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**

TRUE-UP BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

INTRODUCTION

This brief will address the three issues raised at the true-up hearing: the appropriate percentile level to use for the off-system sales margins tracker; whether to deviate from the calculations of regulatory plan amortizations set out in the Stipulation and Agreement in Case No. EO-2005-0329; and the proper capital structure to use for ratemaking.

PERCENTILE LEVEL FOR OFF-SYSTEM SALES MARGINS TRACKER

This issue has to do with whether the Commission should calculate KCPL's rates in this case on the basis of the 25th percentile point of KCPL witness Schnitzer's probability curve, or the 40th percentile point. KCPL, with the somewhat tepid support of the Staff (Tr. 580-583), advocates the continued use of the 25th percentile. Public Counsel asserts that the level should be set at the 40th percentile.

The aspect of this issue that arose at the true-up has to do with the level of forced (unplanned) outages on the KCPL system during 2007. If KCPL had not had such a high number and duration of forced outages, it would have been well above the 25th percentile level that the Commission established in Case No. ER-2006-0314. As a result, but for these forced outages, KCPL ratepayers would be due credits for the amount of off-system sales margins over the 25th

percentile. While the exact figures have been designated Highly Confidential by KCPL, the amount of off-system sales margins lost because of the forced outages is significant.

In Case No. ER-2006-0314, the Commission decided to shift a significant portion of the market risks of off-system sales from KCPL to its customers. Although Public Counsel argued in that case that this shift was not well-supported by the record in Case No. ER-2006-0314, it at least had some support. But there is no support whatsoever to shift the risk of forced outages from shareholders to ratepayers. Never once in its Report and Order in Case No. ER-2006-0314 did the Commission so much as mention forced outages; its entire discussion was about market risk and natural gas prices. In fact, the Commission even noted that "Mr. Schnitzer's testimony focused on the risk KCPL faces in the off-system sales market…." (Case No. ER-2006-0314, Report and Order, p. 31). Even in KCPL's initial brief in this case, the focus was entirely on market risk; there was no discussion of forced outages.

And indeed there are very good reasons to treat the risk of unplanned outages differently from the risk of changes in the market. Market changes are almost entirely out of KCPL's control; forced outages are almost entirely within KCPL's control.

The Commission recognized this sort of distinction when it adopted rules governing Fuel Adjustment Clauses. In those rules (adopted in Case No. EX-2006-0472), only fuel-related costs that are outside of a utility's control are passed through a fuel adjustment clause. Costs such as a utility's fuel handling expenses are not. The rationale is similar to that advanced by Public Counsel here: there is no reason to shift to ratepayers risks that are within the control of a utility's management.

As Public Counsel witness Robertson testified:

> The Commission's decision to assign the off-system sales margins risk normally associated with KCPL to ratepayers was largely based upon its concerns of the

unpredictability of market forces. It was not to insulate the Company from its own operational inefficiencies.
(Exhibit 211, Robertson True-up Rebuttal, p. 4).

Mr. Robertson also noted that:

In its Report and Order in Case No. ER-2006-0314 the Commission did not explicitly address absolving KCPL of all risk associated with incurring a higher than normal level of generation plant outages. I believe to do so would be improper because the risk associated with the outages occurring are not impacted to any large degree by outside market forces. The risks that are associated with the abnormal level of forced outages is the result of decisions made by KCPL's management regarding the operation and maintenance of its generation plant.
(Exhibit 211, Robertson True-up Rebuttal, p. 11).

One of the outages that was "very significant" and a "big part of the reduction" in 2007 off-system sales margins was the steam pipe explosion at the Iatan 1 power plant. (Tr. 1282) KCPL was recently fined by OHSA because of safety violations associated with that explosion. (Tr. 1279, 1282). It would be unreasonable to shift to ratepayers the risk of a reduced level of off-system sales margins due to KCPL's unsafe operation of a power plant.

In addition, KCPL's projections fail to take into two factors that will likely increase the level of off-system sales margins for 2007 over what KCPL now projects. First, KCPL did not take into account the run-up in gas prices in November of 2007. (Tr. 1255). As gas prices go up, KCPL's off-system sales margins also generally go up. (Tr. 1255). Second, KCPL's calculations do not take into account profits from arbitrage. Including these profits would increase off system sales margins, making it easier to hit (or exceed) the percentile target. (Tr. 1257).

REGULATORY PLAN AMORTIZATIONS

Public Counsel proposes that the Regulatory Plan Amortization calculation be performed in the same way it is set out in the Stipulation and Agreement in Case No. EO-2005-0329, the same way it has been performed in this case until the true-up, the same way it was performed in

Case No. ER-2006-0314, the same way it was performed in Case No. ER-2006-0315 (Empire's last rate case), and the same way it is presented in Case No. ER-2008-0093 (Empire's new rate case). KCPL has proposed to perform the calculation in a new way.

KCPL, with Staff's concurrence, has proposed to add a new line to the calculation and use short-term-debt interest as an offset to Missouri jurisdictional revenue when calculating the coverage ratios. In all the times the amortizations have been calculated for both Empire and KCPL (and the parties have done many calculations during the course of each of the cases), short-term-debt interest has **never** been used as such an offset, and it is not shown as such an offset in the appendices to the Stipulation and Agreement in Case No. EO-2005-0329.

In order to evaluate the merits of KCPL's proposed change, it is helpful to step back and look at the Regulatory Plan in general. Because of the significant construction expenditures that KCPL is embarking on, the parties to the Regulatory Plan created a mechanism to insure that KCPL would have sufficient cash flow from its Missouri jurisdictional operations to meet certain financial metrics. There are two regulatory metrics that are calculated to determine whether or not a Regulatory Plan Amortization (RPA) is necessary. Both of these metrics (or ratios) compare Funds from Operations (FFO) to another number. The FFO is used in the numerator in both comparisons and the denominator is either Adjusted Interest Expense or Adjusted Total Debt. The comparison of FFO to Adjusted Interest Expense is referred to as FFO Interest Coverage and the comparison of FFO to Adjusted Total Debt is referred to as FFO as a Percent of Average Total Debt. The experience with the RPA in the current case and in ER-2006-0314 is that it is the second of these credit metrics, FFO as a Percent of Average Total Debt, that is driving the need for an RPA. FFO Interest Coverage metrics have been adequate in both cases.

These two metrics were based on metrics that Standard and Poors (S&P) had in place at the time the Stipulation and Agreement in Case No. EO-2005-0329 was negotiated, but they will not change even if S&P changes its metrics – unless the parties agree to make a change. No party in this case has proposed to change the metrics; KCPL asserts that it is simply adding a step that was omitted from the Stipulation and Agreement in Case No. EO-2005-0329 because of an "oversight" on KCPL's part (Tr. 1178-1179).

Appendix F-3 to the Stipulation and Agreement in Case No. EO-2005-0329 (Exhibit 44) shows a calculation of the FFO along with the calculation of the Adjusted Interest Expense and the FFO as a Percent of Average Total Debt. The FFO calculation is calculated on lines 17 through 35. This calculation makes up the first section of the RPA calculation. The second and third sections of the RPA calculation set out other information needed to calculate total interest costs and debt balances. These are used to determination of the denominator in the metric (ratio) calculation. The fourth section calculates the current metric ratios and the fifth section calculates the necessary cash flows on a pre-tax basis. The final section calculates the necessary cash flows including income tax effects.

Short-term debt interest expense is shown on line 45 and used on lines 63 to determine Adjusted Interest Expense which in turn is the denominator used to calculate the FFO Interest Coverage ratio on line 67 and FFO as a Percent of Average Total Debt on line 68. Short-term debt interest is not included anywhere in lines 17 through 35 of Appendix F-3 (Exhibit 44). This format was followed in Case No. ER-2006-0314 when short-term debt was $80M on a total company basis and Missouri's allocated share of interest expense was $3,547,000 (Exhibit 213). The inclusion of this amount of short-term interest in the calculation of FFO in the prior case would have resulted in an increase in the RPA of approximately $5.7 million ($3,547,000 times a 1.62 income tax gross-up factor). KCPL witness Cline quickly calculated the amount to be "in the $5 million range." (Tr. 1182-1183). Public Counsel believes $5.7 million is a material amount. KCPL witness Cline's refusal to answer the question of whether it was material (Tr. 1179-1180) simply lacks credibility.

The purpose of the RP was to provide adequate cash flows to meet specified financial metrics if cash flows from the traditional rate of return determined revenue requirement did not provide adequate cash flows. Appendix F-3 (Exhibit 44) and the language in paragraph III.B.1.i. (Exhibit 43) clearly references "Missouri jurisdictional revenue requirement" as discussed by Mr. Trippensee in his true-up rebuttal testimony and subsequent cross-examination. Short-term debt interest is not included in the revenue requirement because short-term debt is included in the calculation of Allowance for Funds Used During Construction (AFUDC) on Construction Work in Progress (CWIP). No party disagreed with this concept.

The result is that when the CWIP becomes plant-in-service the total original cost will include AFUDC which in turn includes the short-term interest cost. Stated another way, the short-term interest costs are capitalized and included in future rate cases as depreciation expense and as rate base upon which a return is earned. The inclusion of short-term interest costs in the revenue requirement would result in double recovery of those costs. Only in the event that short-term debt balances exceed CWIP investments would it be appropriate to consider the increment short-term debt costs in the revenue requirement. That clearly is not the case with KCPL and its large construction program. Public Counsel believes the record will reflect approximately $250M of short-term debt existed at the end of the true-up period while CWIP balances exceeded $380M.

KCPL readily admits that short term debt interest is **not** included in the Stipulation and Agreement in Case No. EO-2005-0329. (Tr. 1179, 1181) KCPL's only argument in favor of including it is that it was an "oversight" on KCPL's part. (Tr. 1179). The Stipulation and Agreement in Case No. EO-2005-0329 is a contract. KCPL's position now is analogous to someone entering into a contract to lease a car, and partway through the lease period saying that free gas should be included, even though free gas is not mentioned in the lease contract. Forgetting to include a material term in a contract does not allow a party to unilaterally reform that contract.

CAPITAL STRUCTURE

In a 1993 rate case[1] involving St. Joseph Light and Power Company (SJLP), the Commission was faced with a set of facts almost identical to what it faces in the instant case. Like the capital structure KCPL proposes here, SJLP had a high percentage of equity. SJLP had 58 percent; KCPL proposes 57 percent. The equity ratio of comparable companies in the SJLP case was 53 percent; the average equity ratio in KCPL's proxy group was 46-50 percent.[2] The Commission found that SJLP's 58 percent was not "reasonably close" to the proxy group average. Here, KCPL's proposed equity ratio is even farther away from the proxy group average. The Commission concluded that it could not establish rates based on SJLP's skewed capital structure, and that SJLP's stockholders should bear the burden of its management's decisions and not the ratepayers:

> The portion of common equity in a company's capital structure is important for ratemaking purposes because common equity is the most expensive form of capital. The cost differential between common equity and debt is even

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[1] In the matter of St. Joseph Light & Power Company's proposed tariffs to increase rates for electric service provided to customers in the Missouri service area of the Company, consolidated with Staff of the Missouri Public Service Commission, Complainant, vs. St. Joseph Light & Power Company, a Missouri corporation, Respondent. Case Nos. ER-93-41 and EC-93-252; 1993 Mo. PSC LEXIS 36; 2 Mo. P.S.C. 3d 248; June 25, 1993.

[2] Exhibit 201, Gorman Direct, Schedule MPG-3, page 2 of 2. AUS indicates an average equity ratio of 46 percent and Value Line indicates an average of 50 percent.

greater when the income tax treatment of debt is considered. Interest expense or the cost of debt is tax-deductible, while dividends to shareholders are not. The evidence clearly demonstrates that Staff, Public Counsel and AGP support the position that SJLPC's capital structure is too heavily weighted with common equity. The Commission agrees that SJLPC's capital structure is too heavily weighted with equity. In comparing SJLPC's own assessment of its capital structure with that of its proxy group's average capital structure, the Commission cannot find that SJLPC's capital structure is even in line with its own proxy group. SJLPC's long-term debt ratio of 40.10% is nowhere near the proxy group's long-term debt average of 46.7% which includes only one company with long-term debt lower than that of SJLPC. Similarly, SJLPC's proxy group contains only one company with a common equity ratio higher than its own. The second highest common equity ratio in its proxy group is 51.2%, which is not even close to SJLPC's own equity level of 57.93%. The average common equity of the proxy group is 53.3%, which the Commission, unlike SJLPC, does not believe places SJLPC's common equity of 57.93% reasonably close to its proxy group's average. The Commission cannot support a capital structure for a company such as SJLPC that is so heavily weighted with common equity. The Commission, in its duty to protect the ratepayers, cannot establish rates based on this skewed capital structure. The Commission is of the opinion that if SJLPC chooses to continue with its current debt/equity ratio then its stockholders should bear the burden of its management's decisions and not the ratepayers.

Therefore, the Commission finds that the hypothetical capital structure as proposed by Public Counsel should be used in setting rates in this proceeding.

…

By adopting a hypothetical capital structure for SJLPC, the Commission is not indicating a preference for hypothetical capital structures in establishing revenue requirements for a company. The Commission, in other cases, has utilized the actual capital structure whenever the debt equity ratio has not been shown to be outside a zone of reasonableness. **However, when as in this case, the actual capital structure is so entirely out of line with what the Commission considers to be a reasonable range, a hypothetical capital structure must be adopted to balance properly the interests of the shareholders and ratepayers.**

The Commission, therefore, determines that the hypothetical capital structure as proposed by Public Counsel should be adopted in this proceeding. *Ibid.*, at 11-12; emphasis added.

Other record evidence with respect to average equity ratios also compel a finding that KCPL's capital structure is far out of the range of reasonableness. The average equity ratio for Mr. Gorman's proxy group is very similar to that of Dr. Hadaway's: 46 percent to 49 percent.[3]

[3] Exhibit 201, Gorman Direct, Schedule MPG-3, page 1 of 2. AUS indicates an average equity ratio of 46 percent and Value Line indicates an average of 49 percent.

The Regulatory Plan itself calls for a capital structure that is only 51 percent equity. (Exhibit 44). The data compiled by Regulatory Research Associates (Exhibit 121) shows that **no electric utility in the whole United States had an equity ratio as high as KCPL's proposed 57.62 percent.** The only ones that are even close are two Wisconsin decisions that considered special circumstances not present here. (Tr. 1171-1172). Exhibit 121 shows that the average equity ratio for the first two quarters of 2007 was about 46.8 percent, and close to 48.7 percent for 2006. (See also, Tr. 1169). Exhibit 121 also shows that the average equity ratio **has never been above 50 percent** in any year for the last ten years. There is no reason whatsoever for this Commission to depart from the sound reasoning it espoused in the SJLP case; indeed, KCPL's proposed capital structure is even farther from the norm than SJLP's was.

The Commission's use of a hypothetical capital structure has been approved by Missouri courts. In approving the Commission's use of a hypothetical capital structure, the Court of Appeals of Missouri, Western District stated:

> What the Missouri Commission has in effect done is to adopt a hypothetical capital structure for ratemaking purposes without regard to the manner in which APL acquired equity ownership of the Company. **It appears to be an accepted regulatory practice to disregard the actual book capital structure of a utility when it is deemed to be in the public interest to do so.** <u>New England Telephone and Telegraph</u>, *supra*, 390 A.2d at 39. **There are two circumstances in which a utility commission might disregard a utility's actual capital structure and adopt a hypothetical capital structure for ratemaking purposes.**
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> **The first occurs when the utility's actual debt-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt, necessitating an inflated rate of return.** Id. This situation existed in <u>Communications Satellite Corp. v. Federal Communications Commission</u>, 198 U.S. App. D.C. 60, 611 F.2d 883 (D.C. Cir. 1977) (COMSAT), in which the company was 100% equity financed. The Commission there imputed a 45% debt ratio which was admittedly a hypothetical construct. *Id*. at 898, 902. In approving the Commission's action, the United States Court of Appeals for the District of Columbia stated that the "authority of a public utility commission . . . to assume hypothetical debt for a company derives from its jurisdiction over rates charged by the company, that they be 'just and reasonable.'" *Id*. at 903.

State ex rel. Associated Natural Gas Co. v. Public Service Com., 706 S.W.2d 870, 878 (Mo. Ct. App. 1985) [emphasis added].

The Associated Natural Gas case was recently cited with approval for the concept of the Commission's authority to impose a hypothetical capital structure:

> The court in Associated Natural Gas observes that it is accepted regulatory practice to adopt a hypothetical capital structure for ratemaking purposes, particularly where it is in the public interest to do so, *i.e.*, when a utility's actual capital structure contains too much equity and not enough debt, thereby necessitating an inflated rate of return.
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> State ex rel. Mo. Gas Energy v. PSC, 186 S.W.3d 376, at 386 (footnote 10) (Mo. Ct. App. 2005).

The inflated capital structure issue is even more compelling here because KCPL and Staff are not proposing to use KCPL's actual capital structure, but rather to use GPE's[4] capital structure. During the course of this case, GPE issued debt and used the proceeds to make an equity infusion in KCPL. KCPL witness Cline admitted this at the true-up hearing. (Tr. 1151-1152). GPE's cost for that new debt capital is around 6.5 to 7.0 percent. But KCPL will charge customers an equity return of 9.72 to 11.25 percent (depending on the Commission's decision in this case), plus an income tax adjustment for a net revenue requirement cost of around 16 to 19 percent (9.72 times an effective tax multiplier of 1.62 is 16 percent; 11.25 times the same multiplier is 19 percent). Clearly this new capital was managed in a way to inflate KCPL's profit and revenue requirement.

And while KCPL witness Cline testified that KCPL could not issue the entire $250 million in long-term debt that was in its plans at the beginning of the case, it certainly could have issued at least $100 million. After all, GPE, with a weaker credit rating than KCPL, was able to issue $100 million in debt. (Tr. 1157-1158). Or GPE could have loaned KCPL money as opposed to making an equity infusion; Mr. Cline testified that there is nothing to prevent such a

[4] Great Plains Energy is KCPL's parent company.

transaction. (Tr. 1159). Either of these courses of action (and literally dozens of others that KCPL/GPE management could have taken) would have greatly reduced the inflated equity ratio that KCPL seeks to impose on its ratepayers. The fact that there were two plausible – and eminently reasonable – actions that KCPL could have taken while the case was pending to bring its equity ratio closer to a normal level adds even more compelling reason for the Commission to adopt Public Counsel's proposed capital structure.

Staff witness Barnes had virtually no justification for using GPE's capital structure as opposed to the more balanced capital structure proposed by Public Counsel witness Gorman. Mr Barnes admitted that he did not do any analysis that showed a capital structure with an equity ratio of 66 percent common equity (his original recommendation) is prudent. (Tr. 298). Nor did he do any analysis to see whether KCPL would actually have such a high equity ratio during the period rates set in this case are in effect. (Tr. 299). Mr Barnes acknowledged that the Regulatory Plan anticipated an equity ratio of only about 51 percent. (Tr. 300). Perhaps most critically damaging to Mr. Barnes' analysis of KCPL's capital structure is his frank admission that there is no level at which he would find an equity ratio too high. As he put it "It's gonna be whatever the data is as of September 30th" and he would refuse to do any analysis of whether that number was prudent. (Tr. 303).

However, despite frankly admitting that he would use whatever equity percentage that GPE managed to get in place as of September 30 without any scrutiny, Mr. Barnes recently proposed a hypothetical capital structure for another utility. In the recent Algonquin Water Resources rate case[5] Mr Barnes testified:

[5] In the Matter of the tariff filing of Algonquin Water Resources of Missouri, LLC to implement a general rate increase for water and sewer service provided to customers in its Missouri service areas. Case No. WR-2006-0425.

> Mr. Loos' capital structure is inappropriate to use in this case because he relies on Algonquin Power's consolidated capital structure for ratemaking purposes (Loos, Direct, 16 Page 30, Lines 22-25). Algonquin Power is the parent of AlgonquinMO. Staff believes it is appropriate to use the consolidated capital structure in some cases, but in this case it is inappropriate, because Algonquin Power is incorporated in Canada and trades on the Toronto Stock Exchange. Also, Staff is not familiar with Canadian markets. Additionally, this Company is not organized as a typical publicly traded U.S. water utility corporation. Unlike publicly traded U.S. water utility corporations, Algonquin Power is organized to distribute a majority of its free cash flow to its shareholders. Based on these reasons, Staff does not believe it is prudent to use AlgonquinMO's parent capital structure in this case. Staff chose to apply a hypothetical capital structure based on a comparable group of U.S. water utility companies to AlgonquinMO's rate base. The use of a hypothetical capital structure for AlgonquinMO based on a group of U.S. publicly traded water utility corporations should provide assurance to the Commission that AlgonquinMO's rates are just and reasonable and its rate-of-return is based on the cost of capital in U.S. capital markets. (Case No. WR-2006-0425, Barnes Rebuttal Testimony, pages 3-4).

Apparently, according to Staff, it is appropriate to use a hypothetical capital structure when "Staff is not familiar with Canadian markets." But it is apparently not appropriate when the actual capital structure is badly out of whack and will end up costing ratepayers millions of dollars annually to support the excessive equity. The Commission should not rely on Mr. Barnes' testimony with respect to capital structure. His refusal to consider anything other than GPE's actual September 30 capital structure, his refusal to do any kind of analysis of the prudence of that structure, and his ready resort to a hypothetical capital structure in the Algonquin case completely undermines his credibility in this case.

CONCLUSION

The Commission should set rates based on the 40th percentile level as identified in KCPL witness Schnitzer's testimony rather than the 25th percentile as advocated by KCPL. The Commission should not allow changes to the agreed-upon calculation of regulatory plan amortizations. The Commission should adopt the capital structure advocated by Public Counsel witness Gorman (45.24% debt, 1.33% preferred stock, and 53.43% common equity).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to all parties this 17th day of November 2007.

By:______________________________