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Issue(s):	Fuel Adjustment Clause
Witness:	Gary M. Rygh
Sponsoring Party:	KCP&L Greater Missouri Operations Company
Type of Exhibit:	Surrebuttal Testimony
Case No.:	ER-2010-0356
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MISSOURI PUBLIC SERVICE COMMISSION

Case No. ER-2010-0356

SURREBUTTAL TESTIMONY

OF

GARY M. RYGH

ON

BEHALF OF

KCP&L GREATER MISSOURI OPERATIONS COMPANY

Kansas City, Missouri
January 2011

SURREBUTTAL TESTIMONY

OF

GARY M. RYGH

CASE NO. ER-2010-0356

Q. Please state your name and business address.

A. My name is Gary M. Rygh. My business address is 745 Seventh Avenue - 25th Floor, New York, New York 10019-6801.

Q. By whom and in what capacity are you employed?

A. I am employed by Barclays Capital Inc. as a Managing Director.

Q. Please describe Barclays Capital Inc.

A. Barclays Capital Inc. (Barclays Capital) is the investment banking division of Barclays Bank PLC, a leading global financial institution with over $2.5 trillion of total assets. Using a distinctive business model, Barclays Capital provides large companies, institutions and government clients with solutions to their financing and risk management needs. Barclays Bank PLC is a major global financial services provider engaged in retail and commercial banking, credit cards, investment banking, wealth management and investment management services, with an extensive international presence in Europe, the United States, Africa and Asia. With over 300 years of history and expertise in banking, Barclays Bank PLC operates in over 50 countries with over 145,000 employees.

Q. Please describe your employment history with Barclays Capital.

A. Prior to joining Barclays Capital, I worked in the power and utility area at Morgan Stanley beginning in 1998, was in the global power and utility group at Lehman Brothers starting in July 2007, and have been with Barclays Capital since September 2008, when Lehman Brothers became a part of Barclays Capital.

Q. Please describe your qualifications as well as your duties and responsibilities as a Managing Director.

A. I am currently a Managing Director in the Global Power and Utility Group. Our group is responsible for the corporate finance analysis of, and strategic and capital markets transactions related to the utility and power sectors. I have been in the utility, power and energy investment banking business for approximately 16 years. I have worked extensively on strategic merger and acquisition assignments, debt and equity capital markets transactions, and other corporate finance related assignments in the electric, water and gas utility sectors. I have a Bachelors of Science degree in Commerce, with a concentration in Finance from the University of Virginia.

Q. What is the purpose of your surrebuttal testimony in this case?

A. The purpose of my testimony is primarily to respond to the rebuttal testimony of Missouri Public Service Commission Staff witness John Rogers, as well as the Office of the Public Counsel witness Ryan Kind, both of whom contend that the current KCP&L Greater Missouri Operations Company ("GMO" or the "Company") fuel adjustment clause ("FAC") incentive sharing mechanism should be significantly modified. See Rogers Rebuttal at 7-11; Kind Rebuttal at 6-8. Their testimony runs counter to the uncontested fact that no issues with the FAC have been raised in the review and monitoring process established by the Missouri Public Service Commission ("Commission"), and that the review process has demonstrated that GMO has consistently acted with prudence and diligence since the FAC became effective in July 2007.

Q. What are the key points made in your surrebuttal testimony?

A. My surrebuttal testimony focuses on the importance of the FAC currently as it pertains to capital and financing related issues, which are increasingly important for GMO and utilities in general, given the large capital needs they face now and in the coming years. I also address how the establishment of GMO's FAC has had a significant positive impact on the perceived regulatory environment for GMO and the effect of that perception on GMO's overall financial health and credit quality. These financial market and investor perceptions are important to GMO and its ratepayers because it is these perceptions that drive the overall cost and ability of GMO to access needed capital. Key highlights of my testimony include:

- The critical importance for investors of a highly diligent regulatory process, as well as the need for GMO to maintain a productive relationship with the Commission.
- How perceptions of the regulatory process affect access to and the cost of new capital for GMO with investors, underwriters, credit rating agencies and researchers, their keen awareness of the importance of balanced, mainstream ratemaking policy, and their ability to discern key differences among competing issuers of capital and their associated regulators.
- Why investors, credit rating agencies and other market participants view the current GMO FAC as a highly valuable tool for risk management, as well as reasonable and timely cost recovery, and how establishment of the current FAC in the ratemaking process has affected credit rating agency analysis of GMO, as well as the assessments of investors and their views of the regulatory climate in which GMO is operating.
- Why the potential exists for significant and long-term detrimental repercussions to the cost of capital of GMO if adverse changes are made to the FAC incentive sharing mechanism, considering that no problems in

the FAC's operation have been identified in the established review process and while the only verifiable information detailed in this proceeding is that the FAC has proven to be a critical tool in maintaining the financial health of GMO.

Q. Is the purpose of your testimony to convince the Commission that financial investors, credit rating agencies and other Wall Street perceptions of the Commission should be its primary concern and that their views should be of greater importance than the Commission's duty to ratepayers?

A. Absolutely not. While it can certainly be demonstrated that the financial community had a positive reaction to the establishment of the GMO FAC, it was not because of a perception that GMO had pulled off an investor-friendly regulatory coup at the expense of ratepayers. The positive reaction was based on the Commission's willingness to diligently address the volatility and financial risk created by the absence of a FAC with such investigation correctly determining the critical need for the establishment of the FAC for GMO. It was also well understood that the FAC was established after an exhaustive regulatory review, was largely consistent with those created in other regulatory jurisdictions and that it appropriately balances the concerns of ratepayers and investors.

Q. What criteria are applied when a utility is reviewed by the credit rating agencies?

A. As Moody's Investor Services, Inc. ("Moody's") outlined in August 2009, the majority of the criteria on which a utility is rated is based on regulatory framework and the ability to recover prudently incurred costs and earn allowed returns. As stated by Moody's: "*For a regulated utility, the predictability and supportiveness of the regulatory framework in which it* *operates is a key credit consideration and the one that differentiates the industry from most other corporate sectors"…. "These include how developed the regulatory framework is; its track record for predictability and stability in terms of decision making; and the strength of the regulator's authority over utility regulatory issues*." Moody's went on to address cost recovery mechanisms, chief amongst them being fuel: *"The ability to recover prudently incurred costs in a timely manner is perhaps the single most important credit consideration for regulated utilities as the lack of timely recovery of such costs has caused financial stress for utilities on several occasions."* The diligent balancing of ratepayer and investor concerns are the cornerstones of investor confidence for utilities. When investors are confident that regulators are balancing these concerns appropriately, they can focus their influence to ensure that the utility performs accordingly and makes good on the regulatory construct. From a capital providers perspective some of the most disturbing aspect of Mr. Kind's testimony is the seemingly complete disregard for the concepts of balance and fairness between investors in GMO and its customers. Mr. Kind appears to regard the recovery of prudently incurred costs to procure fuel and purchased power for customers as a privilege, given his failure to discuss this issue at pages 7 and 8 of his rebuttal. However, those investors who provided the necessary financial capital to GMO regard this cost recovery as necessary to compensate them for the risk of being obligated to incur these costs.

Q. Do investors value diligent regulation?

A. Yes, they do. There is a common misperception that investors are looking for lackadaisical and weak regulation. This could not be more incorrect with regards to investing in regulated utilities. Investors who put capital to work at regulated utilities not only appreciate strong regulators, they rely on them. Investors count on regulators and their staffs to ensure the safety of their capital by consistently monitoring utilities to ensure reliability, performance and prudent risk management. Investors not only place a great deal of significance on the quality of regulation, but also on the ability of a utility to maintain a healthy and productive relationship with its regulators, especially in the current challenging economic environment. As stated by Standard and Poors Financial Services LLC ('S&P") in November 2007 when overhauling its rating methodologies for domestic utilities: "*Regulated utilities and holding companies that are utility-focused virtually always fall in the upper range of business risk profiles. The defining characteristics of most utilities--a legally defined service territory generally free of significant competition, the provision of an essential or near-essential service, and the presence of regulators that have an abiding interest in supporting a healthy utility financial profile underpin the business risk profiles of the electric, gas, and water utilities.*" A well-run utility produces the stability of cash flow, earnings and financial performance that investors in utilities prize and need to ensure that the risk inherent in their investment is appropriate for the return they are receiving. Since investors lack the technical expertise and oversight capabilities of regulators, they consider quality regulation critical. In fact, diligent and consistent regulation is essential, as noted in 2009 by Moody's when describing the criteria used to assign utility credit ratings: "*A utility operating in a stable, reliable, and highly predictable regulatory environment will be scored higher on this factor than a utility operating in a regulatory environment that exhibits a high degree of uncertainty or unpredictability.*"

Q. Then what are investors' concerns with potential modifications to the FAC incentive sharing mechanism at this time?

A. The concern with the Commission adopting the FAC modifications recommended by Messrs. Rogers and Kind is that they will communicate several very negative impressions to investors, including: (1) the Commission is not concerned about the volatility and operational /

financial difficulties created for GMO; (2) the Commission has little regard for regulatory certainty and stability in Missouri; (3) the Commission does not believe GMO deserves the opportunity to earn a fair return on capital; and, most concerning, (4) the Commission must believe that GMO is not prudently managing its fuel and purchased power costs and off-system sales, or has some other reason to make a severely negative modification to the FAC.

Fuel and purchased power expenses are the most volatile expense for GMO, and represent a substantial risk. Moreover, the volatility of these expenses is beyond the control of GMO. As Moody's stated in June 2010 regarding fuel adjustment clauses: *"These clauses work to insure that a utility recovers fuel related revenues fairly close to the time it incurs the fuel expense, minimizing the delay in the recovery of these costs. They also reduce the level of regulatory uncertainty for the recovery of these costs…"* A properly designed fuel adjustment clause was identified in this Moody's report (entitled "Cost Recovery provisions Key to Investor Owned Utility Ratings and Credit Quality") as probably the most critical of mechanisms when evaluating a utility's ability to recover costs and earn its allowed returns.

In addition, S&P stated in January 2010 in a report entitled "Top 10 Investor Questions: U.S. Regulated Electric Utilities": *"Many companies have authorized recovery mechanisms for fuel, trackers for pension and uncollectible expenses, and passing costs for renewable energy wind and solar projects through to customers. We view all of these adjustors as conducive for credit quality because they can generally help to smooth cash flows and keep balance-sheet deferrals to manageable levels."*

Q. Are these observations relevant to an evaluation of the FAC by this Commission, in light of the Staff Report?

A. Yes. These specific examples of the significance of the FAC as it pertains to perceptions of the financial strength and credit quality of GMO are extremely relevant, especially when taken into consideration with the Staff Report. That report provided great detail as to how crucial the current FAC and its incentive sharing mechanism design has been to the financial integrity of GMO. Significant items reported in the Staff Report:

- *"Staff has filed two prudence review reports concerning its review of the costs of the Company's FAC and found no evidence of imprudent decisions by the Company's management related to procurement of fuel for generation, purchased power and off-system sales."* [Staff Report at 193]
- *"The Company's total actual energy costs have exceeded the base energy costs collected through customers' bills for GMO in each of the six completed accumulation periods."* [Staff Report at 194]
- *"… Staff observes that the FAC under-collected amount over three years of $121 million (18 percent of total actual energy costs of $557 million) is a significant amount for GMO."* [Staff Report at 195]
- *"… without the FAC GMO would have lost approximately half of its test year net income before taxes (NIBT) due to under-collection of fuel and purchased power costs less off-system revenue during the timeframe of the FAC's first six accumulation periods."* [Staff Report at 195-96 (footnote omitted)]

Q. How do the findings of the Staff Report relate to the interests of investors, and the recommendations of Staff witness John Rogers and OPC witness Ryan Kind?

A. The key findings of the Staff Report are very important to investors. When those findings are taken into consideration with the views of Messrs. Rogers and Kind that GMO has not been provided with enough incentive, any unwarranted change by the Commission to the FAC incentive sharing mechanism will be very difficult for investors to understand. What is of particular concern to the financial community is that the surprising recommendations of Mr. Rogers and Mr. Kind are occurring outside of the well established prudency and true-up review process already in place. Given the substantial capital needs of the utility sector as a whole in the United States, investors have a plethora of opportunities. In a recent survey of fuel adjustment clauses, less than 20% had any sharing mechanism of total fuel and purchased power cost at all. None of the FACs that had a sharing mechanism approached the 25% threshold proposed by Mr. Rogers and Mr. Kind. If GMO were to be found in the normal FAC review process to be violating the terms or the intent of the FAC, investors would want to know the details and would punish GMO accordingly by either refusing to provide capital or charging higher costs for capital. As stated above, investors and rating agencies expect the Commission to thoroughly review every aspect of the FAC and report on any issues found on a regular basis. However, if the Commission decides to make significant modifications to the FAC, investors want to be assured that a proper investigation was conducted. Unfortunately, an ad hoc review like this, which has arisen without any of the parties to this rate case raising any substantive concerns about the FAC or about GMO’s management of its net fuel costs, would not be considered by investors to be a properly conducted review of the FAC.

While Messrs. Rogers and Kind spend considerable effort to attempt to define the “magic line” with regard to the level of sharing for the FAC, where diligence is assured on one side and anarchy prevails on the other, it should be noted that no such line exists. In their attempt to determine where this line rests, they have missed the brightest line. This bright line is critical because investors will not cross it.

Q. What bright line do investors look for?

A. They look at the credibility line. Either a utility has credibility with its regulators or it does not. If GMO is working under the paradigm where management delivers on its compact with the Commission and customers, it should be allowed to earn the fair returns authorized by the Commission and to recover its prudently incurred costs. Investors are looking for firm and even-handed regulation, and a responsible management team that maintains a strong regulatory relationship.

Q. Why are consistent and thorough reviews of the FAC by the Commission important from an investor's perspective?

A. It simply is a matter of risk and reward. From an investor's perspective, there is little to gain by GMO not managing its net fuel costs of GMO in the most effective way possible under a steady and fair regulatory process. However, there is considerable risk if the process is viewed as flawed. The debate over the 95% pass-through provision is not only about dollars at risk, but more importantly about the operational skills of GMO. If it is ever the Commission's view that GMO lacks the capability to procure fuel in a cost-effective manner or is the type of organization that would risk long-term regulatory stability for minimal short-term financial gain, investors want to be informed because that is not consistent with their views of the GMO they have capitalized. As S&P stated in April 2010 regarding GMO: "*A ratings upgrade would be predicated on continued effective management of the company's regulatory risk, long-term demonstrated operational consistency at the generating facilities, and significant long-term improvement of the financial measures*."

Given the influence the Commission has on the financial health of GMO, the presence of the FAC does not change the focus of GMO on prudently managing its net fuel costs. In the testimony submitted on this issue, there have been references to GMO having "skin in the game." See R. Kind Rebuttal at 8. From a much broader and longer term perspective, there is no more "skin in the game" for GMO if the 95% pass-through threshold is reduced. The stability of GMO's relationship with the Commission is at risk in the event GMO fails to manage its net fuel costs properly with the FAC -- even if the pass-through mechanism were raised to 100%, like most FACs throughout the country. If there were evidence that GMO needed an additional financial incentive to abide by its regulatory mandates or that GMO was not competently managing its largest operating expense, the financial community might understand a change in the FAC. But if changes are made to the FAC in the absence of such evidence, it would suggest to investors that the Commission harbors a suspicion that GMO is not prudently managing net fuel costs. That would suggest a much larger regulatory problem than the percentage pass-through issue and would create considerable concern for investors.

Q. What was the investor, rating agency and other reaction to the Commission's initial approval of GMO's request for the FAC?

A. The reaction to the establishment of the FAC was very positive. Beyond the financial stability that is inherent in operating with a properly designed FAC, many in the financial community perceived the FAC approval as a significant event for GMO as it pertained to the quality of regulation in Missouri and GMO's future prospects in the regulatory process. Due to the fact that the large majority of regulated electric utilities in the country benefit from an established FAC, the absence of FACs in Missouri was perceived as a sign that the state was not using an important tool to ensure the long-term credit quality and cash flow stability of its utilities. After Missouri law was changed, the approval by the Commission of a properly designed FAC for GMO was a strong message to the financial community that the regulatory process in Missouri was rigorous and deliberate, and that the Commission properly balanced its duties to ratepayers with investor concerns. Recounted below is a sample of the positive reaction by institutions that influence the overall cost of capital for GMO.

- "*Sustainable operating cash flows are expected to improve due to the following:… approval of a fuel-adjustment mechanism that can be adjusted semiannually and will cover 95% of fuel and purchased power costs not included in base rates. This has an immediate and material effect on cash flows."* – Fitch, Inc. 6/22/2007
- *"Today's rating action is reflective of the improvement in GMO's credit profile following several events including the recent outcome of its rate case in Missouri and related authorization to implement a fuel adjustment clause in its Missouri electric service area."* –Moody's 6/22/2007
- *"Also strengthening GMO's business profile is the improving regulatory environment in Missouri, including the approval of a monthly fuel adjustment clause covering 95% of actual fuel costs in excess of those included in base rates."* – S&P 9/19/08
- *"One area of differentiation between GMO and KCPL is that GMO has regulatory approval for a fuel adjustment clause for sharing up to 95% of energy costs not covered in existing rate authorizations that could provide some added protection against volatility in fuel costs in 2008 and beyond."* – Moody's 7/16/2008

- *“The 'excellent' business risk profile reflects the company's lower-risk integrated regulated electric utilities and management's fundamental regulated strategy. Also reflected in the business risk profile is the company's improved management of its regulatory risk. Additionally, we view the regulatory mechanisms including the fuel adjustment clauses for GMO… to be credit supportive.* ”– S&P 3/26/2010

Q. Please describe the potential adverse effects of altering the 95% pass-through mechanism of the FAC, as suggested by Messrs. Rogers and Kind.

A. The reduction of the established pass-through mechanism in this proceeding would have material negative consequences to investor perception of GMO, the Commission and the quality of the regulatory process in Missouri. Not only would a reduction in the pass-through mechanism represent a major adverse modification to the FAC and make it even more challenging for GMO to earn the return on equity granted by the Commission, it would be a far worse “signaling“ event to the investors whose capital is needed to ensure the continued safe and reliable operations of GMO.

As previously stated, equity and fixed income investors that evaluate allocating capital to GMO are not at odds with the overall goals of the Commission. The financial and operational characteristics that create a safe, reliable and low-cost electric power provider are largely the same as those that produce cash flow stability, prudent risk management and strong regulatory relationships that investors are attracted to.

Q. What specific concerns would arise from a change to the FAC, as recommended by Mr. Rogers and Mr. Kind?

A. The reduction of the 95% pass-through mechanism would create major investor concerns, chief among those being:

- Investors would be concerned that the Commission has reversed its prior findings that the FAC was necessary. They would expect the cost-recovery quality of the FAC to erode or for the FAC to be removed entirely over time. Given today's uncertain economic outlook, volatile commodity markets, and GMO's need to attract capital, the FAC is more critical to the financial health and credit quality of GMO now than in 2007 when the FAC was established .
- The need for a properly designed FAC to allow GMO to earn fair returns was crucial to the original FAC approval and design, which was the result of a very intensive regulatory review. If the Commission were willing to significantly degrade the existing FAC and pass-through mechanism despite GMO's positive operational track record, investors would view such a change as capricious and designed to inflict significant harm on GMO.
- The arguments offered in support of a reduction in the 95% pass-through mechanism are little more than generic and unfounded accusations that GMO is not performing its fiscal duties to ratepayers to the best of its ability. In addition to the lack of a legitimate reason to reduce the pass-through mechanism, the findings in the Staff Report suggest that GMO has made considerable effort to successfully implement the FAC. Consequently, any changes to the FAC by the Commission would, in investors' minds, call into question the motives of the decision-makers.
- More than 90% of integrated electric utilities across the country operate with a FAC and the vast majority of those have no sharing mechanism at all. A finding by the Commission that GMO needs greater incentive to prudently manage its

largest operating expense will lead investors to believe that GMO would risk its long-term regulatory stability for the sake of short-term and relatively insignificant monetary gain, that GMO is held in very little regard by the Commission or, worse, that GMO cannot competently implement a tool that the vast majority of other integrated electric utilities have successfully utilized for years.

Q. What would be the likely result of a reduction of the 95% pass through mechanism from a cost of capital perspective?

A. Ratepayers would be burdened with excessive costs each time GMO accesses the capital markets. The reason for this is that investors will be unable to rely on the two most important tenets of utility regulation: <u>fairness</u> and <u>consistency</u>. Fairness and consistency are the foundation of investors' evaluation of regulators. Any criteria used to judge the level of risk and associated capital cost assumes that these core principles exist. From an investor perspective, any investment in a utility that lacks the benefit of regulatory fairness and consistency is a risky investment that requires an additional return.

In summary, the Commission's prior order regarding GMO's FAC, coupled with its approval of similar FACs for the other Missouri electric utilities that are eligible to utilize one, suggested that the Commission was building a track record of consistent, thoughtful and high quality examination of key issues that affect GMO and the ratepayers it serves. The establishment of the FAC was critical to investors, and the Commission's position in granting it was highly visible. A reduction in the 95% pass-through mechanism in this rate case, without a significant basis in fact, would create negative perceptions of the regulatory climate in Missouri and jeopardize the financial stability of GMO, causing significant harm to the ratepayers over the long term.

Investors expect and rely on the Commission to hold GMO accountable when it does not perform or does not act prudently. However, from an investor perspective, it is my opinion that making a significant adjustment to the sharing mechanism of the FAC in the absence of any performance issues would be viewed as lacking sufficient cause and doing so would create a much less favorable environment in which to consider deploying capital to GMO.

With such challenging times ahead, it would be better for GMO to concentrate on fulfilling its obligation to ratepayers, not recovering from the significant financial issues that would arise if the Commission modified its FAC.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of KCP&L Greater Missouri Operations Company to Modify Its Electric Tariffs to Effectuate a Rate Increase	)))	Docket No. ER-2010-0356

AFFIDAVIT OF GARY M. RYGH

STATE OF NEW YORK)
) ss
COUNTY OF NEW YORK)

Gary M. Rygh, being first duly sworn on his oath, states:

1. My name is Gary M. Rygh. I am employed by Barclays Capital Inc. in New York, New York, as a Managing Director. I have been retained to serve as an expert witness to provide testimony regarding its fuel adjustment clause on behalf of KCP&L Greater Missouri Operations Company.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony on behalf of KCP&L Greater Missouri Operations Company consisting of Sixteen (16) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Gary M. Rygh

Subscribed and sworn before me this 10th day of January, 2011.

Margherita DeLouisa
Notary Public

My commission expires: MARGHERITA DeLOUISA
Registration # 01DE4842124
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