

Exhibit No.:
Issue: Off-System Sales Margin Calculation
Witness: Michael M. Schnitzer
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Kansas City Power & Light Company
Case No.: ER-2006-0314
Date Testimony Prepared: October 6, 2006

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2006-0314

SURREBUTTAL TESTIMONY

OF

MICHAEL M. SCHNITZER

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

**Kansas City, Missouri
October 6, 2006**

*** [REDACTED] *** Designates that "Highly Confidential" Information has been
Removed Pursuant to the Standard Protective Order.

SURREBUTTAL TESTIMONY

OF

MICHAEL M. SCHNITZER

Case No. ER-2006-0314

1 **Q. Please state your name and business address.**

2 A. My name is Michael M. Schnitzer. My current business address is 55 Old Bedford Road,
3 Lincoln, Massachusetts 01773. Effective November 1, 2006 my business address will
4 change to 30 Monument Square, Concord, Massachusetts 01742.

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

6 A. I am a Director of the NorthBridge Group, Inc. ("NorthBridge"). NorthBridge is a
7 consulting firm specializing in providing economic and strategic advice to the electric
8 and natural gas industries.

9 **Q. Are you the same Michael M. Schnitzer who provided Direct Testimony and**
10 **Rebuttal Testimony in support of Kansas City Power & Light Company in this Case**
11 **No. ER-2006-0314?**

12 A. Yes, I am.

13 **I. PURPOSE OF TESTIMONY AND CONCLUSIONS**

14 **Q. Please describe the purpose of your Surrebuttal Testimony.**

15 A. The purpose of my Surrebuttal Testimony is first to briefly update the prospective
16 calculations contained in my Rebuttal Testimony and second to respond to the Rebuttal
17 Testimony of Mr. Steve M. Traxler of the Commission Staff regarding the volatility of
18 KCPL's Off-System Contribution Margin.

1 **Q. Could you please summarize your conclusions?**

2 A. Yes. First, regarding the prospective calculation of KCPL's Off-System Contribution
3 Margin, our preliminary analysis as of September 30, 2006 shows it has declined
4 approximately ** [REDACTED] ** from the June 30, 2006 update noted in my Rebuttal
5 Testimony. Second, regarding Mr. Traxler's Rebuttal Testimony, Mr. Traxler is
6 mistaken when he concludes at pp. 11-12 that KCPL is not experiencing significant risk
7 resulting from volatility in its annual off-system margin. First, he fundamentally
8 misapprehends the nature of volatility and risk and is mistaken in asserting that an
9 upward trend (in off-system margin) over a short period of time implies no volatility or
10 uncertainty in that margin. Second, the data he cites at p. 11 do not support his
11 conclusion that off-system margin volatility is in the 1% to 3% range. Third, his
12 conclusion that KCPL does not face significant risk in off-system margin because of the
13 Company's predominantly baseload capacity is simply wrong. The issue is not whether
14 the Company will be able to sell its available surplus baseload energy (it will), but rather
15 whether the margin the Company will realize on those sales is uncertain (it is).

16 **II. PRELIMINARY RESULTS OF SEPTEMBER 30, 2006 UPDATE**

17 **Q. Do you have any results from the September 30, 2006 update?**

18 A. Yes. Although the results are preliminary and subject to change, the updated distribution
19 of potential KCPL Off-System Contribution Margin outcomes as of September 30, 2006
20 has shifted to the left from the distribution I prepared as of June 30, 2006 for my Rebuttal
21 Testimony. The June 30th median value of ** [REDACTED] ** has declined approximately
22 ** [REDACTED] ** to a September 30th median value in the range of ** [REDACTED]
23 [REDACTED] **.

1 **III. VOLATILITY OF OFF-SYSTEM CONTRIBUTION MARGIN**

2 **Q. What is your response to Mr. Traxler's position on volatility?**

3 A. Mr. Traxler is mistaken in his assessment of KCPL's risk from Off-System Contribution
4 Margin volatility. This error appears to be due to Mr. Traxler's fundamental
5 misunderstanding of what constitutes volatility, and thus risk. At p. 12, lines 4-10 of his
6 Rebuttal Testimony he states:

7 More importantly, KCPL's historical experience does not reflect any
8 significant downward reduction in its off-system sales margin since 2001.
9 Significant volatility is exhibited by significant fluctuations which go both
10 up and down from year to year. To the contrary, KCPL has experienced a
11 continuing increase which has stabilized in 2005 with some additional
12 growth expected in 2006 and 2007. This upward trend cannot be
13 characterized as volatile or risky under any reasonable definition.

14 **Q. How is this mistaken?**

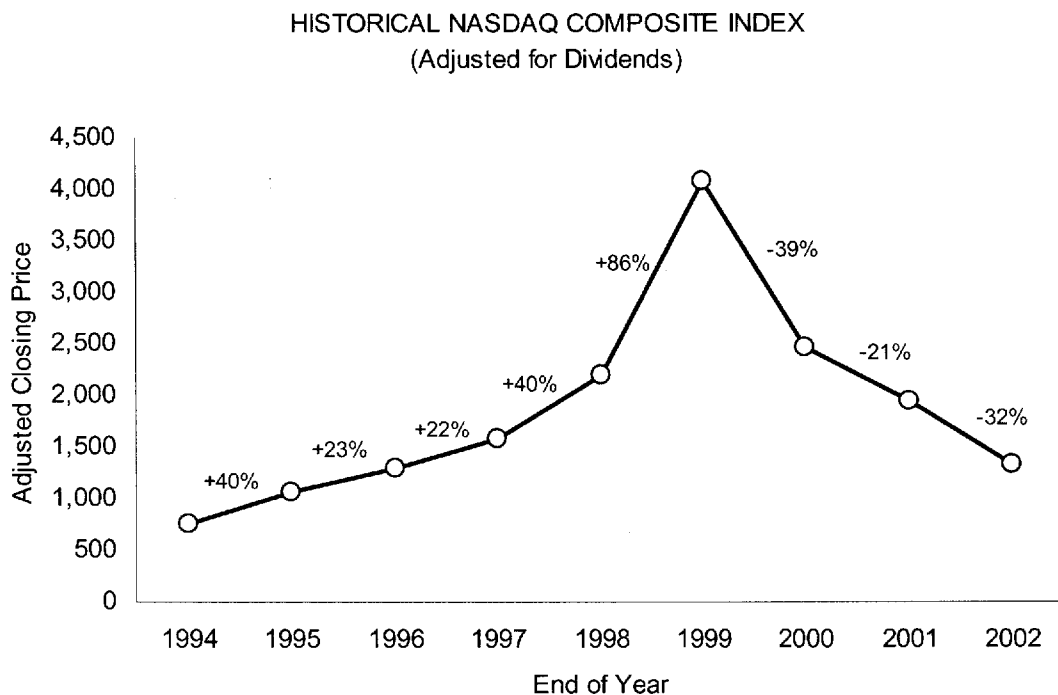
15 A. Mr. Traxler is confusing the risk we commonly associate with "losing" money (e.g., on a
16 wager) with the risk of having exposure to an asset (e.g., a net long position in
17 generation) where the actual realized margin or earnings may vary significantly. In
18 short, he contends that if something keeps increasing year over year in an observed
19 period (i.e., is not "losing" money in some years), then it is by definition not volatile and
20 therefore not risky. There are two problems with his argument.

21 **Q. What is the first problem?**

22 A. Mr. Traxler looks at five years of historical data that show the realized margin increasing
23 from ** [REDACTED] ** (a cumulative 475% increase), and concludes there
24 is no significant risk. A five-year historical look at the NASDAQ Composite Index in
25 January of 2000 would have yielded a similar story: the Index rose each year, from 752 at
26 the end of 1994 to over 4069 at the end of 1999 (a cumulative 441% increase). But in
27 2000, 2001 and 2002 the Index fell each year, closing at the end of 2002 at only 1336,

1 reducing the cumulative increase from 441% to only 78%. Clearly, after the fact we can
2 see there was significant risk in the NASDAQ at the beginning of 2000 as shown in
3 Figure 1 below. As mutual fund disclaimers commonly state: "Past performance is no
4 guarantee of future results."

5 **Figure 1 – NASDAQ Composite Index 1994 to 2002**



6
7 **Q. What is the second problem?**

8 A. The second and more fundamental problem is that the relevant issue in this case is not the
9 historical pattern of off-system margins as Mr. Traxler suggests, but rather the
10 uncertainty in actual realized margins relative to a prior forecast. The first part of my
11 Direct Testimony deals with this topic at length. Let me summarize by saying that in
12 assessing risk we should focus on the difference between KCPL's expected or forecast
13 margin and its realized margin. Mr. Traxler's own data illustrate this point. At p. 11,
14 lines 19 to 21, if we compare the Actual Dollars versus the Budget Dollars for the years

1 2003, 2004 and 2005, we see that actual margin exceeded that budgeted by 79%, 58%
2 and 31% respectively in those three years. This is significant volatility, and as would be
3 expected in a period of rising gas and power prices, the volatility is to the upside for an
4 off-system margin based on sales from coal-fired units. The future risk for KCPL is that
5 the volatility in off-system margin may be to the downside as it was for the NASDAQ in
6 2000-2002.

7 **Q. How do you respond to Mr. Traxler's volatility estimates for Off-System**
8 **Contribution Margin of less than 1% in 2004 and 2005 and less than 3% for 2006**
9 **and 2007?**

10 A. First, for his historical volatility calculation, Mr. Traxler simply picks the realized
11 margins for two years (2004 and 2005) and concludes since the difference is less than 1%
12 that off-system margin is not volatile. The observation is true, but the conclusion he
13 draws from the observation is not true. As discussed above the relevant comparison is
14 between actual and forecast. The Budget Dollars for 2004 and 2005 were ** [REDACTED]
15 [REDACTED] ** respectively and the Actual Dollars for both years was ** [REDACTED]
16 [REDACTED] **. The realized margins were volatile measured from the relevant starting point,
17 the budgeted or forecast margin.

18 Moreover, in addition to missing the main point, Mr. Traxler conveniently ignores
19 the other years in his data set that show sizable year over year changes. He also does not
20 mention that the almost identical ** [REDACTED] ** margins for 2004 and 2005 were
21 largely coincidental. This coincidental result can be seen in Schedule MMS-2 in my
22 Direct Testimony, where the average KCPL off-system sales price increased from
23 \$30.86/MWH in 2004 to \$47.82/MWH in 2005 (a rise of 55%). However, the quantity of

1 KCPL off-system sales decreased from 5,076,508 MWH in 2004 to 3,003,007 MWH in
2 2005 (a decrease of 41%). In a single pair of years, the upside volatility in the underlying
3 price happens to offset the downside volatility in sales quantity, and based on this one
4 observation Mr. Traxler concludes that, in general, off-system margin is not volatile.

5 Second, for his future volatility calculation, Mr. Traxler is simply misapplying the
6 concept of volatility to two projections made at the same point in time. KCPL budgeted
7 its expectation for off-system margin in 2006 and 2007 at a single point in time in late
8 2005. That expectation would have been based on the forward curves for natural gas and
9 electricity in SPP-North that then existed. With a common set of expectations of the
10 variables, we would expect the two projections to be similar. That tells us nothing about
11 the relevant measure of future volatility. If today we expect the price of gold in both
12 2007 and 2008 to be about \$600/ounce that is not the same as saying we believe the price
13 of gold is not volatile. Comparison of two projections is not meaningful as a measure of
14 volatility: future volatility depends on the difference between projected and realized
15 results.

16 **Q. How do you respond to Mr. Traxler's argument that KCPL's significant base load**
17 **capacity has caused the Company's off-system margin to exhibit very little volatility**
18 **historically?**

19 A. At pp. 12-13 of his Rebuttal Testimony, Mr. Traxler is asserting that a reduction in
20 volatility and risk results from KCPL being a low cost producer. He states:

21 KCPL's significant base load capacity has given KCPL an advantage in
22 competing in the off-system sales market. KCPL's most recent experience in
23 off-system sales margin and KCPL's own budgeted levels for 2006 and 2007
24 don't support Mr. Giles' concern of significant risk to KCPL's off-system sales
25 margin to justify a \$19 million reduction to the 2005 level for setting rates in this
26 case.

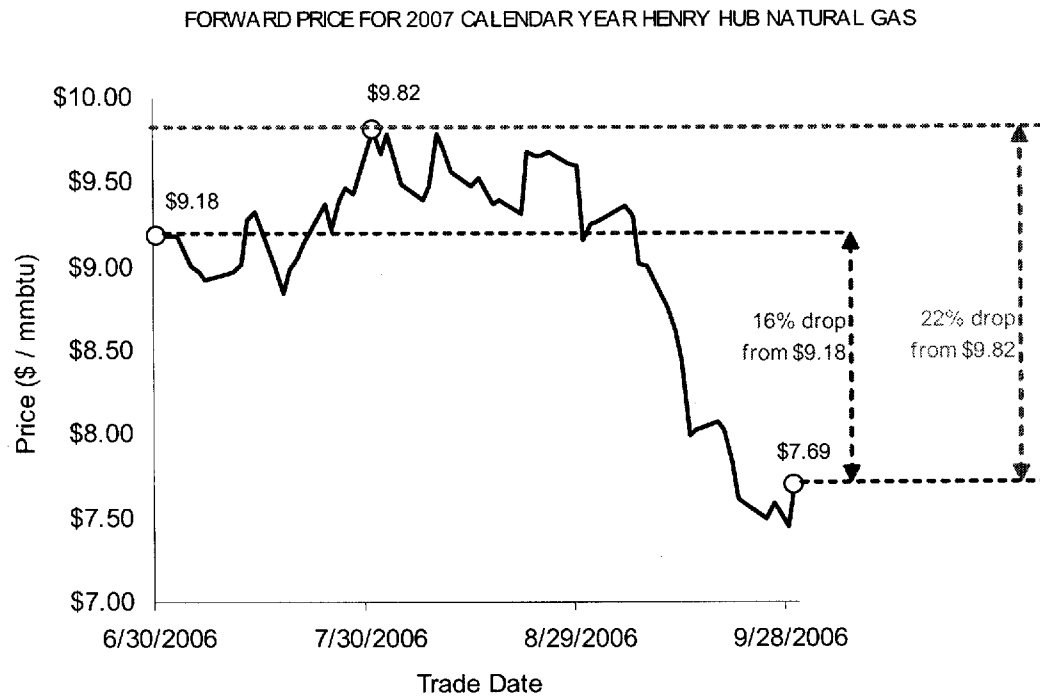
1
2 Mr. Traxler is correct that the low-cost nature of KCPL's capacity means that any surplus
3 energy it can produce would be economic to sell in most hours of the year – but that is
4 not the issue in this case. The question in this case is what margin KCPL will realize on
5 those sales. There is still considerable uncertainty regarding the market prices at which
6 the power is sold and the volumes that may be available for sale. The uncertainty in these
7 drivers means that off-system margin, even when sourced from low-cost base load units,
8 will exhibit significant risk and volatility.

9 **Q. Can you point to any recent market evidence that illustrates this point?**

10 A. Yes. My Rebuttal Testimony contains an update of the prospective calculation of off-
11 system margin as of June 30, 2006. The 2007 forward strip for natural gas on which this
12 analysis is based has changed significantly in the last three months. As shown in
13 Figure 2 below, the strip has declined 16% in this period from \$9.18/mmBtu to
14 \$7.69/mmBtu. From its peak on July 31, the strip has declined 22%. This dramatic
15 decline illustrates how quickly market conditions can change and shows the volatility of
16 the underlying drivers of KCPL's Off-System Contribution Margin.

1

Figure 2 – Henry Hub 2007 Strip June 30, 2006 to September 29, 2006.



2

3 **Q. Does that conclude your testimony?**

4 **A. Yes, it does.**

In the Matter of the Application of Kansas City)
Power & Light Company to Modify Its Tariff to) Case No. ER-2006-0314
Begin the Implementation of Its Regulatory Plan)

COMMONWEALTH OF MASSACHUSETTS)
)
COUNTY OF MIDDLESEX)

1. My name is Michael M. Schnitzer. I work in Lincoln, Massachusetts, and I am employed by The NorthBridge Group, Inc. as a Director.

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.


Michael M. Schnitzer

Subscribed and sworn before me this 6th day of October 2006.

Satish Chandra FOLBRO
Notary Public

My commission expires: June 21, 2013