BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

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

DOE/NNSA POST-HEARING BRIEF

COMES NOW the United States Department of Energy and the United States National Nuclear Security Administration (DOE/NNSA), by and through DOE/NNSA's Counsel, and for its Post-Hearing Brief, states as follows:

Introduction

Kansas City Power and Light Company (KCPL) filed its tariffs seeking a general rate increase on February 1, 2007. In its Application, KCPL explains that this is the second of a series of rate cases called for in the Stipulation and Agreement approved by the Commission in Case No. EO-2005-0329 (hereinafter the "Regulatory Plan").

The Commission's statutory task in this case is to set just and reasonable rates. §§ 393.130, 393.140, RSMo. A "just and reasonable" rate is one that is fair to both the utility and its customers, *St. ex rel. Valley Sewage Co. v. Public Service Comm'n,* 515 S.W.2d 845, 850 (Mo. App., K.C.D. 1974); it is no more than is sufficient to “keep public utility plants in proper repair for effective public service, [and] . . . to insure to the investors a reasonable return upon funds invested.” *St. ex rel. Washington University et al. v. Public Service Comm'n,* 308 Mo. 328, 344-45, 272 S.W. 971, 973 (banc 1925). “The dominant thought and purpose of the policy is the protection of the public . . . [and] the protection given the utility is merely incidental.” *St. ex rel. Crown Coach Co. v. Public Service Comm'n,* 238 Mo. App. 287, 179 S.W.2d 123, 126 (1944).

Ratemaking is a two-step process. The first step is the determination of the “revenue requirement,” that is, the amount of revenue the utility must receive to pay the costs of producing the utility service while yielding a reasonable rate of return to the investors. *St. ex rel. Capital City Water Co. v. Missouri Public Service Comm'n,* 850 S.W.2d 903, 916 n. 1 (Mo. App., W.D. 1993). The second step is the development of an equitable rate design, that is, the construction of tariffs that will collect the necessary revenue requirement from the ratepayers in a way that reflects the cost of serving each class of customer.

Revenue requirement is usually established based upon a historical test year which focuses on four factors: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses. *Capital City Water Co., supra.*

DOE/NNSA’s Post-Hearing Brief follows the order of issues, to which DOE/NNSA will respond, established for the hearing. DOE/NNSA requests the

Commission to resolve the many issues submitted to it for resolution in the case as commented on and recommended by DOE/NNSA in order to achieve just and reasonable rates.

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incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO-2006-0329 allow signatories to the Stipulation & Agreement to propose inter-class shifts in this case?	
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ARGUMENT

ISSUES:
REVENUE REQUIREMENT

Rate of Return

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

A regulated public utility must be afforded an opportunity to recover a reasonable return on the assets it has devoted to the public service. *St. ex rel. Utility Consumers Council, Inc. v. Public Service Comm'n,* 585 S.W.2d 41, 49 (Mo. banc 1979). "There can be no argument but that the Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment." (emphasis added) *St. ex rel. Missouri Public Service Co. v. Fraas,* 627 S.W.2d 882, 886 (Mo. App., W.D. 1981).

For any utility, its fair and reasonable rate of return is its composite cost of capital. *In the Matter of Empire District Electric Co.,* Case No. ER-2004-0570 (*Report & Order,* issued March 10, 2005), p. 37.

A public utility's cost of capital is the sum of the weighted cost of each component, cost of debt and return on equity, of the utility's capital structure. The return on common equity portion of the utility's capital cost, is an estimated cost.

The Commission recognizes the difficulty of estimating the cost of common equity. *In the Matter of Missouri Gas Energy* 12 Mo.P.S.C.3d 581, 591

(2004). In *In the Matter of Empire District Electric Co.,* Case No. ER-2004-0570 (*Report & Order,* issued March 10, 2005), the Commission discussed this process and the Commission commented that "In the final analysis, it is not the method employed, but the result reached, that is important. The Constitution 'does not bind ratemaking bodies to the service of any single formula or combination of formulas.'" at 41. The Commission has the discretion of selecting the methodology or methodologies to be used. *Id.,* at n. 52.

In the two cases cited above, the Commission turned to "benchmarking" to establish the basis parameters of a just and reasonable ROE. This is the "zone of reasonableness" defined in *Missouri Gas Energy,* 12 Mo.P.S.C.3d at 593, and referred to in *Empire, supra,* at 45.

Testimony of KCPL cost of capital was made by KCPL witness Dr. Samuel C. Hadaway (KCPL Exhibit 12). Dr. Hadaway testified that KCPL would require a Return on Equity of 11.25%. This was made up of an ROE of 10.75% plus a 50 basis point premium to compensate shareholders for the additional risk of the major construction project that KCPL has underway. (Hadaway Direct, KCPL Exhibit 12, p. 6, L.16)

Office of Public Counsel cost of capital witness, Mr. Michael Gorman testified that he recommended a Return on Equity of 10.1%. (Gorman Direct, OPC Exhibit 201, p. 2, line 5)

Based on his discounted cash flow models Staff witness Mr. Matthew J. Barnes recommended a Return on Equity in the range of 9.14% to 10.30%. (Barnes Direct, Staff Exhibit 105, p. 20, L.19)

Dr. Hadaway testified about the ROE range as indicated by his DCF analysis, stating that "My reference group analysis indicates that a DCF range of 10.5 percent to 10.8 percent is appropriate (Hadaway Direct, KCPL Exhibit 12, p. 5, L.19), But Dr. Hadaway also testified that "the traditional constant growth model indicates an ROE range of only 9.4 percent to 9.5 percent. Because this result falls 100 basis points or more below my risk premium checks of reasonableness, it is excluded from my final DCF range." (Hadaway Direct, KCPL Exhibit 12, p. 35, L 22)

Thus the three cost of capital witnesses reached the following recommendations for Return on Equity:

Witness	Recommended Range	Recommendation
Dr. Hadaway	10.5% to 10.8%	10.75%
Mr. Barnes	9.14% to 10.30%	9.14% to 10.30%
Mr. Gorman	10.1%	10.1%

However, it would appear that a Zone of Reasonableness should lie somewhere in between the low end of Mr. Barnes 9.14% and Dr. Hadaway's rejected traditional constant growth DCF of 9.4% and on the high end somewhere between Mr. Barnes 10.30% and Dr. Hadaway's 10.75%.

Dr. Hadaway explains in detail in his Direct Testimony his methodology for determining KCPL's required ROE. Without going into the details of the formulae his methodology can best be simplified by reviewing some of the schedules to his Direct Testimony, KCPL Exhibit 12.

Schedule 6 to his direct testimony provides the nuts and bolts of his methodology First, on Schedule 6, page 2 column (3) Dr. Hadaway calculates a dividend yield of a Group Average of 4.19% and a Group Median of 4.15% that becomes his starting point. On page 17 of his Direct Testimony line 13 Dr. Hathaway provides the basic formula that is used to determine ROE.which is k = $D_1/P_0 + g$. k is the required ROE and is obtained by adding the percentage dividend yield by price [(Dividend (D_1)/Price (P_0)] and adding the required growth rate (g). To calculate D_1 Dr. Hadaway has merely taken the dividend of the comparable companies that he has selected (Schedule 6, page 2, column 2) and divided the dividend by the recent price of the shares of the particular company (Schedule 6, page 2, column 1). He then calculated the group average and mean dividend yield for his starting point, i.e. $D_1/P_{0.}$ To D_1/P_0 he must add his growth rate "g".

Solving for "g" is the most important part of the calculation since this is where judgment and analysis is required and is <u>also where Dr. Hadaway's calculations fail</u>. All of the pieces of information that go into solving for "g" must be valid. Dr. Hadaway has used <u>one invalid piece of information</u> that skews his entire set of DFC computations. This piece of information is the <u>Long Term GDP growth rate of 6.6%</u> which he derives from Schedule 5 of his Direct Testimony. He uses this 6.6% growth rate in each of his DFC calculations of "g" in the equation to derive "k" or ROE. Dr. Hadaway rejected one model, the Traditional Constant Growth DCF Model because as he states in his Direct Testimony, Exhibit 12, p. 35, L. 21:

> The DCF results for my comparable company group are presented in Schedule SCH- 6. As shown in the first column of page 1 of that schedule, the traditional constant growth model indicates an ROE range of only 9.4 percent to 9.5 percent. Because this result falls 100 basis points or more below my risk premium checks of reasonableness, it is excluded from my final DCF range.

The reason the ROE calculated using the Traditional Constant Growth DCF Model does not satisfy Dr. Hadaway's criteria that it falls 100 basis points or more below his range of reasonableness is that it <u>makes the least use of his flawed 6.6% GDP growth rate</u> of his three DFC calculations and thus results in an ROE lower than KCPL desires. Calculation of the Traditional Constant Growth DCF Model is shown on the table on Schedule 6 page 2. The average growth rate in this model uses the average of four growth rates:

> In the first version of the DCF model, I use the constant growth format with long-term expected growth estimated from an equally weighted, four-part average of (1) Value Line and (2) Zacks earnings per share growth projections for the coming three to five years, (3) a sustainable growth ("b" times "r") estimate based on Value Line's projected retention rates and earned rates of return for the next three to five years[1], and (4) a long-term estimate of nominal growth in GDP [the 6.6%]. (Hadaway Direct, Exhibit 12, p. 32, L.13)

His model that relies the least on the 6.6% GDP growth rate produces the lowest ROE and his model that relies the most heavily on the 6.6% GDP growth rate produces the highest ROE. This later is the Constant Growth DCF Model Long-Term GDP Growth (the second column on Schedule 6, page 1 of Hadaway Direct Exhibit 12).

One has merely to look at Dr. Hadaway's Schedule 5 from which he calculates his long term GDP Growth Rate Forecast to see why he picked the extremely long period of 50 years. In the early years the Gross Domestic Product Price Deflator was much higher than the later years and included the post World War II years and the high inflation years in the 70s and early 80s. A more reasonable period

[1] The long-term constant rate of growth was calculated using the earnings retention (b times r) method and Value Line's three- to five-year expected return on equity (r) and expected retention rate (b).

would have been the past 20 years which are certainly more representative of growth rates today. Substituting the 20 year average of 5.6% GDP deflator for the 6.6% deflator and applying it to each of Dr. Hadaway's calculated models (which are summarized on Hadaway Direct Schedule 6 page 1) one can observe that each of the three methodologies results in a very similar ROE as follows:

Traditional Constant Growth DFC Model[2] Sched 6, p 4.	Constant Growth DCF Model, Long Term GDP Growth[3] Sched 6, p. 3.	Low Near Term Growth Two Stage Growth DCF Model[4] Sched 6, p. 2.
Av. 9.25%	9.8%	9.5%
Med: 9.21%	9.7%	9.5%

The average of Dr. Hadaway's three DCF models is using the 20 year average GDP deflator of 5.6% for the growth rate is:

Average of averages: 9.5%

Average of medians: 9.5%

Mr. Gorman is also highly critical of Dr. Hadaway's 6.6% GDP growth rate. In his Rebuttal Testimony, Mr. Gorman criticized Dr. Hadaway's use of the long term GDP growth rate.

Q IN WHAT WAY DID DR. HADAWAY OVERSTATE HIS DCF ESTIMATES?

A Dr. Hadaway used a GDP growth rate of 6.6% as one of three growth rates. This GDP growth is excessive and not reflective of current market expectations. (Gorman Rebuttal, OPC Exhibit 202, p. 10, L. 6)

[2] This calculation was made by merely inserting 5.6% in column 29 of Schedule 6 page four and recalculating.
[3] This calculation was made by merely inserting 5.6% in column 18 of Schedule 6 page three and recalculating.
[4] Calculated by subtracting col 29 from col 30 (Schedule 6, page 4) which produces the dividend growth rate of columns 24 through 28 and adding the result to 5.6% rather than 6.6%

Mr. Gorman continues his criticism of Dr. Hadaway's use of the 6.6% GDP growth rate with the following testimony:

Q WHY IS DR. HADWAY'S DCF ESTIMATE EXCESSIVE IN COMPARISON TO THAT OF PUBLISHED MARKET ANALYSTS?

A The consensus economists' projected GDP growth rate is much lower than the GDP growth rate used by Dr. Hadaway in his DCF analysis. A comparison of Dr. Hadaway's GDP growth rates and consensus economists' projected GDP growth over the next five and ten years is shown below in Table 3. As shown in the table below, Dr. Hadaway's GDP rate of 6.6% reflects real GDP of 3.2% and an inflation GDP of 3.3%. However, consensus economists' projections of nominal GDP include real GDP and GDP inflation expectations over the next five and ten years of 3.0%, and 2.1%, respectively. As is clearly evident in the table below, Dr. Hadaway's historical GDP growth reflects historical inflation, which is much higher than, and not representative of, consensus market expected forward-looking inflation. (Gorman Rebuttal, OPC Exhibit 202, p. 11, L. 6)

TABLE 3
GDP PROJECTIONS

Description	GDP Inflation	Real GDP	Nominal GDP
Hadaway	**3.3%**	**3.2%**	**6.6%**
Consensus 5-Year Projection	**2.1%**	**3.0%**	**5.1%**
Consensus 10-Year Projection	**2.1%**	**3.0%**	**5.1%**

Similar to DOE/NNSA's recalculation of Dr. Hadaway's DCF models as shown above, Mr. Gorman recalculated Dr. Hadaway's models using the Consensus 10 year Projection Nominal GDP of 5.1% (i.e. Consensus 10 year Projection GDP Inflation of 2.1% plus Consensus 10 year Projection Real GDP of 3.0% = 5.2%) as discussed in the following exchange:

Q HOW WOULD DR. HADAWAY'S DCF ANALYSES CHANGE IF CURRENT MARKET-BASED GDP GROWTH RATE PROJECTIONS

ARE INCLUDED IN HIS ANALYSIS RATHER THAN HIS EXCESSIVE GDP GROWTH RATE?

A As shown on my Rebuttal Schedule MPG-2, I updated Dr. Hadaway's DCF analyses using a GDP growth rate of 5.1%. This is the consensus five-year projected growth rate of the GDP. As shown on page 1 of my Rebuttal Schedule MPG-2, using this consensus projected GDP growth rate <u>reduces his constant growth DCF result from 9.5% to 9.1%</u>. Using a GDP growth rate of 5.1% would <u>reduce his long-term GDP growth rate from 10.8% to 9.3%</u> as shown on page 2 of my Rebuttal Schedule MPG-2, and his <u>two-stage growth DCF model from 10.5% to 9.1%</u> as shown on page 3 of my Rebuttal Schedule MPG-2 (Emphasis Added, Gorman Rebuttal, OPC Exhibit 202, p. 12, L. 3).

The resulting DFC calculations using the Consensus 10 year Projection Nominal GDP of 5.1% for the growth rate are as follows:

Traditional[5] Constant Growth DFC Model Sched 6, p 4.	Constant Growth[6] DCF Model, Long Term GDP Growth Sched 6, p. 3.	Low Near Term[7] Growth Two Stage Growth DCF Model Sched 6, p. 2.
Av. 9.1%	9.3%	9.1%
Med: 9.0%	9.2%	9.2%

The average of Dr. Hadaway's three DCF models is using the <u>Consensus 10-Year Projection Nominal GDP of 5.1%</u> for the growth rate:

- Average of averages: 9.2%
- Average of medians: 9.1%

The average of the average GDP and the median GDP using Dr. Hadaways three GDP models and the <u>20 year GDP deflator of 5.6%</u> for the growth rate is 9.5%.

[5] Source: Gorman Rebuttal Schedule MPG-2, page 1
[6] Source: Gorman Rebuttal Schedule MPG-2, page 2
[7] Source: Gorman Rebuttal Schedule MPG-2, page 3

Mr. Gormans recommended ROE is 10.1% (Gorman Direct Exhibit 201, p. 2 L.5)

Mr. Barnes recommended ROE is the range of 9.14% to 10.3%.

Mr. Gorman testified that the average authorized ROE for electric utilities for 2006 and the first six months of 2007 was about 10.3%.

It would appear then from the credible evidence elicited in this case is that the Zone of Reasonableness, or at least the zone in which the ROE should reasonably fall, would be between 9.1% and 10.3%. Due to the mitigation of construction and financial risk provided by the Regulatory Plan approved in EO-2005-0329 (discussed below).

DOE/NNSA RECOMMENDATION: DOE/NNSA believes and therefore recommends that the ROE approved by the Commission be set at the mid-point between 9.1% and 10.3% or 9.7%.

Issue 1. a. Is KCPL's decreased risk due to the Kansas City Power & Light experimental regulatory plan the Commission approved in case No. E0-2005-0329 a factor that reduces the return on common equity otherwise appropriate for KCPL?

RESPONSE: Yes, it is the risk of investments that drives investor's required return on the investment above the return on Treasury Bills. Even the company's own witness Michael Cline, Chief Risk Officer and Treasurer of KCPL and GPE, testified that the Regulatory Plan reduced the company's risk

ARGUMENT:

Certainly, no discussion of return on equity would be complete without a reference to the leading cases of *Bluefield Waterworks and Improvement Company and FPC v. Hope Natural Gas Co*. It is a virtual certainty that these two cases will be cited by return on equity witnesses for regulated utilities for the proposition, as Dr. Hadaway put it, that his return on equity "recommendation is premised upon the fair rate of return principles established by the Supreme Court in" Hope and Bluefield. (Hadaway Direct, Exhibit 11, p. 3, L. 4) Regarding the issue of risk, Bluefield is also pertinent:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by <u>corresponding, risks and uncertainties.</u> (Emphasis Added) *Bluefield Waterworks & Improvement Co. V.Public Service Commission Of West Virginia et al*.262 U.S. 679, 692, 43 S.Ct.675, 679(1923)

Dr. Hadaway discussed how the market accounts for the risk of various investments in his Direct Testimony KCPL Exhibit 12, p. 11, L. 1:

> Risk-return tradeoffs among capital market investments have been the subject of extensive financial research. Literally dozens of textbooks and hundreds of academic articles have addressed the issue. Generally, such research confirms the common sense conclusion that investors will take additional risks only if they expect to receive a higher rate of return. Empirical tests consistently show that returns from low risk securities, such as U.S. Treasury bills, are the lowest; that returns from longer-term Treasury bonds and corporate bonds are increasingly higher as risks increase; and, generally, returns from common stocks and other more risky investments are even higher. These observations provide a sound theoretical foundation for both the DCF and risk premium methods for estimating the cost of equity capital. These methods attempt to capture the well founded risk-return principle and explicitly measure investors' rate of return requirements.

To further illustrate his point Dr. Hadaway provided a graph that he referred to as the "widely known Capital Market Line" which slopes up from left to right with the vertical axis being expected rate of return, with the higher on the vertical axis being a higher rate of return, and the horizontal axis being from left to right increased risk. (id. p. 12). The principle of the Capital Market Line is that as risk increases required rate of return to attract investors increases.

Thus it is clear that if the Regulatory Plan reduces risk, by necessity, if Dr. Hadaway is correct, the Plan reduces the rate of return required by investors.

Of all of the witnesses who should understand KCPL's risk and change of risk resulting from the Regulatory Plan it should be Michael W. Cline, Treasurer and Chief Risk Officer of KCPL. He may be the most competent, credible and convincing witness addressing the subject of risk since measuring and obviating risk is, by definition, his job.

It is therefore instructive to review his testimony bearing on risk and to understand what effect the Regulatory Plan has on KCPL risk. Mr. Cline testified,

> **Q: The Regulatory Plan Stipulation and Agreement approved by the Commission in August 2005 in Case No. EO-2005-0329 ("Stipulation") discussed Additional Amortizations to maintain financial ratios. Please explain the significance of these amortizations and the maintenance of financial ratios for KCPL.**
>
> A: The Signatory Parties to the Stipulation agreed that it is imperative that KCPL maintain its debt at an investment grade rating during the implementation period of its Comprehensive Energy Plan (the "Plan"). For its part, KCPL acknowledged its responsibility and commitment to take prudent and reasonable actions to maintain its investment grade rating during this period. The non-KCPL Signatory Parties, in turn, agreed to support the "Additional Amortizations to Maintain Financial Ratios," (the "Additional Amortizations") as defined in the Stipulation and related appendices, in KCPL general rate cases filed prior to June 1, 2010. The Signatory Parties agreed that the Additional Amortizations would be an element in any KCPL rate case only when the Missouri jurisdictional revenue requirement in that case fails to satisfy the financial ratios shown in Appendix E of the Stipulation and Agreement through the application of the process illustrated in Appendix F of the Stipulation. (Cline Direct, Exhibit 4, p. 3, L.4)

The following discussion makes clear the relationship between debt rating and KCPL's ability to raise equity capital. It is Mr. Cline's testimony that the Regulatory Plan reduces the company's risk and moves the company's cost of equity capital further down the Capital Market Line toward lower risk. Lower risk equates to lower cost of equity capital and thus a lower required return on equity needed to attract equity capital.

Q: Why is it important for KCPL to maintain investment grade ratings during the implementation of the Plan?

A: Maintaining high credit quality at KCPL is vital to debt <u>and equity investors</u>, banks, rating agencies, and ratepayers for three primary reasons. First, KCPL and its parent, Great Plains Energy, will rely extensively on the debt and equity capital markets for financing over the next several years. Total capital expenditures (including Plan-related expenditures and "normal course" capital expenditures) over the 2007-2011 period are expected to exceed $2.5 billion. Approximately 45% of this amount will need to be raised through issuances of debt by KCPL and equity by Great Plains Energy. <u>Investors will need to have confidence in KCPL's credit strength and financial wherewithal to feel comfortable making this capital available to KCPL and Great Plains Energy on attractive terms</u>, particularly given competing opportunities for deployment of capital. Second, in addition to new funding required for the Regulatory Plan, KCPL will have a significant amount of debt subject to refinancing during the period of the Plan. KCPL has $225 million of senior notes maturing in March 2007. Further, KCPL has $257 million of tax- exempt debt that is either subject to remarketing during the Regulatory Plan period or is in a weekly or monthly "auction" mode and essentially refinanced at those intervals. KCPL's ability to refinance its debt efficiently, effectively, and on favorable terms will be heavily dependent on bondholder and rating agency views of KCPL's creditworthiness. Finally, the strong financial profile required for an investment grade rating benefits ratepayers by <u>enabling KCPL to (a) attract the capital needed to make infrastructure investments; (b) reduce its interest costs;</u> (c) meet its obligations in a timely fashion; (d) attract and retain a high-quality workforce; and (e) invest in the communities it serves. (Emphasis Added, id L.20)

Q: What is the purpose of the Additional Amortizations?

A: The 2005 Regulatory Plan Stipulation identified three credit ratios deemed most important to the credit rating agency Standard & Poor's ("S&P") in determining a utility's credit quality. These three ratios are: (i) Total Debt to Total Capitalization; (ii) Funds from Operations ("FFO") Interest Coverage; and (iii) FFO as a Percentage of Average Total Debt. The fundamental purpose of the Additional Amortization is to provide a means by which KCPL may achieve an amount of FFO sufficient to sustain levels of ratios (ii) and (iii), above, that are consistent with the low end of the top third of the range for BBB-rated utility companies with an equivalent Business Risk Profile to KCPL, per S&P's guidelines. (id. p. 4, L. 21)

Mr. Gorman, the Office of Public Counsel cost of capital witness was also of the opinion that the Regulatory Plan reduced KCPL's financial risk. In his Rebuttal Testimony Mr. Gorman expressed,

"KCPL's regulatory plan also mitigates construction and regulatory risks by commission review and approval of construction cost budgets and rate treatment after the asset is placed in-service." And again at line 20, Mr. Gorman was asked to comment on the reasonableness of the 50 basis points Dr. Hadaway testified was need to compensate KCPL for additional construction risk. (Exhibit 202, p. 6, L.10)

Q IS DR. HADAWAY'S PROPOSED 50 BASIS POINT RETURN ON EQUITY ADD-ON FOR CONSTRUCTION AND OPERATING RISK REASONABLE?

A No. Dr. Hadway's proposed 50 basis point return on equity add-on is unreasonable for KCPL in this proceeding for several reasons. First, KCPL is not unique in that it is involved in a major construction program. Indeed, most utilities in the electric industry today are involved in major construction programs, and the companies in the proxy group used to estimate KCPL's return on equity are also involved in major construction activity. Second, KCPL has a regulatory plan to help support and mitigate the risk of its major construction program. KCPL currently has over $21 million of additional amortization expense to provide stronger cash flows to support its credit metrics during construction, and the Company has proposed to increase that amortization expense by over $17 million in this proceeding. This regulatory plan amortization expense significantly strengthens KCPL's cash flow during construction which mitigates its construction risk at significant cost to retail ratepayers. It is unreasonable for Dr. Hadaway to ask for additional compensation on top of this significant ratepayer funded risk mitigation provided to KCPL to support its construction program.

KCPL's regulatory plan also mitigates construction and regulatory risks by commission review and approval of construction cost budgets and rate treatment after the asset is placed in-service.

Finally, the risks that Dr. Hadaway identifies for KCPL are only components of KCPL's total investment risk. It is the total risk that determines KCPL's cost of capital not the limited components of investment risk that Dr. Hadaway is focused on. (id. p.5, L.20)

Also from Mr. Gorman's Rebuttal:

Q HAS DR. HADAWAY CONSIDERED THE RISK MITIGATION PROVIDED BY THE REGULATORY PLAN IN HIS EVALUATION OF KCPL'S CONSTRUCTION RISK?

A I do not believe so. KCPL has been permitted to set rates based on regulatory principles that are specifically designed to ensure KCPL cash flows meet specified credit metrics in order to enhance KCPL credit rating during this construction period. The financial ratios included in Mr. Cline's analysis are adequate to allow KCPL to have financial ratios within the top one-third of its current credit rating guideline range as set by Standard & Poor's. Increasing KCPL rates to enhance its cash flows during this construction period mitigates KCPL's construction risk. This reduced construction risk is paid for by ratepayers via the increased rates needed to cover the regulatory plan amortization expense. Dr. Hadaway ignored this construction risk mitigation regulatory plan paid for by ratepayers. (Id. p.8, L.1)

Q SHOULD KCPL'S RETURN ON EQUITY BE INCREASED TO REFLECT ONLY CERTAIN COMPONENTS OF KCPL'S INVESTMENT RISK?

A No. A rational investor will assess KCPL's risk based on its total investment risk, not on only limited components of total risk as suggested by Dr. Hadway. Hence, selecting companies with similar total investment risk to KCPL can then be used to estimate a fair rate of return to compensate investors for KCPL's total investment risk. Importantly, in my direct testimony, I demonstrated that both my proposed proxy group and Dr. Hadaway's proposed proxy group reasonably approximate KCPL's total investment risk. KCPL's construction risk is part of its total investment risk. Therefore, no return on equity adder is needed to fairly compensate KCPL for its total investment risk. (id. p.8, L.14)

Even Dr. Hadaway admitted that the Regulatory Plan reduced risk when he responded to DOE/NNSA cross-examination, testifying,

> Q. Okay. Now, the aim, the reason for the adoption of that additional amortization was and is to reduce the company's financial risk, is it not?
>
> A. I think explicitly it is to attempt to maintain an investment grade bond rating.
>
> Q. And that's done by the device of reducing the company's risk, is it not?
>
> A. It's done by enhancing the company's cash flow metrics that the rating agencies, particularly Standard & Poor's, that Standard & Poor's uses to determine whether a triple B bond rating would be appropriate. That has the effect -- a higher bond rating indicates less overall risk. So overall what you're saying is correct, but it's a little more specific than that. (Transcript Vol 6, p.271, L. 22)

On cross-examination, Chris Giles, KCPL's Vice President of Regulatory Affairs testified that even being granted a return on Construction Work in Progress (CWIP) would not substitute for the Regulatory Plan,

> Q Do you recall being asked about the – something about the regulatory plan?
>
> A Yes.
>
> Q Okay. What, in your view, was the purpose of the regulatory plan?
>
> A Well, the purpose of the regulatory plan from KCPL's perspective was to enable us to embark on a comprehensive energy plan that included building of a coal plant, base load coal plant, environmental equipment that we'll seen in IATAN I, wind generation, and to protect our credit rating once we made that announcement that we were embarking on that. That was our objective.
>
> Q If there had not been an anti-CWIP piece of legislation such as Proposition 1, would you have needed the regulatory plan?
>
> A Yes.

Q Even though you could have filed a series of rate cases to simply have recovered those increments or recovered both on a return on them?

A Yes. (Transcript, Vol 5 p115 Line 11)

Issue 1. 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?

Response: No. This issue is the obverse of a) above and answering a) negatively results in b) also being answered negatively. The arguments to a) above are the same arguments that would be made to b).

a) **If so, what is the impact of these factors:?**

Response: Since the response to b) is No, there are no factors to have an impact.

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

Response: DOE/NNSA supports Office of Public Counsel's position of 45.24% Debt, 1.33% Preferred Stock, and 53.43% Common Equity. (See OPC Statement of Position)

EXPENSE ISSUES

Issue 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 rates?

Response: Yes, the subrogation proceeds KCPL received in 2006 from the 1999 Hawthorn 5 explosion litigation should be included in KCPL's cost of service.

Argument: In 1999, KCPL's Hawthorn No. 5 generating unit boiler exploded. KCPL rebuilt the boiler and returned the generating unit to service. In 2001 KCPL filed a lawsuit against several parties alleging they had responsibility for damages KCPL incurred due to the boiler explosion. KCPL and National Union Fire Insurance Company of Pittsburgh, Pennsylvania (National Union) entered into a subrogation agreement under which recoveries in this suit were allocated 55% to National Union and 45% to KCPL. In 2006, KCPL received, after payment of attorney's fees, proceeds of $38.9 million pursuant to the subrogation agreement. Of the $38.9 million of subrogation proceeds received, KCPL recorded $23.1million as *negative* expense. The recording of $23.1 million of the subrogation proceeds as *negative* expense had the same impact as recording the proceeds as $23.1 million of before-tax income. (Dittmer Direct, Exhibit 801, p.13, L.22, Hyneman Direct, Exhibit 108. p. 4, L.1)

In its direct filing in this case, KCPL made adjustments to remove the effects of how it had booked $23.1 million of Hawthorn subrogation proceeds that it had recorded as negative expense – or income. KCPL's rate case adjustments removing the $23.1 million of Hawthorn subrogation proceeds when developing its adjusted test year cost have service had the effect, of treating the $23.1 million as belonging to its shareholders. (Hyneman Direct, Exhibit 108, p.4, L.16)

Mr. Hyneman appearing on behalf of the MPSC Staff and Mr. Dittmer appearing on behalf of DOE-NNSA propose that the Hawthorn proceeds received by KCPL in the 2006 Historic Test Year be amortized as a credit to

KCPL’s cost of service over a period of five years (Dittmer Direct, Exhibit 801, p. 14, L. 28).

Mr. Dittmer reasoned that:

> This Commission has often allowed Companies – including KCPL – to amortize "extra-ordinary", "non-recurring" or "infrequently occurring" *costs* over a multi-year period so that shareholders are not required to bear the entire cost of such events. The "negative" expense or "income" recorded as a result of receiving recoveries from the Hawthorn litigation can also be characterized as "extra-ordinary", "non-recurring" or "infrequently occurring". Consistent with this Commission's past precedent of amortizing significant or extraordinary "costs" over a multi-year period, I am recommending that this significant and extraordinary *negative expense* or *income* similarly be amortized over a multiyear period (Id. p.15, L.5)

Rather than totally excluding the $23.1 million of Hawthorn 5 boiler explosion insurance subrogation proceeds from cost of service development as proposed by KCPL, the Staff and DOE/NNSA propose a sharing of the benefits of the proceeds between ratepayers and shareholders. Specifically, both Staff and DOE-NNSA recommend a sharing of the subrogation proceeds through their recommendation to amortize the subrogation proceeds over a five year period so that only $4.6 million of total proceeds company ($2.5 million Missouri jurisdictional) are included in KCPL’s cost of service for purposes of setting rates in this case. Because the Hawthorn subrogation proceeds represent a cost-free source of funds to KCPL. KCPL’s shareholders share in the benefits of such subrogation proceeds by virtue of the fact that no party has recommended that the unamortized balance of such proceeds be used as a rate base offset. By *not* reflecting such cost free funds as a reduction to ratebase, KCPL shareholders share in the benefit of such proceeds.. (Hyneman Surrebuttal, Exhibit 109, p.5).

In an attempt to persuade the Commission that it should not amortize the subrogation proceeds as a credit to the cost of service, Mr. Chris Giles appearing on behalf of KCPL, testified that ". . .the cost of replacement power and property damages that resulted from the [Hawthorn] explosion <u>were never paid by customers</u> during the outage or at any time subsequent to the outage" (Emphasis Added, Giles Rebuttal, Exhibit 9, p.2, L.25).

In his oral testimony at the hearing Mr. Giles made a subtle change to his prefiled written rebuttal testimony stating;

> And similar to the expense with the Hawthorn 5 subrogation proceeds, in 1999, when the Hawthorn 5 explosion occurred, we incurred over $150 million in purchase power costs to replace the power loss from that unit. <u>Customers were never billed for those costs</u>. We didn't file a case. We didn't ask to recover them. So subsequent, we get a subrogation proceed in the test year, in this case, of 2006, that's related to that additional purchase power costs back in '99 and 2000. (Giles Tr V.5, page 87, line 20)

No one disputes that KCPL's customers were never specifically "billed" for these costs, but that is entirely different conclusion than Mr. Giles' previous claim that KCPL's customers never paid these costs.

Mr. Giles stated, but offered no proof, that the funds for paying the cost of replacement power and property damages came from any source other than its ratepayers or insurance - the cost of which was always included in the development of rates charged to ratepayers. Nor did Mr. Giles offer proof that its earnings were not totally adequate to cover the cost of damages and replacement power, nor that KCPL had funds from some non-utility source to pay these costs.

Mr. Giles suggests that the burden of proof lies with Staff and DOE-NNSA to unequivocally demonstrate that ratepayers *did pay* the cost of damages and replacement power. Further, Mr. Giles implies that the only way that a party could have demonstrated that ratepayers paid for incremental damages and replacement power stemming from the Hawthorn explosion was to have filed a complaint case against KCPL during the relevant time period claiming that KCPL should adjust its rates downward. While Mr. Giles basically demands such a high burden, he readily admits that "it is not clear to me that he [Mr. Dittmer] could" ever provide the support or evidence he demands. (Giles Rebuttal, page 5, lines 4 – 12).

It is important and significant to note, as pointed out by MPSC Staff witness Mr. Hyneman, that KCPL entered into an agreement to reduce its Missouri retail rates on March 1, 1999 in Case No. ER-99-313. That agreement generally prohibited KCPL from raising its Missouri retail rates prior to September 1, 2001. However, that general prohibition against raising rates provided that an exception could be made if:

> …there is the occurrence of a significant, unusual event, such as an act of God; a significant change in federal or state income tax law; a significant change in federal or state utility law or regulation; or an **extended outage or shutdown of a major generating unit(s) which has a major effect on KCPL or its successors. (Emphasis in Original, Hyneman Surrebuttal, Exhibit 109, p. 7, L.15)**

Thus, by the terms of the settlement agreement that KCPL had just entered into, KCPL was fully entitled to seek rate relief – indeed, virtually invited to seek rate relief – if it believed that its earnings would be too dramatically impacted by the “extended outage” or “shutdown” of the major Hawthorn generating unit. Given that KCPL clearly did not avail itself of the opportunity following the Hawthorn explosion to seek relief that it had specifically bargained for, it is entirely reasonable to conclude that any incremental costs incurred as a result of the Hawthorn explosion were recovered from ratepayers during the 1999 through 2001 time frame when the Hawthorn unit was shut down for repairs. Further, since the cost of the Hawthorn V plant was included in KCPL’s electric rates and KCPL’s customers were paying the depreciation and return on this plant while it was out of service following the explosion, ratepayers have a right to the subrogation proceeds

To summarize, contrary to Mr. Giles’ suggestions, KCPL has the burden to prove that ratepayers did *not* pay for the replacement power. Lacking such proof the presumption is that the ratepayers - not the shareholders - were the source of funds used to pay for damages and replacement power.

. Finally, it should be emphasized that returning subrogation proceeds to ratepayers at this time is completely consistent with Mr. Giles “matching principle”. If the customers paid the rates that covered the incremental costs of the explosion, they have a right to have the costs returned to them. As Mr. Giles testified:

> Q: Mr. Giles, I believe I heard you testify into one -- regard to one of the questions that Mr. Dittmer, a DOE witness, misrepresented the facts in

regard to what you referred to as asymmetrical rate treatment. Can you tell me, please, how specifically Mr. Dittmer, in your opinion, misrepresented facts?

A Well, my -- my reference there is to this idea that the company only wants -- it actually was Mr. Dittmer and Mr. Hyneman. Their position is that when there's costs involved, the company wants to recover them. When there's revenue involved, the company doesn't want to flow that back, similarly to how the costs are amortized. And my point is they are very different items. Revenue follows costs. Revenue matches costs. So if the costs are prudently incurred, they should be recovered. That's the difference between the revenue side and the cost side. ***If the costs had already been previously recovered from customers, then the revenue should certainly be flowed back to customers. So it's a matching principle***. (***emphasis added;*** Giles cross examination, Transcript V. 5, p. 171, L.4)

Accordingly, it is appropriate that ratepayers should receive a benefit from the Hawthorn 5 boiler explosion insurance subrogation proceeds that KCPL received in the 2006 test year by including as a credit to KCPL's cost of service the amortization of such proceeds over a five-year period.

Issue 3. a. If so, should the five year amortization period proposed by the staff be adopted?

RESPONSE: DOE/NNSA believes that a five year amortization period is fairer to the company than requiring KCPL to effectively repay ratepayers the full amount in just one year.

INCENTIVE COMPENSATION

<u>Issue 4 Long term Incentive Compensation.</u> 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?

Response: No, KCPL's and GPE's long-term incentive compensation tied exclusively to total shareholder return should not be an allowable expense included in KCPL's computation of its cost of service.

Argument:

Mr. Dittmer testified that incentive compensation plans tied primarily to promoting shareholder interests should not be included in cost of service stating:

> Incentive compensation tied primarily, if not exclusively, to achievement of earnings or returns to shareholders should not be included within the development of the cost of service underlying retail rates. Comparative earnings or returns to shareholders are not a criteria or element directly considered as a cost component in establishing electric utility rates. In and of itself, efforts to enhance earnings or returns may not be consistent with the interests of utility customers or reasonable pricing for the regulated business, where changes in the level of rate base assets and the cost of capital are more directly relevant to earnings achievable by the utility. Therefore, as a matter of regulatory policy, I believe it is unwise to encourage incentive compensation programs that are entirely or even primarily driven by earnings achievements or total return to shareholders vis-à-vis allowing recovery of such plan costs through regulated utility rates. "Superior," "above authorized," "exceeding peers," or "above targeted" earnings can sometimes be achieved or influenced by short term management decisions that, while temporarily boosting earnings, may not encourage the development of safe and reliable service at the lowest long term achievable costs.
>
> For instance, some maintenance may be deferred temporarily – thereby boosting earnings. But deferral of maintenance can lead to safety concerns or higher subsequent "catch-up" costs. Additionally, incentive compensation based on achievement of earnings can lead to exaggerated or aggressive rate filings which, under a best case scenario leads to extra audit and litigation work, and under a worst case scenario leads simply to unnecessarily high utility rates. (Dittmer direct, pages 7 and 8)

GPE's and KCPL's Long Term Compensation Plan is equity-based, consisting of performance share grants and time-based restricted shares. Compensation paid under GPE's/KCPL's Long-Term Compensation Plan is linked exclusively to GPE's achievement of total shareholder return ("TSR") relative to other peer companies. As such, Mr. Dittmer argues for total cost of service exclusion for all costs associated with the Long Term Compensation Plan.

The Commission has consistently disallowed incentive compensation where the goals were either ill-defined or tied primarily to shareholder wealth maximization. For example:

In the Matter of Union Electric Company, 29 Mo.P.S.C. (N.S.) 313, 325 (*Report & Order,* 1987):

> . . . an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan.

In the Matter of Southern Union Company, doing business as Missouri Gas Energy, 5 Mo.P.S.C.3d 437, 458 (*Report & Order,* 1997)

> The Commission finds that the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers.

In the Matter of Southern Union Company, doing business as Missouri Gas Energy, 12 Mo.P.S.C.3d 581, 606-7 (*Report & Order,* 2004):

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly

> benefits shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

And finally the Commission stated in its Report and Order in KCPL's first rate case under its Regulatory Plan, Case *ER-2006-0314* at page 58, where the same issue arose:

> As far as compensation tied to EPS, the Commission notes that KCPL management has the right to set such goals. However, because maximizing EPS could compromise service to ratepayers, such as by reducing customer service or tree-trimming costs, the ratepayers should not have to bear that expense. What is more, because KCPL is owned by Great Plains Energy, Inc., and because GPE has an unregulated asset, Strategic Energy L.L.C., it follows that KCPL could achieve a high EPS by ignoring its Missouri ratepayers in favor of devoting its resources to Strategic Energy.
>
> KCPL's attempt to state that Staff has no evidence to support its theory that maximizing EPS might not benefit KCPL shareholders misses the point; KCPL has the burden to prove that the Commission should approve the tariffs. Further, KCPL's argument that disallowing any of its incentive compensation costs would put it at a competitive disadvantage fails. KCPL management is free to offer whatever compensation packages it wants. Nevertheless, if the method KCPL chooses to compensate employees shows no tangible benefit to Missouri ratepayers, then those costs should be borne by shareholders, and not included in cost of service.

In summary, removal of all Long Term Compensation Plan costs –which are exclusively tied to achievement of shareholder return - from the test year cost of service is consistent with prior Missouri Public Service Commission rate decisions, including KCPL's last rate decision from Case No. ER-2006-0314.

<u>Issue 5. Short-term Incentive Compensation.</u> Should the costs of KCPL's and GPE's short-term incentive compensation plans be included in cost of service for setting KCPL's rates?

Response. The short-term incentive compensation related to earnings per share or based on discretionary criteria should not be included in cost of service.

Argument. Development of short-term incentive compensation to be included within KCPL's Missouri retail cost of service is more complex than long-term compensation in that GPE's/KCPL's short term compensation is not based exclusively upon achievement of earnings that benefit shareholder. Rather, GPE's'KCPL's annual short term incentive plans based in part upon achievement of earnings for shareholders, but also includes additional goals that are beneficial for ratepayers.

By way of background, there are several short term plans in effect for KCPL and GPE including the following:

- GPE's executive Annual Incentive Plan for senior management - a portion of which is allocated to KCPL (Dittmer Direct, Exhibit 801, p. 5, L 16).
- KCPL's executive Annual Incentive Plan for senior management (Dittmer Direct, Exhibit 801 p. 5, L 15 and p. 6, L 11).
- GPE's short term cash based incentive plan for non-union management, called ValueLink, a portion of which is allocated to KCPL (Dittmer Direct, Exhibit 801, p. 6, L 26).
- KCPL's short term cash based incentive plan for non-union management called ValueLink (Dittmer Direct, Exhibit 801, p. 6, L 26).
- Rewards Plan, a cash based incentive compensation plan for union employees (Dittmer Direct, Exhibit 801, p. 7, L 4).

GPE's and KCPL's executive Annual Incentive Plans are linked in varying degrees to earnings per share, company performance, and customer satisfaction. Additionally, a portion of GPE's and KCPL's executive Annual Incentive Plans are purely "discretionary" in nature, with no linkage to achievement of specific goals.. Mr. Dittmer eliminated the portion of the plans related to earnings per share for the exact same reasons stated in the section on long-term compensation above. Disallowance of the earnings-driven-portions of GPE's/KCPL's executive Annual Incentive Plans is completely consistent with this Commission's previous decisions on the issue of incentive compensation. Further, Mr. Dittmer proposed to eliminate the discretionary compensation elements of GPE's/KCPL's annual incentive compensation plan from cost of service because such compensation is not tied to specific goals and therefore it is not possible to relate them to ratepayer benefits (Dittmer Direct, Exhibit 801, p. 11, L5).

As shown in the Reconciliation filed by the MPSC Staff on September 28, 2007, KCPL's Missouri retail jurisdictional cost of service should be reduced by $677,327 to eliminate that portion of GPE's and KCPL's Annual Incentive Compensation for senior management that is tied to achievement of earnings or which is distributed purely in a discretionary manner.

CLASS COST OF SERVICE / RATE DESIGN

Issue 21. Does the Stipulation & Agreement incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO-2006-0329 permit non-signatories to it to propose, signatories to it to agree to, and the Commission to adopt, further interclass revenue reaqllocation(s) in this or the next KCPL rate proceeding?

RESPONSE: Yes

Issue 21.a. If so, should the Commission adopt any further interclass revenue reallocaton(s) in this or the following KCPL rate proceeding?

RESPONSE: Yes

ARGUMENT

Re GE Capital-ResCom, L.P.Missouri Public Service Commission Case No. TA-95-125 stated that "[t]he Commission is not bound by precedent or collateral estoppel and, indeed, can revise the guidelines as the technology and the public interest evolves. See, State ex rel. GTE North v. Missouri Public Service Commission, 835 S.W.2d 356, 371 (1992).

State ex rel. GTE North v. Missouri Public Service Commission , 835 S.W.2d 356, 371 (1992) stated: "An administrative agency is not bound by *stare decisis. State ex rel. Churchill Truck Lines, Inc. v. Public Serv. Comm'n,* 734 S.W.2d 586 (Mo.App.1987). 'Courts are not concerned with alleged inconsistency between current and prior decisions of an administrative agency so long as the action taken is not otherwise arbitrary or unreasonable.' *Columbia v. Missouri State Bd. of Mediation,* 605 S.W.2d 192, 195 (Mo.App.1980). It is the impact of the rate order which counts; the methodology is not significant. *State ex rel. Arkansas Power & Light Co. v. Public Serv. Comm'n,* 736 S.W.2d 457 (Mo.App.1987)."

I - KCPL RATEPAYERS DO NOT PAY WHAT IT REALLY COSTS TO SERVE THEM

(a) All of the Parties Except OPC Agree That Rates Do Not Reflect Cost of Service

Kansas City Power & Light Company's (KCPL or the Company) rates markedly fail to reflect, and thus fail to collect, the costs of serving the customers who pay them. All of the credible 2006 cost of service studies demonstrate this. Staff states that ratepayers in all three General Service classes pay rates that exceed, and Residential ratepayers pay rates that are far less than, the cost of serving them. (Pyatte Rebuttal, p. 5) Larger users presently pay rates that include KCPL expenses that are not properly ascribed to the cost of serving them.

Staff describes these discrepancies as “obvious misalignments between class revenues and class cost of service." (T-683) The Company agrees that these misalignments continue to exist. (T-699) Staff adds that the misalignments "haven’t gone away since the last KCPL rate case.” (T-683) No party save the Office of Public Counsel (OPC) denies that these misalignments exist. (T-824) Even OPC, in cross-examination, retreated from denying this, asserting only that it is "not entirely clear” that the misalignments exist. (T-828)

(b) The Misaligned Rates Produce Unequal Rates of Returns Among the Classes

When a ratepayer class pays less than it costs the Company to serve that class - that is, provides the Company with less revenue than what the Company expends in order to serve that class - the rate of return that the Company earns on its service to that class is less than 1.0. Similarly, when a ratepayer class pays *more* than it costs the Company to serve that class - that is, provides the Company with *more* revenue than what the Company expends in order to serve that class - the rate of return that the Company earns on its service to that class is more than 1.0. The Company earns unequal rates of return from classes so situated.

DOE witness Gary Price updated the Company's 2006 COS study. His work confirmed and reiterated that:

(1) discrepancies in relative revenue contribution, and thus relative rate of return, among the classes are extremely wide;

(2) rates of return of all of the rate classes except lighting are far higher than that of that of the residential class;

(3) the residential class currently pays rates that contribute less than 67% to the system average rate of return, while other classes contribute 1.11 to 1.51 times that system average. (Price Direct (DOE Exh. 804), p. 6 *et seq.*)

II - RATES THAT ARE NOT BASED ON COST HARM EVERYONE

An electric utility rate should be based as nearly as possible on, and collect, the costs that the supplying electric utility incurs in providing the service or services to the particular ratepayer class that is being served. No party questions this most basic of utility ratemaking principles. (T-698, 823) The ongoing and deleterious effects of rates which violate this principle are well-known. Such rates enable and *impel* the user to purchase and consume electricity at a price that is less than what it costs the supplier to produce and supply that electricity. These incorrect price signals render residential customers less motivated to modulate heating and air conditioning, and less likely to buy energy-saving devices.

Large user rates that are set significantly above cost are similarly deleterious. Large users are close and apt students of their electric rates, and of the manner in which those rates are made. A large user that is contemplating building new facilities or expanding existing facilities carefully examines the electric rates that it will pay if it chooses to do so. It is inevitably discouraged from so doing if it discovers that it will pay rates that are higher than, and made without due consideration of, cost of service. This deprives the community of the economic benefits that such enhanced activities would confer.

Moreover, large users know that, when non-cost-based rates force them to pay costs that are rightly ascribed to other ratepayer classes, they are being forced to *subsidize* those ratepayer classes. In the eyes of such ratepayers, the resultant *interclass subsidies* are very real. Fine-spun arguments about academic and hyper-technical definitions that economists or philosophers give to the words "subsidy" or "subsidize" (T-699, 830) cannot gainsay this.

<u>III - FURTHER INTERCLASS REVENUE REALLOCATION IS NECESARY</u>

For these reasons, the Commission must, however gradually and incompletely, mitigate the non-cost-based rates that underlie the problem. This can be done only by gradual reallocation of revenues among the ratepayer classes.

Recognizing this, the Commission began to reallocate revenues among the ratepayer classes in the 2006 rate proceeding. Further reallocation is necessary now. As Staff stated:

> Explicit action by the Commission is *necessary* to eliminate these misalignments.   They won't go away on their own…" (T-684) (emphasis added)

Staff further stated that the 2006 COS studies show that residential rates should be increased by at least 5.18% to meet this problem. (Watkins Surrebuttal, pp. 3-4)

<u>IV – ONLY OPC ACTIVELY OPPOSES FURTHER REVENUE REALLOCATION</u>

(a) OPC's Reasons For Opposing Further Revenue Reallocation Are Unpersuasive

Only OPC asserts that there is no need for further interclass revenue reallocation to ameliorate the interclass subsidies. (T-839) OPC's assertion is premised upon its belief that the interclass subsidies simply do not exist. This, in turn, is premised upon one and only one cost of service study, which was prepared by OPC itself. Staff Witness Pyatte greatly if not wholly undermined that study's credibility by pointing out that it did not input the costs and class definitions that are specified in the KCPL Regulatory Plan, to which OPC is a party. (Paytte surrebuttal, p.5) That study is so far out of line with all of the others that it does not provide a valid basis for a Commission finding that the interclass subsidies do not exist.

OPC further argues that any further interclass revenue reallocation is unacceptable because it would necessitate a residential rate increase. OPC asserts that no such increase, however measured and gradual, can be tolerated, because the residentials received a rate increase in 2006. (Meisenheimer rebuttal, p. 4) In support of this contention, OPC proffers a greatly overstated the size and proportion of the 2006 increase. Indeed, it asserts that the 2006 increase was so large that any increase in the current proceeding might subject the residential class to "rate shock." (T-913, 914) Staff Witnesses demonstrated persuasively that OPC had greatly exaggerated the 2006 increase. (Pyatte Surrebuttal, p. 7) Staff and the Company agreed that the 2006 residential rate increase was only slightly higher than the increases that were given to other classes, and that the interclass revenue reallocation was actually just 2%. (Watkins Surrebuttal, p. 4; T-678)

OPC's final reason for opposing further revenue reallocation is based on a 2006 Stipulation and Agreement (Agreement) to which it is a party. It asserts that the Agreement bars *any* change in rate structure in this proceeding and the next, including any change in interclass revenue allocation. The language of that Agreement upon which OPC bases its assertion reads in its entirety as follows:

> ...the Signatory Parties agree not to file new or updated class cost of service studies or to propose changes in rate structure… (Agreement, Sec. 3.b.(iv) p. 35)

DOE respectfully summits that this language consists of two and only two specific and narrow prohibitions, that apply only to the parties to the Agreement:

(1) it prohibits those parties from *filing* any cost of service study; and,

(2) it prohibits those parties from *proposing* any change to rate structure.

Beyond these prohibitions, which bind only the parties, this language says nothing at all. It clearly does not:

(1) prohibit the parties from *supporting,* or agreeing to, or simply *not opposing,* any change in rate structure that is proposed by an entity that is not a party to the Agreement;

(2) prohibit the Commission from adopting any change in rate structure that is proposed by an entity that is not a party to the Agreement.

OPC asserts that, if a party to the Agreement supports, or merely agrees to or does not oppose, a proposed change in rate structure, that party, by so doing, itself becomes a *proponent* of that change. This, OPC argues, violates the

Agreement's prohibition against a party *proposing* a change in rate structure. (T-842)

This assertion ignores the manifest distinction between an entity that *proposes* an idea, and one that merely is acquiescent to that same idea, or an entity that does not address that idea at all. The Company disagrees with OPC. It testified that the Agreement does not prohibit changes in rate structure that are proposed by non-signatory parties, and that the parties that signed the Agreement must address proposals that are made by non-parties. (T-726,728, 729)

Only OPC reads the Agreement as barring parties to it from supporting, and the Commission from adopting, changes in rate structure.

(b) The Company Does Not Seriously Oppose Further Revenue Reallocation

The Company proposes no changes in rate structure or rate design. It explains that it is prohibited from doing so because it is a party to above-discussed Agreement. It does not assert that the Agreement prohibits parties to it from accepting, or the Commission from adopting, rate structure changes that are proposed by non-parties to it. (Rush Direct, p. 3 *et seq.*;T-728, 729) OPC is alone it these views.

The Company also avers to the Commission's small 2006 interclass revenue reallocation in its discussion of whether there should be changes in rate structure or rate design. It does not, however, seriously suggest that that so small a reallocation is sufficient reason to refrain from some gradual further interclass revenue reallocation in this proceeding. In sum, KCPL states no serious opposition to further interclass revenue reallocation.

V - FURTHER REVENUE REALLOCATION IS BEST BEGUN NOW

(a) Iatan 2 Will Soon Necessitate a Significant Residential Rate Increase

KCPL is in the process of constructing Iatan 2, a very large coal plant that is expected to be completed in 2010, just a little over two years from now. When that happens, approximately $500 million will be added to rate base all at one time. (T-705) Staff believes (T-966) that that huge addition will inevitably, and wholly apart from anything else that may or may not be done, necessitate a very significant residential rate increase.

Iatan 2 will also cause the extant subsidies from large user classes to residentials to become proportionately greater. The demand allocator (of fixed costs) for residentials is presently about 36% while the energy allocator (of variable costs) is only about 30%. Most of Iatan 2's cost will be attributable to fixed costs/plant. It will, therefore, be allocated to residentials as per the 36% demand allocator rather than the 30% energy allocator. This will make the residential class's overall proportionate share of rate base significantly greater. Obviously, this will make the necessary Iatan 2-related residential rate increase even larger. Staff acknowledges this. (see Watkins Surrebuttal, p. 3)

Under the operant plan, the 2010 rate proceeding is to be the fourth and final KCPL rate proceeding for the foreseeable future. Thus, the residential class will have to be given a very significant rate increase in the fourth and last proceeding, even if the Commission does nothing in that proceeding to further reallocate interclass revenues. The 2010 residential rate increase is bound to render the Commission less willing to further reallocate interclass revenues in the 2010 proceeding, because such further reallocation would exacerbate that increase. Staff Witness Watkins stated candidly that what "likely" will happen "in the case in which Iatan 2 comes on line is probably a focus on the cost of Iatan 2, (and) less focus on interclass revenue shifts…" (T-967) Thus, the Commission must not wait until Iatan 2 enters rate base in the 2010 proceeding to further reallocate interclass revenues. If it does, it will have to impose, in 2010, a punishing "one shot" 2010 residential rate increase that is based on the fiscally lethal combination of:

(1) addition of Iatan 2 to rate base;

(2) that addition to rate base being proportionately more attributable to the residential class than the earlier-existing portion of rate base;

(3) further reallocation of revenues to the residential class to lessen the interclass subsidies.

In sum, it would be most inopportune for all, including the residential class, for the Commission to wait until the fourth and final rate proceeding to further reallocate revenues. To prevent severe "rate shock" in 2010, reallocation is best begun now.

<u>(b) Staff Wants Further Interclass Revenue Reallocation in this Proceeding</u>

Staff favors further interclass revenue reallocation in this proceeding. It stated that, " …class revenue adjustments are required *at this time*…

Watkins Surrebuttal, p. 4 (emphasis added)

Staff Counsel added that:

> Explicit action by the Commission is *necessary* to eliminate these misalignments. They won't go away on their own, and an equal percentage increase won't touch them either. (T-684) (emphasis added)

Staff is receptive to various approaches to the problem. It stated that it:

> …supports to some extent, or does not oppose, all of the class cost-of-service/rate design proposals presented in direct testimony, if the Staff's proposed modifications are adopted in implementing those proposals. (Watkins Rebuttal, p. 8)

Staff also encouraged the Commission to be similarly receptive. It told the Commission:

> Staff invites you to consider *this case* to be an opportunity address (interclass revenue) discrepancies and take a step towards a scenario where the rates that each class pays are closer to that class's fair share of the costs. (T-684) (emphasis added)

Thus, Staff told the Commission that the interclass revenue inequities certainly exist, that the time to address them is now, and that the Commission should be receptive to all reasonable proposals for addressing them. The question is not *whether* or *when* the Commission should further reallocate interclass revenues. The question is *how* it shall do so.

In line with this, Staff itself proposes a step toward revenue reallocation. It would increase the residential class's revenue responsibility by about 1.8% and reduce Medium General Service (MGS) class by about 5%. This would shift about $3.5 million from the MGS class to the Residential class. (Watkins direct p. 2) This proposal is worthy of the Commission's attention. It is driven by Staff's strongly held view that the Commission should further reallocate revenues among the rate classes now. However, Staff Witness Watkins asserted that the

Staff proposal is based on "a consensus of…all the parties' class cost of service studies that were presented in the (2006) rate case..." (Watkins rebuttal, p, 3-4) Cross-examination revealed that, in averring to such a "consensus," Mr. Watkins meant only that "…everybody's (cost of service) study showed that residential rates should be increased at least that much." (T-975) Moreover, the proposal's dollar level adjustment is based on cost of service date that does not reflect the reality of the 2007 rate year. (Price Rebuttal, p. 6) Finally, the proposal mildly adjusts only one service class, but offers no relief of any sort to all of the others. (Price Rebuttal, p. 6) DOE respectfully submits that Staff's proposal, while it would be one very small step in the right direction, does not go far enough.

(c) The Company Wants to Postpone Further Interclass Revenue Reallocation

The Company proposes an equal percentage increase, with no changes at all in rate structure or rate design, in this and in the next proceeding. (Rush Direct, p. 4) It acknowledges that it will not in either of those cases propose to further reallocate interclass revenues. (T-703) It says that it will "use the (2010) Iatan 2 (rate) case as a basis for a rate design case," (T-710,711) or address the subject in a "spin-off" from that 2010 case. (T-711) The Company does not dispute the existence of the subsidies or contend that they are not harmful or that they need not be addressed. It says only that it wants to wait. This is understandable. Any interclass revenue reallocation would be a nuisance for the Company to administer, and perhaps offer it no direct or immediate benefit. As DOE Witness Price observed, the Company is addressing its own revenue needs, and is not concerned about which customer class or classes fulfill them. (Price Direct, p. 8)

(d) OPC Seeks to Avoid Further Interclass Revenue Reallocation by Persuading the Commission that the Situation That Necessitates Further Reallocation Does Not Exist

OPC asks for an across the board increase with no further interclass revenue reallocations in this case or the next. It justifies this by denying the trenchant facts that drive the need to start further interclass revenue reallocation now.

OPC begins with the spurious assertion that there is an appreciable possibility that Iatan 2 will never be placed in service. (Trippensee rebuttal, p. 6) Upon cross-examination, however, it conceded that there is "a very low probability"that Iatan 2 will not ever find its way into rate base. (T-941) It went on to argued, that, when Iatan 2 does enter rate base, it may not necessitate a significant residential rate increase. (T-837, 838) OPC adverted vaguely to possible future changes in usage or in off-system sales, and to "a host of other factors" that cannot now be known or measured. It said that these may somehow cause Iatan 2 to be ascribed to users other than residentials. It argued that these nebulous possibilities bar the Commission from taking any action that is premised upon the completion of Iatan 2, just two years from now. (Trippensee Rebuttal, p. 6) OPC even asserted that the roughly five hundred million dollars that Iatan 2 will likely add to rate base, and the inevitable effects that that will have upon rates, "…*has got nothing to do with* what we are here to talk about…" (T-708, emphasis added)

Thus, OPC wants the Commission to ignore reality. Its recommendation that there be no further interclass revenue reallocation is based on:

(1) the premise that Iatan 2 may never come on line;

(2) the premise that Iatan 2's coming on line may not necessitate a residential rate increase;

(3) the assertion that, because the Commission cannot at this time know the precise final cost of Iatan 2, or exactly how that cost will be allocated among jurisdictions and rate classes, the Commission cannot at this time do *anything at all* in anticipation of the obvious, inevitable, and fast-approaching effects of Iatan 2 upon ratepayers.

DOE respectfully contends that, if the Commission does not accept all of this, it should consider the likely future rate impacts of Iatan 2 when it decides whether and how much further interclass revenue reallocation shall be implemented in this proceeding.

VI – DOE'S PLAN MAKES FURTHER REALLOCATION PRACTICAL NOW

(a) DOE's Plan Allows Gradual Reductions of the Subsidies to Begin Now

As is so often the case, action which is *necessary* will proceed most easily and yield the best result if it is begun at once and carried out gradually. Thus, a plan that continues the process of reallocation of interclass revenues that was begun in 2006, to ameliorate the interclass subsidies, and moves in small steps toward that end, would be best.

DOE respectfully offers such a plan. The Commission reallocated interclass revenues slightly in the 2006 proceeding, by shifting the residential class's relative rate of return by about 5%, so that its deviation from unity in rate of return became 11.3% instead of 16.3%. (Price rebuttal (DOE Exh. 805) p. 5) Building on this, DOE witness Gary Price updated the Company's 2006 COS study. He then used the update as the basis of a plan under which the Commission can adopt a series of small interclass revenue reallocations, toward equalizing the classes' comparative rates of return gradually, over this proceeding and the two which are to follow. Mr. Price sets out the proposed percentage increases, and the dollar effects upon each of the rate classes, of each of the proposed increments. (Price direct p. 9 - 11)

(b) - DOE's Plan Burdens the Residentials Only Minimally

DOE's plan contemplates an increase of just 2%, or $1.38 per month, for residential ratepayers. (Average monthly base or present rate revenue per KCPL customer is $69.20. ($195,787,156 (Base Revenue)/235,785 (Avg. customers) /12 months = $69.20/month). (Company's original application, pdf. page 61 of 67) Multiplying the monthly average cost of $69.20/Month by 2% equals an increase of only about $1.38/Month per residential customer.)

DOE's plan contemplates an increase of just 3.76%, or $2.60 per month, for an average residential ratepayer. (Price Direct, p. 11, Table 3, Column (f)) (The average monthly base or present rate revenue per KCPL customer is $69.20. ($195,787,156 (Base Revenue)/235,785 (Avg. customers)/12 months = $69.20/month). (see Company's original application, at pdf. page 61 of 67)

Multiplying the monthly average cost of $69.20/Month by 3.76% = about $2.60/month.)

<u>(c) The Commission Need Not Adhere Exactly to DOE's Plan. It Can Use the Plan as a Basis for Further Revenue Reallocation at a Pace,and in Gradual Steps, That It Chooses</u>

Staff stated that the Commission can adapt DOE’s plan to craft such gradual steps in the process of further revenue reallocation as the Commission deems best. The Commission can order a series of further interclass reallocations that go well into the future, so that they can be gradual and have less impact on residential ratepayers. As Mr. Watkins stated, the Commission can apply DOE's reallocation targets in this one case alone, and/or in one or both of the upcoming cases as well. (T-977) The Commission can also design lesser or greater targets, to be applied in this proceeding and/or at various future junctures. As Mr. Watkins explained, the Commission can order interclass revenue shifts in the right direction, without affecting a one hundred percent shift. (T-979) The Commission’s chosen steps need not be those which either Staff or DOE recommends. The important thing, DOE submits, is to acknowledge that the Commission must not wait until, or beyond, the 2010 proceeding to address the problem. The important thing is to begin now.

<u>(d) The Commission Can Implement the DOE Plan Without Further COS Studies</u>

Staff states, and no one except OPC denies, that residential rates are too low, and that general service rates are too high, relative to the cost of serving those classes. Staff states that "(w)*e don’t need new or updated studies to see this.”* (T-684 (emphasis added)) Thus, the Commission need not measure or re-measure the problem now. Staff also states that the Commission does not need to determine the cost of service for each class, in order to make further revenue reallocations among the classes. (T-979) All of the discussion in this case as to which of the studies is best is irrelevant for this present endeavor, because it does not matter which COS study the Commission uses. (Pyatte Surrebuttal, p. 4-6) All of the studies demonstrate the existence of the interclass subsidies. Any one or combination of the studies, or any new study that the Commission orders, can serve as a sound basis for further interclass revenue reallocation. The Commission does not need to know exactly how many dollars must be reallocated in order ultimately to remove the subsidies and attain unity of return among the classes. It need only begin with relatively small moves in the direction of alleviating those subsidies, and moving toward that unity.

VII - CONCLUSION

DOE respectfully asserts that the presently-existing non-cost-based rates and the resultant interclass subsidies cause small and large users alike to behave in ways that are deleterious to both their own individual interests and those of the commonweal. This can be alleviated only by further interclass revenue reallocation. Prudence compels the Commission to further address this problem now, with a plan to move in gradual and palatable steps toward further reallocation of interclass revenues. This will enable it eventually to remove or greatly alleviate the class's unequal returns, and the very damaging interclass subsidies which those unequal returns underlie. DOE respectfully recommends that this be done by at least beginning with the plan which it proposes.

The interclass subsidies exist and they will not go away. If they are left unattended until the fourth rate case in 2010, the results will be very burdensome for all, including the residential ratepayers and the Company itself. If the process of attending to them begins now, it can be accomplished with minimal burden to all, including residential ratepayers. DOE urges the Commission to begin to address this very serious problem now, in this proceeding.