross electric revenues of $1.3 million, exclusive of gross receipts and franchise taxes, pending resolution of SJLP's pending permanent rate increase case on the basis that the "Company's financial integrity and credit worthiness will be impaired to the extent that the capital necessary for the provision of safe and adequate service cannot be raised." 21 Mo.P.S.C.(N.S) at 372, 373. The Commission went on to state that it could not ignore the extreme financial burden which full participation in the Iatan project placed on SJLP and its customers. Therefore, the Commission conditioned its authorization of emergency/interim rate relief on SJLP being required to refund the emergency/interim rate relief to its customers if, among other things, it did not submit to the Commission documentary evidence that it had entered into a binding agreement disposing of 57 to 67 MWs of its Iatan 1 entitlement by the effective date of the final Report And Order issued in connection with SJLP's permanent rate case, ER-77-107. *Id.*

[45] The Case No. ER-77-93 Report And Order reported at 21 Mo.P.S.C.(N.S.) 356 does not reflect the correction made to the date by which SJLP was directed by the Commission to dispose of 57 to 67 megawatts of Iatan 1 capacity. The correction is reflected in an unreported Correction Order issued by the Commission on April 26, 1977 in Case No. ER-77-93.

On June 3, 1977 KCPL and SJLP executed an amending supplement to their Iatan Memorandum Of Understanding, which adjusted their ownership interests in Iatan upon authorization by the Commission. By a joint application filed July 26, 1977 in Case No. EO-78-12, KCPL and SJLP sought Commission approval of the proposed adjustments to their ownership interests in Iatan as to the site, common facilities and Iatan 1 generating unit. On August 22, 1977 in Case No. EO-78-12, the Commission issued an Order Granting Application To Adjust Ownership Interests (unreported decision) authorizing KCPL and SJLP to adjust their ownership interests in Iatan as requested and as reflected in the First Supplement to their Iatan Memorandum Of Understanding. The Commission concluded that "the authority sought is in the public interest in that it permits SJLP, within the time dictated, to divest itself of a portion of its entitlement at Iatan in compliance with the Commission's order in Case No. ER-77-93."

There is a dearth of court cases on Section 393.135. A review of the few cases that exist may be of some benefit: *State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Serv. Comm'n*, 606 S.W.2d 222 (Mo.App. 1980); *State ex rel. Missouri Pub. Serv. Co. v. Fraas*, 627 S.W.2d 882 (Mo.App. 1981); *State ex rel. Union Electric Co. v. Public Serv. Comm'n*, 687 S.W.2d 162 (Mo. banc 1985); and *State ex rel. Union Electric Co. v. Public Serv. Comm'n*, 765 S.W.2d 618 (Mo.App. 1988). The Section 393.135 issues in the first two cases principally involved tax timing difference issues and the last two cases involved UE's requested recovery of the cancellation costs of the abandoned second generating unit at the Callaway nuclear generating station, referred to herein as Callaway II. Some of the issues in these cases might be considered quite arcane. Counsel for the Staff does not relate them for the purpose of going into unnecessary detail but to provide an indication of the context in which Section 393.135 has arisen judicially to date.

The 1980 *UCCM* decision of the Western District Court of Appeals, not to be confused with two earlier notable judicial pronouncements in appeals brought by UCCM, involved UCCM's challenge of the amount permitted by the Commission to be reflected in rates for depreciation, investment tax credit and construction expenses in a Union Electric Company rate case. Of these three items the relevant one for the instant discussion is construction expenses. The category "construction expenses" was comprised of interest, property taxes, pensions and other costs charged to construction, which would be capitalized for ratemaking recovery purposes, but for then current income tax purposes would be deducted from income, resulting in a then current reduction of income taxes paid by the utility. Interest, property taxes, pensions and other costs charged to construction would be added to the cost of the production facilities. The income tax savings for ratemaking purposes would not be "flowed-through" to the ratepayer as the construction expenses were incurred. These construction expenses and the income tax savings would be amortized over the life of the facilities beginning when the facilities were placed in service. The Court stated: "Sec. 393.135, RSMo 1978, prohibits the company from earning any return upon facilities before they are actually placed in service." 606 S.W.2d at 226. Again, under the tax "normalization" method approved by the Commission, the income tax savings resulting from the current deduction of these expenses from income were not "flowed through" to ratepayers concurrently. *Id.* Flow through treatment requires the utility to charge, as an operating expense and recover in rates from customers, only the amount of taxes actually paid to the Internal Revenue Service (IRS), whereas normalization treatment allows the utility to charge, as an operating expense and recover in rates from customers, the amount of taxes which the utility would have been required to pay to the IRS had it not taken advantage of the accounting practices which allow it to reduce the amount of taxes it pays in the earlier years of payment, but ultimately require the utility to make up in its payments to the IRS in the later years of payment.

The Court held that (1) the Commission's order approving normalization of income taxes for construction expenses was supported by good and valid reasons, (2) UCCM had not demonstrated that the Commission's order regarding this matter was unlawful or unreasonable and (3) the Commission's order regarding this matter was within the zone of allowable discretion which is not to be disturbed upon judicial review. 606 S.W.2d at 227.

The *Missouri Public Service Co.* case, involved several issues, two of which, (a) the flow through, instead of normalizing, certain income tax timing differences and (b) the exclusion from rate base of compensating bank balances, the Western District Court of Appeals found related to Section 393.135, and one of which, (c) the inclusion in rate base of only 25% of the cost of constructing the generating facilities "common facilities," the Western District Court of Appeals found unrelated to Section 393.135.[46] The Commission filed a Motion To Dismiss with the Western District Court of Appeals on the grounds of mootness because the tariffs at issue had been superseded by subsequent tariffs and thus the reviewing court could not give any relief because any error which may have been made could not be corrected retroactively or prospectively because the tariffs at issue on appeal had been replaced by subsequent tariffs filed and approved. An exception may be made by the Court where an issue presented is of a recurring nature, is of general public interest and importance and will evade appellate review

[46] The Court in the context of the attrition issue noted that a future or projected test year, instead of an historical test year "would not be available in Missouri because of the adoption by popular vote of Initiative Proposition 1, now Section 393.135." 627 S.W.2d at 888.

unless the court exercises its discretionary jurisdiction. The Court held that some of the issues on appeal fit into the exception to the mootness rule and others did not. 627 S.W.2d at 884-85.[47]

Taking the normalization versus flow through issue first, the Commission allowed normalization treatment of investment tax credit, accelerated depreciation, amortization of extraordinary purchased power costs and various quick turn around items, but ordered flow through treatment of funds used during construction, pensions and taxes capitalized, Jeffrey Energy Trust deduction and removal costs. The Court in the *Missouri Public Service Co.* case noted that the problem of normalization versus flow through treatment was discussed in *State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Serv. Comm'n*, 606 S.W.2d 222 (Mo.App. 1980) in which it was held that the choice was a matter of administrative discretion. The Court stated:

> . . . The Commission has adopted the policy that "cash flow, interest coverage and internally generated funds analyses will determine the need of a given company for normalization." . . . This presents a purely factual question which does not fall within the exception to the mootness doctrine. This matter therefore will not be reviewed. *State ex rel. Mo. Public Service Co. v. Fraas, supra.*

627 S.W.2d at 891. Thus, the Court applied the mootness doctrine in not ruling on the issue.

Regarding compensating bank balances, the Commission excluded these monies from the utility's rate base on the grounds that the lines of bank credit were used to support the financing

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[47] The Court further explained exception to the mootness doctrine as follows:

> An exception, however, is made where an issue is presented of a recurring nature, is of general public interest and importance, and will evade appellate review unless the court exercises its discretionary jurisdiction. *State ex rel. Laclede Gas Co. v. P.S.C.*, 535 S.W.2d 561 (Mo.App.1976); *State ex rel. The Empire District Electric Company v. Public Service Commission of State of Mo., supra*; *State ex rel. Laclede Gas Co. v. P.S.C.*, 600 S.W.2d 222 (Mo.App.1980). The question of whether to exercise this discretionary jurisdiction comes down to whether there is some legal principle at stake not previously ruled as to which a judicial declaration can and should be made for future guidance. If the matter in dispute is simply a question of fact dependent upon the evidence in the particular case, there is no necessity for a declaration of legal principle such as to call the exception into play.

627 S.W.2d at 885.

of CWIP. The Court stated that the cost should not be included in rate base but instead should be allowed in AFUDC. 627 S.W.2d at 890-91.

Concerning the Jeffrey Energy Center common facilities, the Court held that the common facilities issue fell within the exception to the mootness doctrine and Section 393.135 was not applicable. The Jeffrey Energy Center was a four generating unit site. The first of the four units went into commercial service during the test year. The utility sought to include in rate base all of the common facilities. The Commission held that that only 25% of the common facility costs should be allowed in rate base because ratepayers should not be required to pay for facilities that were also for units 2, 3 and 4 which were not in service. The Court reversed the Commission finding that the common facilities were in full use during the test year. 627 S.W.2d at 889-90.

Finally, *State ex rel. Union Electric Co. v. Public Serv. Comm'n*, 687 S.W.2d 162 (Mo. banc 1985) and *State ex rel. Union Electric Co. v. Public Serv. Comm'n*, 765 S.W.2d 618 (Mo.App. 1988) involve the cancellation of the Callaway II unit. The Commission first disallowed recovery of the partial construction and cancellation costs of the abandoned Callaway II unit on the basis that the terms of Proposition One, Section 393.135, precluded the Commission from allowing recovery of any amount from ratepayers relating to abandoned construction. In the first appellate court decision respecting UE's effort to recover in rates the costs associated with the abandoned Callaway II unit, the Missouri Supreme Court held that Proposition One, Section 393.135, did not have the purpose and did not have the effect, of divesting the Commission of the authority to make any allowance for the costs of abandoned generating plant construction. The Court based its conclusion "the established practice of allowing such charges, absent a statutory command to the contrary, and on the absence from Proposition One of explicit language dealing with abandoned construction." 687 S.W.2d at 168.

The case was remanded to the Commission for further proceedings. After further proceedings on the remanded issues, the Commission again rejected recovery in rates of the construction and cancellation costs of Callaway II. The Commission held that UE's shareholders had already been compensated for some of their loss through the rates of return in prior UE cases. 765 S.W.2d at 621. Among other things, the Commission determined that UE shareholders had received some compensation for the risk of their investment in UE which included a risk of cancellation of Callaway II. The Court found that the Commission's decision was within the Commission's discretion and was supported by competent and substantial evidence. *Id.* at 623-24.

Conclusion:

The Regulatory Plan additional amortization is a financial determination, not a cost of service determination. The Regulatory Plan additional amortization is not driven by construction; it is driven by sources of capital. The Commission does not literally include CWIP in rates, but the Commission does consider in its ratemaking determinations the overall financial condition of the electric utility in question including its construction projects. Items that support both operations and construction are not excluded from such consideration by the Commission when establishing rates.

CONCLUSION

For the reasons stated in the Staff's Post-Hearing Brief filed November 6, 2007, and herein, the Commission should adopt the Staff's positions on the remaining contested issues in this case.

WHEREFORE the Staff submits the foregoing as its posthearing reply and true-up brief for this case.

Respectfully submitted,

/s/ Kevin Thompson
Kevin Thompson
General Counsel
Missouri Bar No. 36288

/s/ Steven Dottheim
Steven Dottheim
Chief Deputy General Counsel
Missouri Bar No. 29149

/s/ Nathan Williams
Nathan Williams
Deputy General Counsel
Missouri Bar No. 35512

/s/ Sarah Kliethermes
Sarah L. Kliethermes
Legal Counsel
Missouri Bar No. 60024

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8702 (Telephone)
(573) 751-9285 (Fax)
kevin.thompson@psc.mo.gov
steve.dottheim@psc.mo.gov
nathan.williams@psc.mo.gov
sarah.kliethermes@psc.mo.gov

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I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 16th day of November 2007.

/s/ Nathan Williams