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**

REPORT AND ORDER

Issue Date: **December 6, 2007**

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REPORT AND ORDER

APPEARANCES

James M. Fischer and Larry W. Dority, Esq, Fischer & Dority, P.C., 101 Madison Street, Suite 400, Jefferson City, Missouri 65101, for Kansas City Power & Light Company.

Karl Zobrist and Roger W. Steiner, Esq., Sonnenschein Nath & Rosenthal, LLP, 4520 Main Street, Suite 1100, Kansas City, Missouri, 64111, for Kansas City Power & Light Company.

William G. Riggins, Esq., General Counsel, and **Curtis Blanc, Esq.**, Managing Attorney – Regulatory,1201 Walnut, Kansas City, Missouri, 64141, for Kansas City Power & Light Company.

Diana C. Carter, Esq., Brydon, Swearengen & England, P.C., 312 East Capitol Avenue, Post Office Box 456, Jefferson City, Missouri, 65102, for Missouri Gas Energy, a Division of Southern Union Company, The Empire District Electric Company, and Aquila, Inc.

Mark W. Comley, Esq., Newman, Comley & Ruth, P.C., 601 Monroe Street, Suite 301, Post Office Box 537, Jefferson City, Missouri 65102-0537, for the City of Kansas City, Missouri.

Stuart W. Conrad, Esq. and David L. Woodsmall, Esq., Finnegan Conrad & Peterson, L.C., 1209 Penntower Building, 3100 Broadway, Suite 1209, Kansas City, Missouri 64111, for Praxair, Inc.

Jeremiah D. Finnegan, Esq., Finnegan Conrad & Peterson, L.C., 1209 Penntower Building, 3100 Broadway, Suite 1209, Kansas City, Missouri 64111, for Pershing Road Development Company.

Diana M. Vuylsteke, Esq., Bryan Cave, LLP, 211 North Broadway, Suite 3600, St. Louis, Missouri 63102, for Missouri Industrial Energy Consumers and Ford Motor Company.

Arthur Perry Bruder and Lewis Campbell, Esq., United States Department of Energy, Office of General Counsel, 1000 Independence Avenue S.W., Washington, DC 20585, for the United States Department of Energy, on behalf of the National Nuclear Security Administration.

Shelley A. Woods, Esq., Assistant Attorney General, Office of the Attorney General, Post Office Box 899, Jefferson City, Missouri 65102-0899, for the Missouri Department of Natural Resources.

Jeffrey A. Keevil, Esq., Stewart & Keevil, L.L.C., 4603 John Garry Drive, Suite 11, Columbia, Missouri 65203, for Trigen-Kansas City Energy Corporation.

Lewis R. Mills, Jr., Esq., Public Counsel, Office of the Public Counsel, 200 Madison Street, Suite 650, Post Office Box 2230, Jefferson City, Missouri 65102, for the Office of the Public Counsel and the public.

Kevin A. Thompson, Esq., General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

Steven Dottheim, Esq., Deputy Chief General Counsel, **Nathan Williams, Esq.**, Deputy General Counsel, and **Sara Kliethermes, Esq.**, Assistant General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

SENIOR REGULATORY LAW JUDGE: Ronald D. Pridgin

Procedural History

On February 1, 2007, Kansas City Power & Light Company submitted to the Commission proposed tariff sheets, effective for service on and after January 1, 2008, that are intended to implement a general rate increase for electrical service provided in its Missouri service area.[1] KCPL's proposed tariffs would increase its Missouri jurisdictional revenues by approximately $45 million, or by 8.3%.[2] The Commission issued an Order and Notice on February 6, in which it gave interested parties until February 26 to request intervention.

The Commission received timely intervention requests from: Pershing Road Development Company; Missouri Gas Energy, a Division of Southern Union Company; and Trigen-Kansas City Energy Corporation. In addition, the Commission received untimely intervention requests from the United States Department of Energy, acting on behalf of the National Nuclear Security Administration, and the City of Kansas City, Missouri. The Commission granted these requests.

In addition, in Commission Case No. EO-2005-0329, KCPL had entered into a Stipulation and Agreement regarding an Experimental Regulatory Plan, which was the genesis for this rate case. A portion of that agreement provided that the non-KCPL signatories would automatically become intervenors in this rate case. The non-KCPL signatories to the Stipulation and Agreement in Case No. EO-2005-0329 that are intervenors in this case are: the Staff of the Commission; the Office of the Public Counsel;

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[1] Unless otherwise stated, all dates are in 2007.

[2] Staff and KCPL filed a True-Up Reconcilement/ Reconciliation on November 5, in which KCPL's trued-up revenue requirement was $47,318,855. However, at the true-up hearing, KCPL stated that it was not seeking recovery of the trued-up number, but of the approximately $45 million amount as filed in its direct case. *See* Tr. Vol. 15, p. 1287.

the Missouri Department of Natural Resources; Praxair, Inc.; Missouri Industrial Energy Consumers; Ford Motor Co.; Aquila, Inc.; The Empire District Electric Company; Missouri Joint Municipal Electric Utility Commission; and the City of Kansas City, Missouri.

Furthermore, part of the Commission's February 6 notice stated that in Case No. EO-2005-0329, the signatories to the stipulation in that case agreed that the test year for this case would be the historic test year period ending December 31, 2006, updated for known and measurable changes through June 30, with a true-up period through September 30, and KCPL filing a reconciliation in the true-up proceeding on or about October 21. At the parties' request, the Commission changed the end of the update period from June 30, to March 31. No parties objected to the remainder of the true-up dates, and the Commission adopted them. The Commission held local public hearings in Marshall and Carrollton on August 20 and in Kansas City on August 22, an evidentiary hearing on October 1-5 and 9-12, and a true-up hearing on November 8.

Non-Unanimous Stipulations and Agreements

On October 3, during the hearing, KCPL and Staff filed a Stipulation and Agreement as to Certain Issues. The stipulation resolved the rate base issues, and many of the expense issues. The Commission allowed parties until noon, October 9 to object. No parties objected. Therefore, as permitted by Commission Rule 4 CSR 240-2.115, the Commission will treat the stipulation, affixed to this Report and Order as Appendix A, as if it were unanimous. The Commission finds the above-referenced stipulation reasonable and approves it.

Also, on November 13, KCPL and Staff filed a Nonunanimous Stipulation and Agreement Regarding Pensions. Commission Rule 4 CSR 240-2.115(2)(B) allows parties seven days to object to a nonunanimous stipulation and agreement. No party objected; therefore, the Commission will treat the stipulation, affixed to this Report and Order as Appendix B, as if it were unanimous.

Conclusions of Law

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact and conclusions of law. The positions and arguments of all of the parties have been considered by the Commission in making this decision.

Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision. When making findings of fact based upon witness testimony, the Commission will assign the appropriate weight to the testimony of each witness based upon their qualifications, expertise and credibility with regard to the attested to subject matter.[3]

[3] Witness credibility is solely within the discretion of the Commission, who is free to believe all, some, or none of a witness' testimony. *State ex. rel. Missouri Gas Energy v. Public Service Comm'n*, 186 S.W.3d 376, 389 (Mo.App. 2005).

Conclusions of Law Regarding Jurisdiction

KCPL is an electric utility and a public utility subject to Commission jurisdiction.[4] The Commission has authority to regulate the rates KCPL may charge for electricity.[5]

The Staff of the Commission is represented by the Commission's General Counsel, an employee of the Commission authorized by statute to "represent and appear for the commission in all actions and proceedings involving this or any other law [involving the commission.]"[6] The Public Counsel is appointed by the Director of the Missouri Department of Economic Development and is authorized to "represent and protect the interests of the public in any proceeding before or appeal from the public service commission[.]"[7] The remaining parties include governmental entities, other electric utilities, and industrial and commercial consumers.

Burden of Proof

"At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the . . . electrical corporation . . . and the commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible."[8]

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[4] Section 386.020(15), (42) RSMo 2006 (all statutory cites to RSMo 2006 unless otherwise indicated).

[5] Section 393.140(11).

[6] Section 386.071.

[7] Sections 386.700 and 386.710.

[8] Section 393.150.2.

Ratemaking Standards and Practices

The Commission is vested with the state's police power to set "just and reasonable" rates for public utility services,[9] subject to judicial review of the question of reasonableness.[10] A "just and reasonable" rate is one that is fair to both the utility and its customers;[11] 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."[12] In 1925, the Missouri Supreme Court stated:[13]

> The enactment of the Public Service Act marked a new era in the history of public utilities. Its purpose is to require the general public not only to pay rates which will keep public utility plants in proper repair for effective public service, but further to insure to the investors a reasonable return upon funds invested. The police power of the state demands as much. We can never have efficient service, unless there is a reasonable guaranty of fair returns for capital invested. * * * These instrumentalities are a part of the very life blood of the state, and of its people, and a fair administration of the act is mandatory. When we say "fair," we mean fair to the public, and fair to the investors.

The Commission's guiding purpose in setting rates is to protect the consumer against the natural monopoly of the public utility, generally the sole provider of a public necessity.[14] "[T]he dominant thought and purpose of the policy is the protection of the

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[9] Section 393.130, in pertinent part, requires a utility's charges to be "just and reasonable" and not in excess of charges allowed by law or by order of the commission. Section 393.140 authorizes the Commission to determine "just and reasonable" rates.

[10] *St. ex rel. City of Harrisonville v. Pub. Serv. Comm'n of Missouri*, 291 Mo. 432, 236 S.W. 852 (Mo. banc. 1922); *City of Fulton v. Pub. Serv. Comm'n*, 275 Mo. 67, 204 S.W. 386 (Mo. banc. 1918), *error dis'd,* 251 U.S. 546, 40 S.Ct. 342, 64 L.Ed. 408; *City of St. Louis v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 509, 207 S.W. 799 (1919); *Kansas City v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 539, 210 S.W. 381 (1919), *error dis'd,* 250 U.S. 652, 40 S.Ct. 54, 63 L.Ed. 1190; *Lightfoot v. City of Springfield*, 361 Mo. 659, 236 S.W.2d 348 (1951).

[11] *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n*, 515 S.W.2d 845 (Mo. App. 1974).

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

[13] *Id.*

[14] *May Dep't Stores Co. v. Union Elec. Light & Power Co*., 341 Mo. 299, 107 S.W.2d 41, 48 (Mo. App. 1937).

public . . [and] the protection given the utility is merely incidental."[15] However, the Commission must also afford the utility an opportunity to recover a reasonable return on the assets it has devoted to the public service.[16] "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."[17]

The Commission has exclusive jurisdiction to establish public utility rates,[18] and the rates it sets have the force and effect of law.[19] A public utility has no right to fix its own rates and cannot charge or collect rates that have not been approved by the Commission;[20] neither can a public utility change its rates without first seeking authority from the Commission.[21] A public utility may submit rate schedules or "tariffs," and thereby suggest to the Commission rates and classifications which it believes are just and reasonable, but the final decision is the Commission's.[22] Thus, "[r]atemaking is a balancing process."[23]

Ratemaking involves two successive processes: first, 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

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[15] *St. ex rel. Crown Coach Co. v. Pub. Serv. Comm'n*, 179 S.W.2d 123, 126 (1944).

[16] *St. ex rel. Utility Consumers Council, Inc. v. Pub. Serv. Comm'n*, 585 S.W.2d 41, 49 (Mo. banc 1979).

[17] *St. ex rel. Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882, 886 (Mo. App. 1981).

[18] *May Dep't Stores*, *supra,*107 S.W.2d at 57.

[19] *Utility Consumers Council*, *supra*, 585 S.W.2d at 49.

[20] *Id.*

[21] *Deaconess Manor Ass'n v. Pub. Serv. Comm'n*, 994 S.W.2d 602, 610 (Mo. App. 1999).

[22] *May Dep't Stores*, *supra,*107 S.W.2d at 50.

[23] *St. ex rel. Union Elec. Co. v. Pub. Serv. Comm'n*, 765 S.W.2d 618, 622 (Mo. App. 1988).

investors.[24] The second process is rate design, that is, the construction of tariffs that will collect the necessary revenue requirement from the ratepayers. Revenue requirement is usually established based upon a historical test year that focuses on four factors:[25] (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. The calculation of revenue requirement from these four factors is expressed in the following formula:

$$RR = C + (V - D)\,R$$

where:	RR	=	Revenue Requirement;
	C	=	Prudent Operating Costs, including Depreciation Expense and Taxes;
	V	=	Gross Value of Utility Plant in Service;
	D	=	Accumulated Depreciation; and
	R	=	Overall Rate of Return or Weighted Cost of Capital.

The return on the rate base is calculated by applying a rate of return, that is, the weighted cost of capital, to the original cost of the assets dedicated to public service less accumulated depreciation.[26] The Public Service Commission Act vests the Commission with the necessary authority to perform these functions. The Commission can prescribe uniform methods of accounting for utilities, and can examine a utility's books and records and, after hearing, can determine the accounting treatment of any particular transaction.[27]

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[24] *St. ex rel. Capital City Water Co. v. Missouri Pub. Serv. Comm'n*, 850 S.W.2d 903, 916 n. 1 (Mo. App. 1993).

[25] In the present case, the test year was established as the twelve months ending December 31, 2006, updated for known and measurable changes through March 31, 2007. *See In re KCPL,* Case No. ER-2007-0291, *Order Concerning Test Year and True-up, and Adopting Procedural Schedule* (April 5, 2007).

[26] *See St. ex rel. Union Elec. Co.*, 765 S.W.2d at 622.

[27] Section 393.140.

In this way, the Commission can determine the utility's prudent operating costs. The Commission can value the property of electric utilities operating in Missouri that is used and useful to determine the rate base.[28] Finally, the Commission can set depreciation rates and adjust a utility's depreciation reserve from time-to-time as may be necessary.[29]

The Revenue Requirement is the sum of two components: first, the utility's prudent operating expenses, and second, an amount calculated by multiplying the value of the utility's depreciated assets by a rate of return. For any utility, its fair rate of return is simply its composite cost of capital. The composite cost of capital is the sum of the weighted cost of each component of the utility's capital structure. The weighted cost of each capital component is calculated by multiplying its cost by a percentage expressing its proportion in the capital structure. Where possible, the cost used is the "embedded" or historical cost; however, in the case of Common Equity, the cost used is its estimated cost.

The Issues

On September 21, Staff submitted a list of issues for determination by the Commission. Commission Rule 4 CSR 240-2.080(15) allows parties ten days to respond to pleadings. No party timely objected to Staff's list.

Also, on November 9, the Commission ordered the parties to tell the Commission whether they believe the Commission should rule upon any other issue other than the ones

[28] Section 393.230. Section 393.135 expressly prohibits the inclusion in electric rates of costs pertaining to property that is not "used and useful."

[29] Section 393.240.

listed in the September 21 List of Issues. The November 15 deadline to respond to the November 9 order passed, and no parties responded.

Therefore, the only issues pending in this case are resolved below.

Rate of Return

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

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

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

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

Cost of Common Equity:

Discussion

Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return. The cost of long-term debt and the cost of preferred stock are relatively easy to determine because their rate of return is specified within the instruments that create them. In contrast, determining a return on equity requires speculation about the desires and requirements of investors when they choose to invest their money in KCPL rather than elsewhere.

For additional guidance on exactly where the Commission should set KCPL's return on equity, the Commission must turn to the expert advice offered by financial analysts. This "is an area of ratemaking in which agencies welcome expert testimony and yet must often make difficult choices between conflicting testimony."[30]

KCPL, Staff, and OPC sponsored financial analysts who recommended a return on equity in this case. Their recommended ROEs are: KCPL – 11.25%, OPC – 10.1%; Staff – 9.14-10.3%, the median of which is 9.72%. The recommended ROEs all fall into a "zone of reasonableness" described further in the Conclusions of Law, so the Commission cannot immediately exclude any of these recommendations for a lack of reasonableness.

The Commission does not believe it would be necessarily be appropriate for its return on equity finding to simply mirror the national average. That average, of course, could be appropriate for KCPL, or for any other utility. But, if all commissions just approved average ROEs, then returns on equity would not change, and commission approved ROEs would merely cluster around each other despite changing economic conditions and different companies' management styles.

The circularity of such behavior should be apparent. Nonetheless, the national average is a good indicator of the capital market in which KCPL will have to compete for the equity needed to finance its operations. The Commission has an obligation under the law, as well as a matter of practical necessity, to allow KCPL an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefits if KCPL is starved for capital, especially while KCPL is investing hundreds of millions of dollars in infrastructure to implement the Experimental Regulatory Plan.

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[30] L.S. Goodman, 1 The Process of Ratemaking, 606 (1998).

To further put these recommendations in perspective, the Commission notes that in the first six months of 2007, the lowest electric ROE awarded was 9.67%, and the highest was 10.9%.[31] When compared to other nationwide electric ROEs awarded the first half of 2007, if the Commission adopted Staff's median ROE of 9.72%, KCPL's ROE would be the second lowest in the nation, only five basis points away from the bottom. On the other hand, if the Commission picked KCPL's recommendation, then KCPL would earn the highest ROE in the United States by over 30 basis points. Finally, using OPC's recommendation, KCPL's ROE would be somewhat below average; of the 18 reported ROEs the first half of 2007, 14 of them, including Missouri regulated AmerenUE and Aquila, were at or above the 10.1% recommended by OPC.[32] The evidence further suggests that vertically integrated utilities like KCPL tend to receive higher ROEs, and that distribution companies operating in some form of restructured environment are less risky.[33]

Economists employ a variety of methods to try to ascertain a proper return on equity. The comparable earnings method is one way to do so. That method reviews accounting returns for unregulated companies that are believed to have similar risk to the regulated company whose return is being estimated. But this method is generally not favored, since it assumes the unregulated companies are earning actual cost of capital, and that its equity book value and market book value are the same.[34]

The Capital Asset Pricing Model (CAPM) is a risk premium approach that estimates the cost of equity by combining a virtually risk-free government bond rate with explicit risk

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[31] Ex. 121, p. 4.

[32] *Id.*

[33] Tr. Vol. 6, pp. 244-45.

[34] Ex. 11, p. 15.

measures to determine the risk premium that the market requires. This model is not used in many regulatory jurisdictions because of the additional data requirements and potentially questionable underlying assumptions.[35] Because analysts cannot actually know investor expectations, it is not possible to know how those expectations or formed, or to know what time period is most appropriate in the analysis.[36] Such a risk premium model, though, is a useful parallel approach with the Discounted Cash Flow (DCF) model as a check on reasonableness of the ROE estimation.[37]

The DCF model is the most widely used ROE estimation model, and is essentially the sum of the expected dividend yield and the expected long-term dividend growth rate. But because the technical application of the model requires long-term growth estimates out to infinity, some see the model as too speculative. Thus, a multistage growth DCF model is often used to minimize the speculative aspects of the model.[38] A multistage model is simply expanded to incorporate more than one growth period rate.[39]

A combination of the DCF model and a risk premium model gives the most accurate estimate of investors' expectations, and will be used to analyze return on equity in this case.[40] Indeed, OPC witness Gorman also used a recommended return on equity based on a constant growth DCF, a two-stage growth DCF model, a Risk Premium model and a CAPM analysis.[41] Staff witness Barnes used DCF as his primary tool, with CAPM used as

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[35] *Id.*

[36] Id. at 19.

[37] Id. at 21-22.

[38] *Id.* at 15.

[39] Id. at 19.

[40] Id. at 22.

[41] Ex. 201, p. 2.

a reasonableness check on his result.[42] And KCPL witness Hadaway uses three versions of the DCF model for his analysis, with a risk premium model check on the reasonableness of his results.[43]

The Commission must now analyze these suggested ROEs.

KCPL

KCPL's main witness on this issue was Dr. Hadaway. Dr. Hadaway's credentials are impeccable; he earned his Doctor of Philosophy in Finance from The University of Texas – Austin in 1975, and has also been an adjunct professor there.[44] He has also been either an Assistant or Associate Professor of Finance at The University of Alabama, Texas Tech University and Texas State University – San Marcos. Furthermore, Dr. Hadaway was Director of the Economic Research Division at the Public Utility Commission of Texas. His job duties consisted of supervising the Texas Commission's economic, finance and accounting staffs, as well as serving as the Texas Commission's chief financial witness in telecommunications and electric cases. Finally, he has taught numerous courses at utility conferences concerning, among other issues, cost of capital.

Dr. Hadaway's analysis began with a reference group of 26 companies that have: at least a triple-B (investment grade) bond rating; at least 70 percent of revenues from regulated utility sales; consistent financial records not affected by recent mergers or restructuring; and a consistent dividend record with no dividend cuts within the past two years.[45] Once he obtained his proxy group, Dr. Hadaway then used three versions of

[42] Ex. 105, pp. 14-15.

[43] Ex. 11, p. 32, 36.

[44] Ex. 11, App. A.

[45] Ex. 11, pp. 3-4; 32.

the discounted cash flow (DCF) model.[46] Dr. Hadaway's explanation of the DCF model is that it

> comes from taking the present value of all the dividends that investors expect to get. In that model you discount all the dividends back to today. That tells you the price of the stock. You assume that you know what the required rate of return is in that calculation. ROE witnesses flip the model around and they say we want to take today's price of the stock, the estimates of the dividends and we want to derive the rate of return.[47]

His analysis using traditional DCF was a range of 9.4 to 9.5%; however, because that result falls some 100 basis points below his risk premium check of reasonableness, he excludes those results.[48] Dr. Hadaway then used recalculated constant growth results with the growth rate based on long-term forecasted growth in GDP, yielding an ROE range of 10.7% to 10.8%.[49] He did this because growth in nominal GDP (real GDP plus inflation) is the most general measure of growth in the U.S. economy, and because of his reliance on academicians who postulate that dividend growth on average is expected to continue in the foreseeable future at about the same rate as that of the nominal gross domestic product (real GDP plus inflation).[50] Finally, using a multistage DCF model, Dr. Hadaway arrived at an ROE range of 10.5% to 10.8%.[51] Dr. Hadaway used a multistage DCF model because the constant growth aspect of the traditional DCF model does not fit the reality of the wild

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[46] *Id*. at p. 32.

[47] Tr. Vol. 6, p. 248.

[48] Ex. 11, pp. 35-36.

[49] *Id*. at 36.

[50] Ex. 11, p. 33-34 (cites omitted).

[51] *Id.*

fluctuations, and even complete elimination of some electric utility dividends, during the past twenty years.[52]

In short, Dr. Hadaway used a risk premium model as a check of reasonableness on his DCF results, and his results from that model were between 10.7% and 11.4%.[53] His ultimate ROE recommendation is an approximate mid-point of that range at 11.25%, which consists of his overall average return on equity of 10.75% combined with an extra 50 basis points to account for the high construction risk KCPL will have during its Experimental Regulatory Plan, for a total of 11.25% recommended ROE.[54] His "adder" came from risk adders he studied in FERC cases, and he used a 50 basis point adder because that is the smallest adder FERC has recently used.[55]

Staff

Staff witness Matthew Barnes earned a Bachelor of Science Degree in Business Administration in Accounting from Columbia College in December 2002, and an MBA with an emphasis in Accounting from William Woods University in May 2005. He has been an auditor for Staff since 2003.[56]

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[52] Ex. 11, p. 18.
[53] *Id.*
[54] *Id.* at 6-7.
[55] Tr. Vol. 6, p. 266, 269.
[56] Ex. 105, p. 1.

Mr. Barnes used sixteen companies in his proxy group.[57] Beginning with 66 companies listed in ValueLine[58] as electric utilities, he narrowed his list to the 16 companies in his proxy group that met the following criteria: publicly traded stock; information printed in ValueLine; ten years of available data; percent of electric utility revenues greater than or equal to 70%; no pending merger in the last six months;[59] no reduced divided in the last ten years; generation assets; two sources for projected growth with at least one available from ValueLine; and at least investment grade credit rating.

Mr. Barnes calculated a DCF cost of common equity for each of the comparable companies.[60] First, he calculated a growth rate. Because of the volatility of historical growth rates, Mr. Barnes instead relied upon projected growth rates, which he believed would be in a range of 5.34% to 6.50%.[61] Then, to arrive at an expected yield for each comparable company, Mr. Barnes used a slightly modified version of DCF to arrive at an expected yield of 3.80%.[62] He verified the reasonableness of that result by using the CAPM (Capital Asset Pricing Model).[63]

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57 *Id*. at p. 14.

58 Although not described by the parties, the Commission will take administrative notice that ValueLine is an investment survey published for approximately 1,700 companies, both regulated and unregulated. It is updated quarterly and probably represents the most comprehensive and widely used of all investment information services. It provides both historical and forecasted information on a number of important data elements

59 But GPE, KCPL's parent, has applied to buy Aquila, Inc., in Commission Case No. EM-2007-0374. That case is still pending before the Commission.

60 Ex. 105, p. 17.

61 *Id*. at 17-18.

62 *Id*. at 18.

63 *Id.* at 19.

OPC

OPC's cost of capital witness, Michael Gorman, received a Bachelor of Science Degree in Electrical Engineering in 1983 from Southern Illinois University, and a Master's Degree in Business Administration in 1986, from The University of Illinois at Springfield.[64] He has performed financial analysis at the Illinois Commerce Commission, Merrill-Lynch, as well as his current employer, Brubaker & Associates, Inc.[65] He has testified before public utility commissions in twenty-two states.[66]

Before Mr. Gorman applied a DCF analysis to determine his recommended ROE, he, like Dr. Hadaway and Mr. Barnes, had to construct a proxy group. For his group, consisting of 17 companies,[67] he began with all of the ValueLine electric utility companies, then removed those that failed to meet the following criteria: S&P's bond rating in the "BBB" and "A" categories; Moody's bond rating in the "Baa" and "A" categories; consensus analyst growth rates estimates available from Zacks, Reuters and SNL Financial; had not suspended dividends over the last two years; common equity ratios to total capital between 40% and 60%; S&P's business profile scores in the range of 4 to 6; and no significant merger and acquisition activities; not exposed to corporate or market restructuring.[68] Interestingly, he not only constructed his own group, but also used Dr. Hadaway's group as well.[69] Even though KCPL's parent company, Great Plains Energy, has proposed to buy

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[64] Ex. 201, App. A, p. 1.
[65] *Id.*, App. A, p. 3.
[66] *Id.*
[67] Ex. 201, Sch. MPG-3, MPG-4, MPG-5.
[68] Ex. 201, p. 10.
[69] *Id*. at 9.

Aquila,[70] Gorman excluded two of Hadaway's companies from his "Hadaway group" because those companies are undertaking mergers or acquisitions.[71]

Mr. Gorman posits that the projected increase in utility earnings and dividend paying ability is not a sustainable trend, but rather is the result of an abnormally high period of industry construction expenditures. He believes that once generation reserve margins are increased, transmission capacity investments are made to alleviate transmission constraints, and environmental upgrades are complete, capital expenditures by utilities will decline to a more normal and sustainable growth level. This will, in turn, cause utility earnings to also drop to a sustainable growth level.[72] To combat this, Mr. Gorman uses a two-stage DCF model; one stage for short-term growth, and another for long-term growth.[73] Using a DCF model on his own group, Mr. Gorman arrived at an ROE of 10.7%. He derived a 10.6% ROE using Dr. Hadaway's group.[74]

Findings of Fact

OPC witness Gorman testified that, according to Edison Electric Institute, the average allowed return in the electric utility industry for the second quarter of 2007 was 10.27%.[75] Dr. Hadaway, a KCPL witness, also testified that the average ROEs for both the first and second quarters of 2007 was 10.27%.[76] Staff submitted a study showing that for

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[70] Commission Case No. EM-2007-0374.

[71] Ex. 201, p. 18.

[72] *Id*.

[73] *Id.* at 19.

[74] *Id.* at 14-15.

[75] Ex. 202, p. 2.

[76] Tr. Vol. 6, 236-37.

the first two quarters of 2007, the average electric utility ROE was 10.27%.[77] Thus, the Commission finds that the recent national average of awarded ROEs is 10.27%, and that the Commission should set return on equity somewhere in between 9.27% to 11.27%.

The Commission believes Dr. Hadaway, Mr. Gorman and Mr. Barnes all quite qualified to submit ROE expert testimony, and finds all of their testimony credible. However, the Commission finds Dr. Hadaway's testimony the most persuasive for several reasons. Dr. Hadaway has more education and experience than does Mr. Gorman and Mr. Barnes. Dr. Hadaway's proxy group of 26 companies is larger than Barnes' group of 16, and Gorman's group of 17. Also, Dr. Hadaway's proxy group appears more reasonable than Mr. Gorman's or Mr. Barnes' group because Mr. Gorman and Mr. Barnes excluded companies undergoing mergers, while Dr. Hadaway included Green Mountain Power and Duquesne Light Holding, two companies undergoing mergers, in his proxy group. KCPL's parent company, Great Plains Energy, is attempting to purchase Aquila, Inc., so including, rather than excluding, companies undergoing mergers seems more reflective of reality. A proxy group that is the largest submitted in this case, and that includes companies undergoing mergers, appears to more accurately reflect KCPL's current market risk, and is therefore more likely to assist the Commission in applying the standards enunciated in *Hope* and *Bluefield*.

In addition to finding Hadaway's testimony more credible than Barnes' and Gorman's, however, the Commission finds another more compelling reason to adopt the 10.75% ROE recommended by Dr. Hadaway. That reason is that the record is replete with other possible ROEs that the witnesses arrived at either by using their own analysis, by or

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[77] Ex. 121, p. 4.

changing variables in another witness' analysis, and those ROEs tend to congregate around 10.75%. For example, Dr. Hadaway's reference group shows a 10.5-10.8% ROE[78]. His ROE recalculated using constant growth, based upon long-term forecasted growth in Gross Domestic Product, is a range of 10.7-10.8%.[79] His risk premiums associated with equity returns for 2006 shows an ROE of 10.6%.[80] If Staff witness Barnes had given any weight to CAPM, then Barnes' base ROE and construction adder should result in at least a 10.75% ROE.[81] Mr. Gorman's constant growth DCF analysis showed a 10.7% ROE, and 10.6% ROE using Hadaway's comparables.[82] Dr. Hadaway testified that had OPC witness Gorman not forced unreasonably low GDP growth into his two-stage DCF, the resulting average would have been 10.7% ROE.[83] Updating prices through August 24 and averaging long- and short-term growth rate estimates would yield a DCF estimate of 10.9%.[84] OPC witness Gorman fails to explain that in his own risk premium data, there is not one government bond risk premium as low as the 5.15% he recommends, and that his own data actually supports an ROE range of 10.5% to 11.0%.[85] Dr. Hadaway's updated DCF (Discounted Cash Flow) is a 10.6% to 11.1%.[86]

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[78] Ex. 11, pp. 5-6.
[79] Ex. 11, p. 36.
[80] Ex. 12, pp. 31-32.
[81] Ex. 13, p. 2.
[82] Ex. 201, p. 30; Sch MPG-5.
[83] Ex. 12, p. 4.
[84] *Id*. at p. 12.
[85] *Id*. at p. 13.
[86] Ex. 12, p. 15.

Staff witness Barnes' CAPM analysis produces an estimated cost of common equity (ROE) of 11.33% for the comparables when using the long-term arithmetic average risk premium period, an estimated ROE of 9.92% using the long-term geometric average risk premium period, and an estimated ROE of 5.76% using the short-term risk premium period.[87] Mr. Barnes discounted the 5.76% because it was well below the current cost of utility debt.[88] Mr. Barnes prefers the geometric means, rather than an arithmetic means, to determine his risk premium, explaining the concept this way:

> Suppose that an investor makes a $1 stock investment over a three-year period. If an investor pays $1 for a stock in year I and in year 2 the stock increases to $1.50, then the investor would have a 50 percent growth rate. In year three, the price of the stock decreases by 50 percent to $0.75. If an investor performed a simple arithmetic average of these two returns, then that investor would think that he/she received 0 percent [(50 percent + -50 percent)/2] growth in their investment over the three-year period. However, in reality, the investor actually had a 25 percent decline in his/her investment over this three-year period. This is why using the arithmetic mean is questionable.[89]

However, Mr. Barnes admits that some people don't hold onto securities for long periods of time, and had he taken that into consideration and averaged his 11.33% long-term arithmetic average risk premium with his 9.9% long-term geometric average risk premium he would have arrived at a 10.63%.[90]

Also, the Experimental Regulatory Plan, while allowing KCPL's credit metrics to stay at investment grade, thus pleasing the **bond** community, does not necessarily make KCPL more attractive to **equity** investors.[91] Stockholders must have a reasonable opportunity for

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87 Ex. 105, p. 20.

88 Tr. Vol. 6, pp. 312-313.

89 Ex. 107, pp. 4-5.

90 Tr. Vol. 6, pp. 313-314.

91 Tr. Vol. 5, p. 108-110; Vol. 6, p. 273 (emphasis supplied).

dividends. If those dividends come from additional amortizations, rather than cash earnings, the impact of paying those dividends on KCPL would essentially double.[92] But, if KCPL instead uses the additional amortization money to help fund the construction contemplated by the Experimental Regulatory Plan instead of paying dividends it would otherwise pay, then KCPL's ability to raise further funds to support that construction would be virtually impossible due to the anticipated drop in the stock price.[93] As KCPL invests in Iatan 2, a coal-fired power plant in the first phases of construction, and other assets during the course of the Experimental Regulatory Plan, it likely would almost double its rate base.[94] With these factors in mind, the Commission finds that it should tilt the revenue requirement balance more towards traditional ratemaking revenue requirement, and away from additional amortizations, as requested by Staff, OPC, and some intervenors.

As far as KCPL's projected growth rate, contrary to OPC's view, the 6.6% figure that KCPL uses is actually weighted more toward recent history.[95] As Dr. Hadaway explained at the hearing, "(t)he 20-year average is included five times. And so we gave more weight to that more recent slightly lower inflation influenced GDP. That weighted average, then, is the bottom line there, the 6.6% forecast."[96]

The final issue in return on equity is KCPL's requested "adder" of 50 basis point, or 0.5% additional ROE, requested due to the company's construction risk.[97] The level of risk

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[92] Tr., Vol. 5, p. 108.
[93] *Id*. at Vol. 5, p. 129.
[94] Ex. 11, p. 5, Sch. SCH-1.
[95] See Ex. 11, p. 35; see also Ex. 13, pp. 10- 11.
[96] Tr. Vol. 6, pp. 228.
[97] Ex. 11, pp. 6-7; Tr. Vol. 6, p. 251.

that KCPL, and therefore KCPL investors, will endure during its Experimental Regulatory Plan is somewhat, although not completely, ameliorated by the additional amortizations KCPL may book. As Dr. Hadaway himself acknowledged, although the Experimental Regulatory Plan benefits primarily bondholders, it also has some lesser benefit to shareholders as well.[98] Dr. Hadaway identified companies with comparable investment grade bond ratings (at least "BBB") to KCPL to estimate its return on equity.[99] Based on a comparable risk proxy group with KCPL's bond rating, Dr. Hadaway estimated KCPL's return on equity to be 10.75%. Dr. Hadaway's proposal to add a 50-basis point return on equity adder to his proxy group return would provide KCPL an ROE higher than other utilities with the same bond rating. What is more, the Commission will remove considerable risk from KCPL's volatile off-system sales, as discussed below.

The Commission realizes this final ROE is lower than what it awarded KCPL last year. But such an award is in line with the rest of the nation, which has seen electric utility ROEs decline steadily over the past five years.[100] For these reasons, the Commission is of the opinion that KCPL's evidence does not warrant an upward adjustment of 50 basis points.

[98] *See supra* at fn. 85.

[99] Ex. 11, p. 4.

[100] Ex. 11, p. 31, Ex. 12, p. 5 (showing average return on equity awards for electric utilities being as follows: 2002 – 11.16%; 2003 – 10.97%; 2004 – 10.75%; 2005 – 10.54%; 2006 – 10.36%; 2007 (first two quarters) – 10.27%.

Conclusions of Law

The Commission must estimate the cost of common equity capital. This is a difficult task, as academic commentators have recognized.[101] The United States Supreme Court, in two frequently cited decisions, has established the constitutional parameters that must guide the Commission in its task.[102] In the earlier of these cases, *Bluefield Water Works*, the Court stated that:

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.[103]

In the same case, the Court provided the following guidance as to the return due to equity owners:

> 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 corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[104]

The Court restated these principles in *Hope Natural Gas Company*, the later of the two cases:

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[101] C.F. Phillips, Jr., The Regulation of Public Utilities, 390 (1993); Goodman, 1 The Process of Ratemaking, supra, at 606.

[102] *Fed. Power Comm'n v. Hope Nat. Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

[103] *Bluefield, supra,* 262 U.S. at 690, 43 S.Ct. at 678, 67 L.Ed. at 1181.

[104] *Id*., 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[105]

The Commission must draw primary guidance in the evaluation of the expert testimony from the Supreme Court's *Hope* and *Bluefield* decisions. Pursuant to those decisions, returns for KCPL's shareholders must be commensurate with returns in other enterprises with corresponding risks. Just and reasonable rates must include revenue sufficient to cover operating expenses, service debt and pay a dividend commensurate with the risk involved. The language of *Hope* and *Bluefield* unmistakably requires a *comparative method*, based on a quantification of risk.

Investor expectations of KCPL are not the sole determiners of ROE under *Hope* and *Bluefield*; we must also look to the performance of other companies that are similar to KCPL in terms of risk. *Hope* and *Bluefield* also expressly refer to objective measures. The allowed return must be sufficient to ensure confidence in the financial integrity of the company in order to maintain its credit and attract necessary capital. By referring to confidence, the Court again emphasized risk.

The Commission cannot simply find a rate of return on equity that is "correct"; a "correct" rate does not exist. However, there are some numbers that the Commission can use as guideposts in establishing an appropriate return on equity. In the recent *Missouri*

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[105] *Hope Nat. Gas Co., supra,* 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

Gas Energy decision, the Commission stated that it does not believe that its return on equity finding should "unthinkingly mirror the national average."[106] Nevertheless, the national average is an indicator of the capital market in which KCPL will have to compete for necessary capital. The Commission described a “zone of reasonableness” extending from 100 basis points above to 100 basis points below the recent national average of awarded ROEs to help the Commission evaluate ROE recommendations.[107] Because the evidence showed the recent national average ROE for electric utilities is 10.27%, that “zone of reasonableness” for this case is between 9.27% to 11.27%.

Decision

The Commission finds that the appropriate return on common equity is 10.75%. KCPL’s decreased risk due to the Kansas City Power & Light Company Experimental Regulatory Plan the Commission approved in Case No. EO-2005-0329 is not a factor that reduces the return on common equity otherwise appropriate for KCPL. Instead, the plan to keep KCPL’s credit metrics at investment grade level largely benefits bondholders, while having little effect on stockholders.[108] KCPL’s increased risk due to its large construction undertakings is not a factor that increases the return on common equity otherwise appropriate for KCPL because that construction risk is already factored into its return on equity.

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[106] *In re Missouri Gas Energy*, 12 Mo.P.S.C.3d 581, 593 (Report and Order issued September 21, 2004).
[107] *Id.*
[108] Tr. Vol. 6, pp. 273-78.

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

Discussion

A company must obtain cash generally in one of two ways; namely, it must borrow the money (debt), or it must receive an investment from its owners (equity). The percentage of money that company receives from lenders and from shareholders can be expressed as a "capital structure". For example, if a company has $1000 cash, and obtained that $1000 by borrowing $600 and receiving $400 in investments, its capital structure would consist of 60% debt and 40% equity.

The capital structure recommended by OPC contains less equity than does the structure recommended by KCPL and Staff. It costs a company more to issue equity than it does to incur debt. Therefore, a capital structure that uses a lot of debt with relatively low levels of equity is less expensive for the company. That means that, all else being equal, a capital structure that includes a low percentage of equity and a large percentage of debt will be less costly, resulting in a lower rate of return, and consequently a lower revenue requirement and lower rates to customers.

However, all else is not equal. Including a high percentage of debt in a capital structure has an effect on the cost of equity. The shareholders in a company – the holders of equity – are subordinate to bondholders. Generally, the company must pay the interest on debt, such as bonds issued by the company, before it can pay dividends to its shareholders, or before it can invest profits in other ways that benefit shareholders. If a company's income goes down, the risk is borne by the shareholders. Furthermore, if something really goes wrong and the company has to be liquidated, the holders of debt get paid first. The shareholders get only what, if anything, is left over. Therefore, a company with a capital structure that includes a high percentage of debt is more risky for shareholders. The shareholders will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt.

The composition of the capital structure and the embedded cost of the components other than common equity are not difficult to ascertain. It is simply a "snapshot" of a given moment in time. KCPL and Staff favor using Great Plains Energy's *actual* capital structure as of September 30, which had a consolidated capital structure that consisted of 57.62% common equity, 1.45% preferred stock, and 40.93% long-term debt.[109] OPC favors the capital structure that KCPL *projected* (incorrectly) that it would have as of September 30, which is 53.43% common equity, 1.33% preferred stock and 45.24% debt.[110] The actual capital structure is more equity rich than the projected capital structure because KCPL did not complete an anticipated long-term debt issuance.[111]

Findings of Fact

OPC witness Gorman says a capital structure should contain a reasonable balance of debt and equity.[112] The Commission agrees. OPC's hypothetical capital structure is not reasonable, though, because it does not reflect the reality of the capital structure of KCPL's parent company, GPE. The actual capital structure as of September 30, 2007 is known and measurable to all parties, and is thus a more reasonable structure than one does not even exist.

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[109] Ex. 36, pp. 1-2; Ex. 125, pp. 1-2.

[110] Ex. 210, p. 3 (referring back to KCPL's projected capital structure in its direct case).

[111] Ex. 36, p. 2.

[112] Ex. 210, p. 2.

The Commission is mindful that KCPL did not issue the long-term debt it predicted it would issue before the end of the true-up period.[113] While KCPL's capital structure is somewhat equity rich, worldwide credit concerns and the sub-prime mortgage crisis have prevented KCPL from issuing debt it would have otherwise issued.[114] KCPL did not issue the long-term debt it anticipated issuing by now, but still plans on issuing it once it is prudent to do so.[115] KCPL reacted properly to this past summer's credit crunch by not issuing the debt it had planned to issue.[116] Therefore, the Commission will use the actual, rather than hypothetical capital structure, to set rates.

Conclusions of Law

As pointed out by the Court of Appeals, "(p)erhaps the ultimate authority for imputing debt and equity financing . . . is the Supreme Court's statement in *Hope Natural Gas:* "The rate-making process under the Act, *i.e.,* the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests."[117]

Decision

The Commission rejects OPC's proposal, and finds that it should use KCPL's actual capital structure as of September 30, 2007, which is 57.62% common equity, 1.45% preferred stock, and 40.93% long-term debt.

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[113] Ex. 36, p. 2; Tr. Vol. 15, pp. 1153-54.

[114] Ex. 36, p. 4; Tr. Vol. 15, pp. 1151-54.

[115] Tr. Vol. 15, pp. 1152-53.

[116] *Id*. at p. 1160.

[117] *State ex. rel. Associated Natural Gas Co. v. Public Service Comm'n of Missouri*, 706 S.W.2d 870, 879 (Mo. App. 1985)(citing *Hope Natural Gas*, 320 U.S. at 603, 64 S.Ct. at 288).

3. *Off-system sales margin:*

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

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

Discussion

In Case No. EO-2005-0329, the Commission approved a Stipulation among KCPL and the other signatory parties that contemplated an Experimental Regulatory Plan. Under the terms of the Stipulation, KCPL agreed that off-system energy and capacity sales revenues and related costs will continue to be treated "above the line" for ratemaking purposes.[118] KCPL also agreed that it would not propose any adjustment that would remove any portion of its off-system sales from its revenue requirement determination in any rate case during the life of the Experimental Regulatory Plan. Despite this language in the Stipulation, OPC has a different view than KCPL and Staff of what amount of off-system sales should be included in KCPL's revenue requirement.

KCPL argues that the Commission should do as it did last year, and include KCPL's projected nonfirm off-system sales at the 25th percentile in its revenue requirement.[119] The projected 25th percentile of nonfirm off-system sales is even less than last year's

[118] Off-system sales are sales made to customers other than KCPL's customers, with nonfirm sales being sales made on the spot market, rather than under contract. "Above the line" denotes revenue and expense items that enter fully and directly into the calculation of periodic net income, in contrast to below the line items that affect capital accounts directly and net income only indirectly

[119] Ex. 8, p. 8-10.

projection.[120] As of August of 2007, KCPL was not even halfway to last year's projected 25th percentile margin.[121] As this past year has shown, if nonfirm off system sales had been set at the 50th or even 40th percentile, KCPL would likely be below investment grade today.[122] To the extent KCPL makes sales in excess of that 25% level, those margins should be credited to ratepayers, as the Commission determined in the 2006 rate case.

KCPL witness Giles has testified that the Commission properly set rates at this level in 2006, in light of the risks facing the Company from the volatile markets in which it sells energy and capacity not needed to serve native load. He stated that prices in the marketplace have continued to decline in 2007 and, as supported by highly-confidential testimony, Mr. Giles states that it will be a significant challenge for the Company even to reach the 25% level this year.[123]

Staff largely concurs in KCPL's position.[124] Further, it requests that any actual margin in 2008 that exceeds the 25th percentile should be deferred as a regulatory liability in a future rate case.[125] But Staff also recommends Commission adopt OPC's tracking method called "cumulative until and after baseline is met."[126] Staff believes that an accumulated balance of margin should be recorded as pre-tax earnings until it reaches the 25th percentile.[127] All additional margins should be a regulatory liability. Finally, because

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[120] *Id.* at p.11.
[121] Tr. Vol. 7, p. 533.
[122] Ex. 9, p. 12.; Tr. Vol. 7, pp. 540-41.
[123] See Ex. 9, p. 12; Tr. Vol. 7, p. 533.
[124] Tr. Vol. 7, pp. 581-82.
[125] Ex. 113, p. 3.
[126] *Id.*
[127] *Id.*

the Commission did not put an interest adder in Case No. ER-2006-0314 for excess margin, the Staff does not support OPC's interest adder request.

In contrast, OPC lobbies for a 40th percentile point on Schnitzer's curve. OPC believes that KCPL may have a small incentive to exceed the 25th percentile due to an immediate, short-term cash flow benefit. However, that benefit would be offset by any refund of the excess margin it has to credit back to ratepayers in the future.[128] OPC reminds the Commission that KCPL likely already has in place several financing resources for the normal utility investments or costs this additional cash flow would support. Furthermore, if every dollar of additional nonfirm off-system sales margin above the baseline is to be refunded to ratepayers KCPL may perceive higher levels of margins to be contrary to its interest because they would help parties argue in future cases for a higher baseline or normalized amount.[129]

OPC proposes that interest associated with excess margins be calculated by treating the balance as if it was earned on an even monthly basis over the course of the year and then applying an appropriate interest rate to each month's balance for the period from when it was earned until it is credited back to ratepayers.[130] OPC recommends prime interest plus 1%.[131]

Findings of Fact

KCPL sponsored the testimony of Michael Schnitzer, Director of the NorthBridge Group, Inc., a consulting firm for the electric and natural gas industry. Mr. Schnitzer's

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[128] Ex. 205, p. 9

[129] *Id.* at pp. 9-10.

[130] *Id.* at p. 13.

[131] *Id*. at p. 18.

testimony focused on the risk KCPL faces in the off-system sales market, and offered a probabilistic analysis of what KCPL's non-firm off-system sales would be in 2008.[132] In summary, KCPL witness Giles relied upon Mr. Schnitzer's analysis to form the opinion that the Commission should set the nonfirm off-system margin at the 25th percentile, meaning that KCPL would have a 75% chance of achieving or exceeding the predicted level of those sales.[133]

Not unlike KCPL's witness Dr. Hadaway, Michael Schnitzer possesses impressive qualifications: after receiving degrees from Harvard and Massachusetts Institute of Technology, Mr. Schnitzer has been in private industry consulting electrical and gas companies on strategic and economic issues since 1979.[134] The disagreement that OPC has with KCPL and Staff seems not to be with Mr. Schnitzer's analysis, but KCPL witness Giles' choice to pick the 25th percentile from among the probabilities.[135] OPC recommends that the Commission set off-system sales at a higher level. Those recommendations, if adopted, would place more into revenue requirement from off-system sales, thereby lessening the revenue to be collected from Missouri retail customers.

Mr. Giles chose the 25th percentile from Mr. Schnitzer's analysis due to the large portion of riskier, nonfirm off-system sales KCPL makes in comparison to less risky regulated sales.[136] As of August of 2007, KCPL was not even halfway to last year's

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[132] Ex. 22, 23.
[133] Ex. 8, p. 8; Tr. Vol. 7, p. 526.
[134] Ex. 22, Sch. MMS-1.
[135] Tr. Vol. 7, pp. 526-27.
[136] Ex. 8, p. 8.

projected 25th percentile margin.[137] As this past year has shown, if nonfirm off-system had been set at the 50th or even 40th percentile, KCPL would be below investment grade today.[138]

OPC is understandably concerned about forced outages largely contributing to KCPL's unexpectedly low margin.[139] The Commission is concerned as well. But the major reason for reduced OSS margins in 2007 is not forced outages, but rather the drop in the price of electricity.[140] Projected electricity price levels for 2007 were based on estimates made in 2006. The price of electricity in 2007, however, averaged over $10 per megawatt hour (MWh) less than in the prior year, mostly because of the drop in the price of natural gas.[141]

Another reason for decreased sales in 2007 was lower MWh sales volumes. This was mainly caused by an increase in KCPL's native load and an increase in forced outages.[142] Despite those outages, KCPL's available generating capacity appeared to be consistent with national averages in 2007.[143] An example of a forced outage is the Hawthorn 5 explosion, discussed later in this order, and the steam pipe explosion at Iatan 1.[144]

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[137] Tr. Vol. 7, p. 533.

[138] Ex. 9, p. 12.

[139] Ex. 211, pp. 4-5, 10-11.

[140] See Ex. 38, p. 2.

[141] *Id*. at pp. 2-3 ; Ex. 38, Sch. BLC-1; Tr. Vol. 15, pp. 1254-55

[142] See Ex. 38, pp. 2-3.

[143] Tr. Vol. 15, p. 1264.

[144] *Id.* at p. 1273, 1276, 1279.

In the portion of its off-systems sales discussion in the Report and Order in Case No. ER-2006-0314, the Commission pointed out that the probability of an event occurring, or not occurring, was not the end of the analysis. In addition, the Commission concluded that an event's importance should weigh heavily as the Commission contemplates what to do.[145] In other words, in deciding what level of projected off-system sales to put into revenue requirement, the Commission believed it was wise to not just look at sheer percentages, but what benefit or harm would accrue to what stakeholders should KCPL succeed, or fail, to attain a certain level of off-system sales. The Commission not only adopts that same analysis, but does so in recognition of the fact that KCPL has little, if any, chance to hit even the projected 25th percentile of sales in 2007.

Under the Experimental Regulatory Plan, KCPL has the option to file a rate case again on February 1, 2008. KCPL now plans to wait until April or May of 2008 to file that case.[146] That means that any rates decided in this case likely will be in effect for only approximately one year. Consequently, although Missouri ratepayers would not receive the benefit of corresponding rate base reduction from a higher amortization, *in the short term*, Missouri ratepayers are not harmed by the 25th percentile scenario presented by KCPL, especially in light of the fact that the Commission will order KCPL to account for any sales over that 25th percentile and to flow them back to ratepayers, as KCPL witness Giles suggested. In contrast, the potential importance of not achieving that level during a time when KCPL will be issuing equity and investing hundreds of millions of dollars in

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145 *In re KCPL*, Commission Case No. ER-2006-0314, Report and Order, p. 34-36 (December 21, 2006).
146 Ex. 8, p. 4.

infrastructure construction and upgrades could be disastrous to KCPL.[147] The Commission need only look to KCPL's current situation of off-system sales margin to see that even the 25th percentile can be difficult to achieve.

In short, in balancing the interests of shareholders and ratepayers, straying from KCPL's recommended 25th percentile might benefit ratepayers some, but might also damage KCPL much, much more than any benefit that might accrue to ratepayers. The Commission will adopt KCPL's position, with the added requirement that KCPL must file monthly monitoring reports on its nonfirm off-system sales with the Commission's Staff.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

KCPL's rates should continue to be set at the 25th percentile of nonfirm off-system sales margin as projected in this case for 2008 as proposed by KCPL, and accepted by the Staff, and not at the 40th percentile as proposed by Public Counsel. KCPL shall continue to book all amounts above the 25th percentile as a regulatory liability, with no corresponding regulatory asset should sales fail to meet the 25th percentile, as ordered in Case No. ER-2006-0314. KCPL shall pay a short-term interest rate of LIBOR[148] plus 32 basis points on all margin amounts exceeding the 25% level, with the interest paid not charged to ratepayers in cost of service. Any margins in excess of the 25th percentile, and any interest paid on those margins, shall be returned to the ratepayers no later than the conclusion of

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147 Tr. Vol. 5, p. 107. See also Stipulation and Agreement, App. B, Case No. EO-2005-0329 (filed March 28, 2005)

148 London Interbank Offered Rate. It is a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London, England interbank market.

"Rate Filing #4" as defined in Paragraph III.B.3.d on page 41 of the Stipulation and Agreement approved in Commission Case No. EO-2005-0329. KCPL shall report its monthly nonfirm off system sales margins to the Staff of the Commission each month.

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

Discussion

In last year's rate case, the parties disagreed on many issues but, at the end of the day, agreed that once the Commission made its decisions on revenue requirement, the parties agreed how to calculate the additional amortization described in the Experimental Regulatory Plan Stipulation and Agreement from Case No. EO-2005-0329. This year, however, the parties disagree on whether short-term debt should be included in the calculation.

KCPL states that it will need another $14,155,968 million in amortization expense.[149] Staff disagrees with KCPL's final number, but Staff and KCPL agree that short-term debt and its expense should be included in the calculation.[150] KCPL avers that short-term debt expense was erroneously omitted from previous calculations, in part, because the figure was not viewed as material.[151] However, given the financial turmoil of recent months and KCPL's inability to fulfill its plan to issue a large amount of hybrid debt because of

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[149] Ex. 36, Sch. MWC-9; Tr. Vol. 15, pp. 1178-80.

[150] Tr. Vol. 15, p. 1196.

[151] *Id*. at 1178-80.

unfavorable market conditions, the amount of short-term debt -- $259 million -- was material and its costs were properly included in the Additional Amortizations calculation.[152]

According to OPC, 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 many times the parties have calculated amortizations for KCPL (as well as similar amortization calculations for cases involving The Empire District Electric Company), 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.

Findings of Fact

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 second of these credit metrics, FFO as a Percent of Average Total Debt, is driving the need for additional amortization.

These two metrics were based on metrics that Standard and Poors (S&P), a credit rating agency, 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

[152] Tr. Vol. 15, pp. 1179-80, 93. The exact amount of the short-term debt is $258,647,000, found on Line 37 of both KCPL's calculation in Cline Schedule MWC-9 and Staff's calculation in Ex. 214.

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.[153]

Appendix F-3 to the Stipulation and Agreement in Case No. EO-2005-0329[154] 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 determine 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.[155] 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.[156] Including this amount of short-term interest in the calculation

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[153] Tr. Vol. 15, pp. 1178-79.

[154] Ex. 44.

[155] Ex. 44.

[156] Ex. 213.

of FFO in the prior case would have resulted in an amortization increase 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."[157] OPC believes that $5.7 million is a material amount, and that KCPL witness Cline's refusal to answer the question of whether it was material simply lacks credibility.[158]

Appendix F-3[159] and the language in paragraph III.B.1.i[160] of the Experimental Regulatory Plan Stipulation and Agreement clearly references "Missouri jurisdictional revenue requirement" as discussed by OPC witness 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 Commission is persuaded by OPC witness Trippensee, who has some thirty years regulatory experience, when he states that the primary reason that short-term debt is not normally included in the capital structure used to determine revenue requirement is because short-term debt is used to support CWIP (construction work in progress), and the related interest cost is capitalized and subsequently built into rates via the process referred to in the Uniform System of Accounts as Allowance for Funds Used During Construction (AFUDC). 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

157 Tr. Vol. 15, pp. 1182-83.

158 Tr. Vol. 15, pp. 1179-80.

159 Ex. 44.

160 Ex. 43.

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. Including 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. Likewise, KCPL's evidence that this last-minute attempt to insert short-term debt interest into the amortization calculations this year is because of an "omission" is less credible than OPC's evidence because KCPL could not state what dollar amount of such an omission would rise to the level of being a material enough omission to include in revenue requirement.[161]

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.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission finds this issue in favor of OPC. Any additional amortization that is required by KCPL's Experimental Regulatory Plan approved by the Commission in Case No. EO-2005-0329 shall be calculated by using the method sponsored by OPC, and shall not include short-term debt, as requested by KCPL.

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[161] Tr. Vol. 15, pp. 1179-80.

Rate Base

Rate base is the second step in determining revenue requirement. According to the Stipulation and Agreement as to Certain Issues filed by KCPL and Staff, the rate base issues in this case are settled. Thus, other than approving that stipulation, the Commission has no need to resolve any rate base issues.

Allowable Operating Expenses

The final variable in the revenue requirement equation that the Commission must resolve is what expenses are prudent, and therefore should be included in KCPL's cost of service.

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

a. If so, should the five-year amortization period proposed by Staff be adopted?

Discussion

In 1999, a boiler explosion occurred at Hawthorn 5, removing the unit from service until it was rebuilt and returned to service in 2001.[162] In 2001, KCPL and its insurers filed suit against twelve defendants to recover costs related to the explosion. After extensive litigation, a defendant paid KCPL some $38.9 million in 2006.[163] KCPL does not expect to

[162] Ex. 108, p. 4; Tr. Vol. 5, p. 161.

[163] Ex. 108, p. 4.

receive any additional subrogation proceeds.[164] The issue here is the way KCPL booked some $23.1 million of the proceeds.[165] Staff proposes a five-year amortization of those proceeds, which would translate into a $4.6 million decrease in this year's revenue requirement.

KCPL argues that the proceeds of litigation have nothing to do with the test year, and that it is mere happenstance that KCPL received money during the test year for the 1999 Hawthorn 5 explosion. KCPL's theory is that its ratepayers never paid for cost of replacement power and property damages because KCPL did not ask for a rate increase during or after the outage that resulted in recovery of replacement power costs.[166] According to KCPL, both Staff and DOE are requesting retroactive ratemaking, which is forbidden, under the theory that KCPL must have been earning too much or it would've asked for a rate increase during the Hawthorn 5 litigation.

DOE states that KCPL's position is inconsistent. KCPL wants non-recurring revenue items excluded from cost of service, but non-recurring expenses included. DOE is simply seeking symmetrical treatment of all non-recurring costs and revenues.[167]

Staff reminds the Commission that a company is assumed to recover its expenses and earning a reasonable return until it files for a rate increase.[168] Because KCPL did not ask for a rate increase while Hawthorn 5 was offline, customers were therefore paying those costs during that time. Also, Staff suggests that KCPL didn't file a rate case because

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[164] Tr. Vol. 5, p. 176.
[165] Ex. 108, p. 4.
[166] Tr. Vol. 5, p. 162.
[167] Ex. 801, p. 15.
[168] Ex. 109, p. 6.

KCPL was earning a robust ROE for those years; data requests responses show that KCPL's return on equity percentages were: 2002-12.85%; 2003-14.64%; 2004-14.66%; 2005-12.82%; 2006-11.82%.[169] Because the subrogation proceeds were received during the test year, they are properly included in this case. Rather than totally excluding the $23.1 million from cost of service, or putting it all in, sharing the benefits is the wisest course.[170] Shareholders get interest free use of the funds over the five years. Staff asserts that the Commission should give five-year amortization, and no rate base treatment, to subrogation proceeds.

Findings of Fact

The Commission finds this issue in favor of KCPL. Staff argues that because KCPL did not file a rate case until 2006, the cost of operating Hawthorn 5 remained in KCPL's rates during the 1999 – 2001 outage, that KCPL thereby recovered the cost of operating the plant during that time, and that including Hawthorn 5 in rates during that time was somehow tantamount to a windfall for KCPL. However, as testified to by Mr. Giles, KCPL "incurred about $150 million in purchase power expense above what would have normally been incurred had Hawthorn been operating."[171] As a result of these expenses and other expenses related to the explosion, the expenses associated with Hawthorn 5 outage were greater than any savings KCPL may have realized by virtue of Hawthorn 5 not operating.[172]

The timing of the proceeds of litigation happened coincidentally during the test year for this case. The proceeds are an unusual non-recurring event, were exceeded by KCPL's

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[169] *Id*. at p. 8.
[170] Ex. 109, p. 12.
[171] Tr. Vol. 6, p. 161.
[172] Tr. Vol. 6, p. 128, 168, 170-71.

costs to purchase power to replace the power KCPL would have otherwise generated with Hawthorn 5, and should be excluded from the test year.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission adopts KCPL's position, and concludes that subrogation proceeds KCPL received in 2006 concerning the 1999 Hawthorn 5 boiler explosion litigation should not be included in cost of service for setting KCPL's rates.

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

Discussion

KCPL witness Michael Halloran, a consultant with Mercer Human Resource Consulting, testified that the uses of short-term and long-term incentives are powerful tools to benefit both customers and shareholders. The use of financial measures is a very effective way to reflect performance on a broad range of customer service measures. In particular, a program that focuses on the achievement of Earnings Per Share is beneficial for customers and shareholders.[173] The theory is because KCPL is a regulated public utility, the organization is committed to its responsibility to achieve its EPS through the provision of efficient, clean, safe and affordable electricity. Therefore, EPS is an important

[173] Ex. 14, pp. 3-5.

measure of performance and productivity in areas related to product and service delivery.[174]

Through the testimony of witness Dittmer, The U.S. Department of Energy objects, stating that incentive compensation linked to EPS should be eliminated from cost of service.[175] It again claims that KCPL is inconsistent; KCPL wants non-recurring revenue items excluded from cost of service, but non-recurring expenses included. Also, DOE lists several Commission orders from roughly the last decade or so, not the least of which was KCPL's rate case from last year, in which the Commission denied a company's request for incentive compensation because the goals of that compensation were tied primarily to shareholder wealth maximization.[176]

In addition to concurring in DOE's arguments, Staff maintains that KCPL would pay that compensation with stock, not cash, so KCPL would not need to recover money from the ratepayers to pay the compensation.[177]

Findings of Fact

KCPL has the right to tie compensation to EPS. However, because maximizing EPS could compromise service to ratepayers, such as by reducing maintenance, the ratepayers should not have to bear that expense.[178] What is more, because KCPL is owned by Great Plains Energy, Inc., and because GPE has an unregulated asset, Strategic Energy L.L.C.,

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[174] *Id*. at. p. 3.

[175] Ex. 801, pp .2, 7-8.

[176] *In the Matter of Union Electric Company*, 29 Mo.P.S.C. (N.S.) 313, 325; *In the Matter of Southern Union Company, doing business as Missouri Gas Energy*, 5 Mo.P.S.C.3d 437, 458; *In the Matter of Southern Union Company, doing business as Missouri Gas Energy*, 12 Mo.P.S.C.3d 581, 606-7; *In re Kansas City Power & Light Company*, Commission Case No. ER-2006-0314, Report and Order (December 21, 2006).

[177] Ex. 112, pp. 30-31.

[178] Ex. 801, p. 8.

KCPL could achieve a high EPS by ignoring its Missouri ratepayers in favor of devoting its resources to Strategic Energy. Even KCPL admits it is hard to prove a relationship between earnings per share and customer benefits.[179] 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.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The costs of KCPL's and GPE's long-term incentive compensation plans should not be included in cost of service for setting KCPL's rates.

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

Discussion

KCPL's argument for including short-term executive compensation in rates is much the same as its argument for long-term incentive compensation.[180] Staff argues that EPS is not relevant to providing cash to serve ratepayers, because that cash is recovered from ratepayers via a normal level of maintenance expense.[181] DOE largely concurs in Staff's

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[179] Tr. Vol. 5, p. 156-57.

[180] Ex. 14.

[181] Tr. Vol. 5, pp. 184-85.

position, and points out that such compensation is not tied directly to specific goals and therefore not related to any ratepayer benefits.[182]

Findings of Fact

KCPL was understandably proud to tout its "Tier 1" standing of excellence, and its' "Edison Award" as evidence of customer service excellence which purportedly translates into customer benefits. But KCPL's witness was unsure precisely who placed KCPL in that tier, or what the tier or award even means.[183] The Commission finds that the relationship between KCPL and GPE's short-term executive compensation plans and benefits to KCPL ratepayers is simply too tenuous to include in cost of service.[184]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission rejects KCPL's position, and adopts the position of Staff. Part of the costs of KCPL's and GPE's short-term executive compensation plans should be excluded from cost of service for setting KCPL's rates.

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

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[182] Ex. 801, p. 11.

[183] Tr. Vol. 5, pp. 143-46.

[184] Tr. Vol. 5, p. 157 (wherein KCPL witness Halloran admits it's hard to prove a direct relationship between incentive compensation and ratepayer benefit).

a. If so, should the costs be recognized in cost of service using KCPL's proposed deferral and amortization to expense over five years?

Discussion

KCPL states that it has incurred two distinct sets of severance costs during the test period. The first set is severance payments, outplacement service costs, and payroll taxes of 119 Company employees who left the Company as a result of the Talent Assessment Program. The second set is severance costs KCPL has incurred in the past, for which it requests to recover a three-year average.[185]

Staff proposes that the severance payments related to the Talent Assessment Program be disallowed. Staff argues:

(1) There is no evidence that KCPL was not providing safe and adequate service with the employee base that existed prior to the talent assessment severance program;

(2) There is no evidence that the costs of this talent assessment program has yet or will ever provide any benefit to KCPL's customers;

(3) KCPL's management is responsible for the hiring of employees and training of employees. If the employees who were terminated under this program did not meet KCPL's management's performance expectations, then KCPL's management should bear the primary responsibility for this result;

(4) Severance costs of the talent assessment program were removed from KCPL's 2006 earnings in the determination of KCPL's management incentive compensation.[186]

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[185] Ex. 2, pp. 2-3.
[186] Ex. 108, p. 7.

Findings of Fact

In the autumn of 2005, management employees were identified under this program as "Role Models," "Well Placed," or "Not Keeping Pace." Employees identified as "Not Keeping Pace" could either attempt to improve any shortcomings, or could voluntarily separate their employment with the Company.[187] Employees who did not improve their performance either voluntarily separated their employment, or were involuntarily separated effective on or before March 31, 2006. All employees identified as "Not Keeping Pace" were given the opportunity to receive severance payments under this program.

When a company improves the performance of its employees, both the shareholders and ratepayers benefit. Common sense dictates that a company that is run more efficiently makes more money, at least in part because a higher level of efficiency results in happier customers. Indeed, the record is replete with evidence that KCPL's customer service is excellent.[188] What is more, KCPL's ranking among Midwestern public utilities rose from eighth to fourth in 2006, according to a J.D. Powers and Associates survey, with those rankings measuring such components as power quality and reliability and customer service.[189]

While Staff understandably points to the loss of experience KCPL will suffer due to several veteran employees leaving, KCPL reasonably assessed that it did not need the type of experience that those employees had. KCPL's Talent Assessment program was a prudent way to attempt to reshape its corporate culture away from the decades-old mindset

[187] *Id.* at p. 3.
[188] Tr. Vol. 4, pp. 20-21, 33, Tr. Vol. 7, pp. 470-71, 498.
[189] Ex. 109, p. 17. Tr. Vol. 7, p. 468.

of encouraging electricity use, and then building or buying supply to meet that demand, and towards a mindset of a utility also concerned with some new goals articulated in the Experimental Regulatory Plan, including generating energy via wind, conserving energy altogether, and reducing pollution.[190]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission finds this issue in KCPL's favor. The Commission concludes that the Talent Assessment costs should be recognized in cost of service and deferred and amortized to expense over five years.

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

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

Discussion

KCPL states that it incurs routine and recurring severance costs due to changing job requirements, corporate reorganizations, and downsizing.[191] Severance payments are a helpful and legitimate business tool to ensure that the Company has the human capital capable of delivering outstanding, reliable service at reasonable prices. These costs should be included in rates since such costs are necessary in order to hire and retain the

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[190] Ex. 2, pp. 6-7.

[191] *Id*. at p. 8.

appropriate employees within the organization to implement the Company's strategic goals and continue to achieve Tier I levels for cost, reliability and customer service. KCPL is requesting that a three-year average of severance payment amounts be included in the revenue requirement as representative of its ongoing level of severance costs.[192]

Staff argues that KCPL incurred these severance costs to protect shareholders and they did not have the effect of decreasing payroll; therefore, these costs should not be included in cost of service.[193] Staff reminds the Commission that KCPL made this same proposal in its 2006 rate case, Case No. ER-2006-0314, the Commission rejected it, and that KCPL has not provided anything new to persuade the Commission to change a position it took less than 12 months ago.

Findings of Fact

As it found in KCPL's last rate case, the Commission again finds that these severance costs largely protect shareholders against litigation, and they did not have the effect of decreasing payroll; therefore, these costs should not be included in cost of service. KCPL did not seek to eliminate those positions and, indeed, the pay for those positions was still being recovered from ratepayers in rates. In fact, KCPL is increasing payroll, not decreasing it.[194]

Conclusions of Law

There are no additional conclusions of law for this issue.

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[192] *Id*.

[193] Ex. 108, p. 5-6.

[194] Tr. Vol. 7, p. 406.

Decision

The severance costs of KCPL employees terminated for reasons other than KCPL's talent assessment program should not be included in cost of service for setting KCPL's rates.

10. Department of Energy Nuclear Fuel Overcharge Refund: Should the Department of Energy Nuclear Fuel Overcharge Refunds for 1986 through 1993 KCPL received during the test year in this case be included in KCPL's cost of service for setting KCPL's rates?

a. If so, should the five-year amortization period proposed by Staff be adopted?

Discussion

The United States Department of Energy overcharged KCPL for uranium enrichment services from 1986 until 1993. KCPL filed a lawsuit against DOE to recover the amount KCPL was overcharged. The lawsuit ultimately settled and in December 2006, KCPL accrued $427,150 for the settlement.[195]

Similar to its argument against including Hawthorn 5 subrogation proceeds in cost of service, KCPL argues against including the fuel overcharge refunds in cost of service. It is no more appropriate to reach back beyond the test year, than it would be for the Company to reach back to recover expenses incurred between 1986 and 1993. In either case, the inclusion would constitute retroactive ratemaking.

[195] Ex. 101, p. 46.; Ex. 9, p. 6.; Ex. 109, p. 12.

Staff, on the other hand, continues with the same theory it had on the Hawthorn 5 issue, arguing that the Commission should presume KCPL recovered those overpayments from ratepayers in the rates it was charging ratepayers from 1986 to 1993. Staff insists the ratepayers paid KCPL the costs of the DOE overcharges because KCPL agreed to a rate reduction in 1994. The 1994 rate reduction must have included 1992-93 as part of its test year, and that time period was when KCPL was paying an excessive amount for nuclear fuel, and recovering that excessive amount from ratepayers.[196] As a result, in the rates set in this case based on a 2006 test year, ratepayers should receive a benefit from the Department of Energy Nuclear Fuel Overcharge Refunds for 1986 to 1993 that KCPL received in the 2006 test year by including the refunds in KCPL's cost of service in this case.

Findings of Fact

Just like the Hawthorn 5 issue, KCPL customers never paid the overcharges because KCPL did not have a rate case or a fuel adjustment clause during the period when these costs were incurred. The refunds do not pertain to the test year in this case, but were merely an atypical, unusual revenue KCPL happened to receive during the test year.[197]

Conclusions of Law

There are no additional conclusions of law for this issue.

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[196] Ex. 109, p. 13.

[197] Tr. Vol. 9, p. 656.

Decision

The Department of Energy Nuclear Fuel Overcharge Refunds for 1986 through 1993 KCPL received during the test year in this case should not be included in KCPL's cost of service for setting KCPL's rates.

<u>Class Cost-of-Service and Rate Design</u>

The rates that KCPL will be allowed to charge its customers are based on a determination of the company's revenue requirement. The Commission has resolved issues regarding revenue requirement; now, what remains is what class of customers must pay what share of that revenue requirement. This is a zero-sum game. If the Commission wants to remove a dollar's worth of revenue requirement responsibility from one customer class, it must assign that dollar to another customer class to keep revenue requirement the same.

11. Does the Stipulation and Agreement incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO- 2005-0329 allow the signatories to the Stipulation and Agreement to propose inter-class revenue shifts in this case?

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

Discussion

In beginning its rate design analysis, the Commission notes that much is made of language contained in a stipulation the Commission approved in Case No. EO-2005-0329, which is the genesis of this pending rate case. In that stipulation, the signatories agreed that in this rate case:

> (iv) Rate Design. The Signatory Parties agree not to file new or updated class cost of service studies or to propose changes to rate structures in Rate Filing #2.[198]

However, the parties have differing views of what that language means, and different definitions of exactly what "rate structures" are. To KCPL and OPC, the language means that any rate increase should be applied equally across all customer classes.[199] The Regulatory Plan's contemplation of additional amortizations makes the traditional revenue requirement, and the traditional ratemaking paradigm, inapposite for this rate case.[200] Further, the extensive efforts and costs and minor benefits do not justify any rate design changes for this case. The rate case anticipated to be filed in 2009, when Iatan 2 is anticipated to be online, is the appropriate time to deal with rate design issues.

Staff and many intervenors disagree, claiming, *inter alia*, that the Commission can shift revenues or change charges to certain classes without the change rising to the level of proposing a change in rate structure, which is forbidden under the Experimental Regulatory

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198 Commission Case No. EO-2005-0329, *Stipulation and Agreement*, Paragraph III.B.3.b(iv), p. 25 (filed March 28, 2005).

199 Ex. 19, p. 5, Ex. 204, pp. 3-4., Ex. 208, p. 2.

200 Ex. 209, p. 4.

Plan stipulation.[201] What is more, some parties in this rate case were not signatories to the stipulation in Case No. EO-2005-0329, and are thereby not bound by it.[202]

Findings of Fact

KCPL's different customer classes pay different rates of return.[203] But different customer classes also have different levels in risk, with a large industrial or commercial customer being a riskier customer to serve than a residential customer because, for example, the industrial or commercial customer could close down or go bankrupt, thus depriving the company of revenue until rates are reset.[204]

The only substantive resistance KCPL puts up against Staff's position is that the EO-2005-0329 stipulation prevents anything other than an equal percentage increase to each class. In fact, KCPL admits that Staff ". . . continues the effort to levelize class revenues while maintaining the key elements of rate continuity established in the rate design effort that concluded in 1996. Further, the proposal is consistent in structure to the design approved in the ER-2006-0314 case."[205] As will be discussed below, the Commission does not accept KCPL's and OPC's argument that anything other than an equal percentage increase among customer classes is required by the EO-2005-0329 stipulation. Therefore, the Commission must now address what the proper inter-class shift is.

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[201] Ex. 111, pp. 7-8; Ex. 118, p. 2; Ex. 602, pp. 3-6; Ex. 701, p. 14; Ex. 804, pp. 4-7.

[202] DOE-NNSA and Trigen are parties in this case, and did not sign the stipulation. Ex. 804, p. 4; Tr. Vol. 13, p. 1055.

[203] Tr. Vol. 11, p. 713, p. 931.

[204] Tr. Vol. 11, p. 781.

[205] Ex. 20, p. 6.

The class cost of service and rate design witnesses have quite impressive credentials. KCPL witness Rush has an accounting degree and a Master of Business Administration degree.[206] Staff witness Pyatte holds a baccalaureate degree and a master's degree in economics and has been employed by the Commission since June 1977.[207] Notably, Ms. Pyatte has participated in the last three KCPL rate design and class cost of service studies, dating back to 1978.[208] Staff witness Watkins has an undergraduate degree in economics, and lacks only a dissertation for a Ph.D. in Economics.[209] He has taught economics at the collegiate level, and been on the Staff of the Public Service Commission since August 1, 1982.[210] DOE witness Price has a degree in electrical engineering, and has worked in utility industry some 35 years.[211] OPC witness Meisenheimer has an undergraduate degree in Mathematics and has completed the comprehensive exams for a Ph.D. in Economics. She has taught economics and mathematics courses at several local colleges, and has performed analyses of class cost of service and rate design for OPC for over ten years.[212] OPC witness Trippensee has an accounting degree, is a Certified Public Accountant, and has been an accountant for either the Commission's Staff or OPC for roughly 30 years.[213]

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206 Ex. 19, p. 1.
207 Ex. 111, p. 1.
208 Id. at p. 2.
209 Ex. 16, p. 1.
210 *Id*.
211 Ex. 804, p. 1-3.
212 Ex. 204, pp. 1-2.
213 Ex. 207, pp. 1-2.

While all the class cost of service and rate design witnesses are quite qualified to give their testimony, and they all present compelling arguments, the Commission is most persuaded by Staff's position, due to Staff witness Pyatte's work on, and familiarity with, KCPL rate design issues since the 1970s.

The Commission concludes that it is just and reasonable to shift $3,536,542 of current revenue responsibility from the Medium General Service class to the residential class. The Medium General Service class is a glaring problem, and the Commission is unsure how much of a problem, if any, the remainder of the classes' rate of return is.[214]

The eight studies discussed in Ms. Pyatte's testimony show that, after the shift from MGS to residential customers agreed upon and ordered in last year's case, the residential class is still underpaying anywhere from .41% (2.41% - 2%) to 23.19% (25.19% - 2%).[215] Also, these same studies indicate that the Medium General Service class still bears anywhere from 8.30% (8.75% - 0.45% = 8.30%) to11.46% (11.91% - 0.45% = 11.46%) extra revenue responsibility.

This decision will be a 5% decrease to Medium General Service, and a 1.8% increase to the residential class. As far as how this shift would affect residential customers, KCPL has approximately 233,632 Missouri residential customers.[216] While these new rates are in effect, the shift would amount to an average monthly residential customer bill

[214] *Id*. at 976.

[215] Ex. 111, p. 5; Ex. 118, pp. 3-4. *See also In re KCPL*, Case No. ER-2006-0314, Report and Order, App. D (December 21, 2006)(the appendix being a Commission approved stipulation in last year's rate case which contemplated a class cost of service shift that increased residential rates by 2%, and reduced rates for other classes, including Medium General Service, by 0.45%.)

[216] Ex. 103, App. pp. 4-5.

increase of approximately $1.26 per month.[217] The Medium General Service class has approximately 4,653 Missouri customers.[218] Shifting the $3,536,542 away from them would save each MGS customer an average of $63.34 per month.

This appears to be the most moderate position, and strikes a balance between no revenue shift at all between classes and DOE's proposal to shift more than twice as much revenue responsibility onto residential customers via a 3.76% increase to the residential class.[219] In fact, as it concerns the residential class, Staff's position is virtually a midpoint between the KCPL/OPC position and the DOE position.

As the Commission stated previously, a company receiving a higher return from one class than another is not necessarily charging unjust or unreasonable rates. But an abundance of evidence showing that the residential class is paying considerably less than its cost of service, coupled with what is sure to be a massive increase in rate base if Iatan 2 is placed into service when anticipated, mandates that the Commission continue shifting moderate portions of the revenue requirement onto residential customers.[220] While no rate increase is completely painless, this inter-class shift of revenue responsibility amounts to only about $1.25 per month per residential customer. The Commission understands OPC's argument that OPC's time-of-use study, the type of study that the Commission has

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[217] $3,536,542/233,632 customers = $15.14 annual increase/12 months = $1.26 per month increase.

[218] Ex. 103, pp. 4-5.

[219] The 3.76% proposal was designated as Highly Confidential in Ex. 804, p. 11. However, DOE mentioned that percentage in its publicly filed post-hearing brief. See DOE/NNSA Post-Hearing Brief, pp. 44-45. Because DOE made the information publicly available, the Commission now considers that information public.

[220] The Commission, per the parties' agreement, began such a shift in last year's case. *See id.*

previously approved, shows that <u>no</u> inter-class shift is appropriate. But even OPC stated that class cost of service studies are a **guide** to setting rates.[221]

If the Commission fails to make this moderate shift now, the Commission as well as Missouri ratepayers, could be caught in a quandary. Waiting until Iatan 2 likely will be placed into rate base, and then foisting a much larger increase upon residential ratepayers, could be such a "rate shock" as to amount to rates that are not just and reasonable. On the other hand, mandating that commercial and industrial customers continue to pay an even higher rate of return than the already disproportionate rate of return that they are currently paying after Iatan 2 is in service could also result in rates that are not just and reasonable. Finally, forcing KCPL shareholders to pick up the tab for plant being used to serve ratepayers would likely be confiscatory and illegal; if the plant is used and useful to serve ratepayers, its prudent costs belong in cost of service.

The Commission will continue the course initiated last year of slowly moving towards rate parity among KCPL's customer classes by placing an additional, yet moderate amount of revenue responsibility upon the residential class.

Conclusions of Law

To attempt to support its position on the above-referenced language in the ERP Stipulation, Staff inserted some information gleaned during settlement negotiations in its prefiled testimony.[222] OPC and KCPL object, and ask the Commission to strike that portion of the testimony on the grounds that that information is privileged.[223]

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[221] Tr. Vol. 11, p. 827 (emphasis supplied).

[222] Ex. 111 (HC), pp. 9-11.

[223] Praxair, Inc., also concurs with OPC's motion.

The Supreme Court of Missouri has enunciated a two-step process for determining admissibility of evidence; the evidence must be both logically and legally relevant.[224] The disputed testimony is logically relevant; that evidence tends to support Staff's interpretation of the meaning of the disputed language in the stipulation. But there is a second hurdle Staff must clear, which is legal relevance.

Legal relevance weighs the probative value of the evidence against its costs, including unfair prejudice, confusion of the issues, misleading the jury, undue delay, waste of time, or cumulativeness. Thus, logically relevant evidence is excluded if its costs outweigh its benefits.[225] Using this balancing test, the Commission will sustain the objections and motions to strike launched by OPC and KCPL and joined in by Praxair. The Commission finds the cost of admitting settlement negotiations far outweighs any benefits.

The complexity of the issues and the number of parties often involved in rate cases can be staggering. Parties regularly engage in settlement negotiations, sometimes resolving their disputes with "black box" settlements. That is to say, the many parties arrive at, for example, a final revenue requirement number that they all find acceptable. But that settlement does not reveal *how* the parties arrived at that number, who moved how many dollars on what issue, etc. Indeed, given the sometimes frantic pace of negotiations as the Commission's operation of law date approaches, and the many people involved, the parties may not *know* exactly how they arrived at that number, and one representative of a party may not *know* what another representative of a party has promised someone.

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[224] *State v. Anderson*, 76 S.W.3d 275, 276 (Mo. banc 2002).
[225] *Id.*

If these parties, who employ attorneys, accountants, economists, engineers, as well as several other experts, cannot engage in candid and frank settlement discussions without fear of those discussions being used against them, then the entire settlement process at the Commission could implode. Indeed, in the case at bar, despite the regulatory plan stipulation, a non-unanimous stipulation on pensions, and a non-unanimous stipulation regarding several rate base and expense issues, once sub-issues are counted as separate issues, this case has roughly thirty issues. If parties do not feel free to lay all of their cards on the table during settlement discussions, they could become even more entrenched in their positions. As a result, many more issues might the parties bring to the Commission for resolution.

Absent a statutory change, the absolute deadline for the Commission to resolve a rate case is fixed at 120 days plus six months beyond the tariff effective date.[226] If the issues are not settled, the parties and the Commission would simply have to cram even more work and more issues into an already rather compressed time frame. Several weeks that are currently used for discovery and negotiation would instead have to be used for several weeks of hearings to accommodate the additional issues.

The Commission will not go down that road. The Commission will sustain the objections launched by OPC and KCPL regarding Staff's inclusion of settlement discussion in Staff witness Pyatte's testimony, and will strike from the record the portions of Ms. Pyatte's testimony to which OPC and KCPL objected.

In interpreting the disputed language of the prior stipulation, the Commission need look no further than its own orders approving similar stipulations. For instance, in Case

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[226] Section 393.150 RSMo. 2000.

No. ER-2001-299, the parties executed a Stipulation regarding class cost of service / rate design. In that Stipulation the parties agreed that any rate increase would be "allocated to each customer class on an equal percent of current revenues basis and reflected on all Empire Missouri rate schedules as an equal percentage increase (or decrease) to each rate component on each tariff."[227] In approving the Stipulation, the Commission recognized "this approach as a means of essentially maintaining the same rate design as exists and is presently lawful and approved, since it increases each charge by an equal percentage basis."[228]

Another example proves that parties practicing before the Commission know how to draft language to implement an equal-percent rate increase. That example states that "(t)he Parties agree that the increase in the Company's revenue requirement shall be allocated to each rate schedule on an equal-percent-of-current-revenues basis."[229] More recently, the parties to Case No. WR-2007-0216 also demonstrated an ability to implement an equal percent across the board rate increase. "No party opposed this portion of the rate design and from all appearances in Appendix A-1 of the Global Agreement, the parties agreed to maintain the status quo as evidenced by repeated references to the terminology of 'equal percent class revenue increase/decrease.'"[230]

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[227] See *In re The Empire District Electric Company*, Commission Case No. ER-2001-299, Report and Order, p. 21 (September 20, 2001).
[228] *Id.*
[229] *See In re The Empire District Electric Company*, Commission Case No. ER-2002-424, Report and Order, p. 6 (November 14, 2002).
[230] *See In re Missouri-American Water Company*, Commission Case No. WR-2007-0216, Report and Order, p. 54 (October 4, 2007).

In short, the Commission finds that if the parties had intended the disputed language to mean an equal percentage rate increase to all classes, then they would have agreed upon language similar to what is discussed above, and not on something as open to interpretation as "rate structures."[231] What is more, even *if* that language means an equal percentage shift, the Commission was not a party to that stipulation,[232] is not bound by it, and finds that just and reasonable rates would not result from ignoring the glaring differences in rate of return among the customer classes.

KCPL has the burden of proof to show that its proposed tariffs are just and reasonable, *including* the reasonableness of its rate design.[233] Just because a company derives a higher rate of return from one class than another does not necessarily render those rates unjust or unreasonable.[234] Class cost of service is often considered but a starting point in quantifying what part of the revenue responsibility is afforded to each customer class.[235] Indeed, class costs of service studies are often considered more art

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[231] Ex. 602, pp. 4-6.

[232] *In re KCPL*, Commission Case No. EO-2005-0329, Report and Order, p. 34 (July 28, 2005).

[233] *See, e.g., State ex rel. Monsanto Company v. Public Service Commission,* 716 S.W.2d 791 (Mo. 1986) "Laclede filed the tariffs here in question using the existing rate design. In the suspension order and notice of proceedings dated January 18, 1983, the Commission noted that the Company bore the burden of proof before the Commission and ordered the Company 'to provide evidence and argument sufficient for the Commission to determine . . . the reasonableness of the Company's rate design.'" *Id.* at 795. See also *In re Empire District Electric Company*, Commission Case No. ER-2004-0570, Report and Order (March 10, 2005).

[234] *Midwest Gas Users Ass'n v. Kansas SCC,* 595 P.2d 735, 747 (Kan. App. 1979).

[235] *Shepherd v. City of Wentzville*, 645 S.W.2d 130, 133 (Mo. App. 1982)

than science.[236] Other factors should be considered when establishing rates.[237] It is up to the Commission to evaluate the testimony of expert witnesses and accept or reject any or all of any witness's testimony.[238]

Decision

The meaning of the disputed language from the Stipulation and Agreement in Case No. EO-2005-0329 allows parties to propose inter-class shifts. The proper inter-class shift is to move $3,536,542 of current revenue responsibility from medium general service (MGS) to residential, resulting in a 5% decrease to the Medium General Service (MGS) class, and a 1.8% increase to the residential class.

12. Large Power Service Rate Design:

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

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

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236 *Associated Natural Gas Co*., 706 S.W.2d at 880 (citing *United States v. Federal Communications Commission,* 707 F.2d 610, 618 (D.C.Cir. 1983).

237 *State ex rel. Associated Natural Gas Co. v. Public Service Commission of Missouri*, 706 S.W.2d 870, 879 (Mo. App. 1985) (citing *Southwestern Bell Telephone Company v. Arkansas Public Service Commission,* 593 S.W.2d 434, 445 (Ark. 1980); *Shepherd v. Wentzville,* 645 S.W2d 130 (Mo. App. 1982*); State ex rel. City of Cape Girardeau v. Public Service Commission*, 567 S.W.2d 450 (Mo. App. 1978); *Midwest Gas Users' Ass'n v. State Corp. Com'n, 595 P.2d 735* (Kan. App. 1979); *Central Maine Power Company v. Public Utilities Commission, 382 A.2d 302* (Me. 1978); *St. Paul Area Chamber of Commerce v. Minn. Public Service Commission*, 251 N.W.2d 350 (Minn. 1977); and *American Hoechest Corporation v. Department of Public Utilities*, 399N.E.2d 1(Ma.1980).

238 Id.(*citing In Re Permian Basin Area Rate Cases*, 390 U.S. 747,800, 88 S.Ct.1344,1377, 20 L.Ed.2d 312, (1968)).

Discussion

Praxair recommends rate realignment, with Large Power Class energy charges being reduced, and demand charges being increased.[239] This proposed rate realignment affects only the Large Power Service class, and no other class. Praxair states that energy charges in the Large Power Service rate should be reduced by 1.0 cent/kWh, which would put them near 1.4 cents/kWh, still above variable costs, with a concurrent increase on the demand charge.[240] However, Praxair supports a non-specific adjustment to prevent KCPL from suffering revenue loss due to customer migration.[241]

Praxair continues by arguing that a lot of customer-related costs are not collected through the customer charge. Those costs would normally be recovered in the early blocks of a declining block demand structure, which is one reason to support declining block demand charges. Customers who take service at the substation or transmission level do not require as much distribution network as other customers, so there is less cost associated with serving them, and they should pay a lower demand charge.

KCPL states that to correct for the shift in revenues between classes that Praxair's proposal would cause, an adjustment is needed to correct for the deficiency. This recommended change will result in an increase to some customers of about 6.37%, and a decrease to others of up to 9.06%.[242] These shifts are before reflecting any change in rates due to the increase requested by the Company. KCPL states that Praxair's proposal would

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[239] Mr. Brubaker testified on behalf of Praxair, Inc., Ford Motor Company, and Missouri Industrial Energy Consumers. For brevity's sake only, these positions will be referred to as Praxair's position only. No disrespect is intended to any party, counsel or witness.

[240] Ex. 601, p. 6.

[241] Ex. 602, p. 6.

[242] Ex. 20, pp. 3.

make many customers in the Large Power Service class move, and would require a revenue adjustment to make up for the deficiency. Further, most of those customers (75 out of 89) would not benefit from Praxair's proposal.[243] A KCPL alternative proposal is if, and only if, the Commission decides to adopt Praxair's proposal, it should limit the change to a half cent per kWh for the first two blocks, then no decrease for the last.[244]

Staff argues that no change should be made to the Large Power Service class because Praxair's proposal would drop the energy rates below KCPL's incremental cost to provide that energy. As an alternative, Staff supports some of Praxair's proposals, as long as something is done to prevent customers switching from Large Power Service to Large General Service.[245] Any reduction to existing energy rate values should be accomplished on a proportional or equal-percentage basis.[246] Any offsetting increases to the demand rate values that result from reducing energy rate values should be applied so as to reduce or eliminate the declining block feature of the existing LPS demand charge.[247] Any revenue reduction from customers presently being served on the Large Power Service rate schedule due to existing Large Power Service customers switching to the Large General Service rate schedule should be recovered from the remaining Large Power Service customers by proportionately increasing the demand and energy charges of the Large Power rate schedule.[248]

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[243] Tr. Vol. 11, p. 737-38.
[244] Tr. Vol. 11, p. 787-88.
[245] Ex. 117, p. 3.
[246] *Id.* at p. 6.
[247] *Id*. at p. 7.
[248] *Id*.

Findings of Fact

The Commission has already listed the credentials of KCPL witness Rush and Staff witness Watkins.[249] Praxair witness Brubaker has graduate degrees in engineering and business administration. He has been in private industry, analyzing class cost of service and rate design, for over 35 years.[250] All of these witnesses are extremely qualified to testify on this topic. For the reasons discussed below, the Commission chooses the KCPL and Staff proposal of no changes to the Large Power Service tariff.

Praxair's proposal would cause Large Power Service customers to migrate to Large General Service. To mollify the effects of this anticipated migration, Praxair supports some sort of "adjustment" to make KCPL whole.[251] But the Commission will not support such an adjustment, since it is unclear how large that adjustment would be, and who would pay what portion of it. Further, without that adjustment, KCPL could not collect its revenue requirement under Praxair's proposal.

In addition, the majority of Large Power Service customers, 75 out of 89, would be worse off under Praxair's proposal.[252] Finally, adopting Praxair's proposal would drop the energy charge for some blocks below incremental cost, which would thwart conservation efforts and encourage wasteful uses of electricity.[253] Thus, the Commission will reject Praxair's proposal.

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[249] *See supra*. at fn. 190, 193.

[250] Ex. 601, App. A, pp. 1-3.

[251] Ex. 602, p. 6.; Tr. Vol. 11, p. 766.

[252] Ex. 20, p. 3; Tr. Vol. 11, pp. 739, 741-42.

[253] Ex. 118, p. 9.

In addition, Staff's alternative proposal would seem to do more harm than good to Praxair and other high-load factor customers. For KCPL customers, energy usage (on a kWh basis) is charged in a sequential fashion. Energy is first billed at the initial 180 hour energy block rate; any usage in excess of this is billed at the second 180 hour energy block and finally, any remaining usage is billed at the tail block rate.[254] In order to receive the benefit of the lower energy charges in the second energy block and the tail block, customers must first fill the preceding blocks and pay for energy at the associated higher energy rate.[255] Customers receiving service exclusively out of the first energy block have a load factor less than or equal to 25%.[256] Given that these customers will usually take service only during the peak hours of the day when energy costs are higher (Monday – Friday, 8:00 a.m. through 5:00 p.m.), they are billed at a higher energy charge.[257] Similarly, customers using enough energy to fill both the first and second energy block have a load factor of 50%.[258] These customers will likely be taking energy during the same peak hours as well as some usage during evening and nights or weekends.[259] Finally, customers using energy in excess of the second energy block will have a load factor in excess of 50% and will receive the benefit of the lowest energy charge. These customers are taking energy at the lowest cost off-peak periods experienced by the utility.[260] Staff's alternative proposal to

[254] Tr. Vol. 11, pp. 755-56.
[255] Id. at p. 756.
[256] Id. at pp. 756-57.
[257] Ex. 601, p. 4.
[258] Tr. Vol. 11, p. 757.
[259] Ex. 601, p. 4.
[260] Tr. Vol. 11, p. 757.

reduce or eliminate the declining block rate would take away the lower energy charges the high-load factor customers currently enjoy, and give no corresponding benefit.

KCPL's alternative suggestion would likewise not benefit Praxair and other high load factor customers. KCPL's fallback position is to lower the first and second energy blocks by 0.5 cents per kWh, with no reduction to the tail block. This alternative does nothing to help the large users on the LPS tariff because they will receive proportionately less of the benefit on the energy side. Furthermore, any benefit they receive on the energy side will be made up on the demand side without the benefit of the declining demand block; therefore leaving more of the demand side charges to be absorbed by the large users on the LPS tariff.

One overarching purpose of Praxair's proposal is to reduce the amount of fixed costs paid in the tail block energy rate, as opposed to the fixed costs paid in the other blocks' energy rates.[261] Spreading the energy charge reduction equally among the three energy rate blocks, which is Staff's proposal, would not alleviate the disparity of the fixed costs paid in the tailblock rate when compared to the other two blocks. Further, Staff's condition to eliminate the tailblock in the demand charge would require Praxair and other high-load factor customers to pay proportionately more of the reduced energy charges than the other customers on the LPS tariff would pay.

A better, overall solution for the Large Power Service class is to continue the current course at the present time, with an eye towards the class cost of service study that the Commission has ordered KCPL to file in its next rate case, to see how to better align the Large Power Service rates, both within that class, and as compared to other customer classes.

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[261] Ex. 601, p. 5.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Stipulation and Agreement incorporating the KCPL Experimental Regulatory Plan that the Commission approved in Case No. EO-2005-0329 does allow the signatories to the Stipulation and Agreement to make rate design modifications within the Large Power Service rate schedule. Nevertheless, the Commission declines to make any modifications at this time. Therefore, the appropriate demand and energy charges for the Large Power Service rate schedule are in accordance with KCPL's current Large Power Service rate design.

13. General Service All-electric tariffs and general service separately-metered space-heating tariff provisions:

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

Discussion

KCPL avers that no further adjustments should be made until a class cost of service study is completed. And, continuing its theme that the stipulation in Case No. EO-2005-0329 prevents such a study now, KCPL pushes for a delay of any class cost of service study, and thereby any inter-class revenue shift away from commercial and industrial commercials, until after the Iatan 2 rate case is completed.[262]

[262] Ex. 20, p. 11.

Further, KCPL warns that adopting Trigen's position would increase all other customers' rates, since customers would likely leave KCPL for alternative heating sources, such as Trigen. As a result, KCPL will lose some of its electricity usage in off-peak periods and will have to increase rates to cover the fixed investments previously being recovered by the customers who leave the KCPL system.[263]

Both Trigen and Staff maintain that the separately-metered space heating rates should be increased by 10% on a revenue-neutral basis.[264] But Trigen argues that Staff's position on all-electric tariff rates, while going in right direction, does not go far enough. Trigen believes the Commission should increase the all-electric tariff rates more than the associated standard general application rates so that *the difference* between the general service standard general application rates and the general service all-electric tariff rates is reduced by one-third.[265] Trigen's hope is also for the next two rate cases to have a similar one-third reduction, thus putting the all-electric tariff customers at parity with the general service standard customers.

Staff witness Watkins, seeing no justification for continuing the non-residential, all-electric and separately metered space heating rates, proposes phasing them out in three steps:

1. Increase the separately metered space heating rates by 10% on a revenue neutral basis, prior to any shifts in class responsibility. Also, any approved reduction in

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[263] Ex. 21, p. 7.
[264] Ex. 117, p. 4.
[265] Ex. 703, p. 3.

revenue responsibility for the Medium General Service Class should not be applied to the separately metered space heating rates.

2. Increase the first block of the all-electric rate's winter energy blocks by 10%.

3. Increase the second block of the all-electric rate's winter energy blocks by 5%.[266]

Mr. Watkins further proposes to restrict the availability of the all-electric and separately-metered space heating rates to customers currently served on one of those rate schedules, but only for as long as they continuously remain on that rate schedule.

Findings of Fact

According to the stipulation approved in Case No. EO-2005-0329, the rate case in which Iatan 2 is contemplated to be included in KCPL's cost of service request is due to be filed on October 1, 2009, with new rates to go into effect September 1, 2010.[267] KCPL says that the class cost of service study could be done during that case, but that KCPL would prefer to wait until after that rate case to begin such a study.[268] Such a rate design case would have no operation-of-law date (as opposed to a rate case such as this), so the "spin-off" rate design case could conclude quickly, or could take years.[269]

Regardless of what the stipulation in EO-2005-0329 does, or does not, say, the Commission was not a party to it, and is not bound by it. What is more, Trigen also did not sign that stipulation. Waiting until anywhere from 2009 to 2012 to address the rate

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[266] Ex. 117, p. 5.

[267] See *In re KCPL*, Case No. EO-2005-0329, Report and Order, Attachment 1, Paragraph III.B.3.d .

[268] Tr. Vol. 13, pp. 1061, 1064.

[269] *Id.* at pp. 1064-67.

disparities that the separately-metered space heating and all-electric tariff customers pay compared to the general service tariff customers is waiting too long.

The Commission will again choose Staff's moderate approach; Staff's support for some of Trigen's proposals seems somewhat tepid, as Staff wonders if any of the classes other than Medium General Service even *has* a rate design problem.[270] Trigen's and Staff's argument that increasing all classes' rates the same percentage would effectively increase the size of the general service space-heating rate discounts, and exacerbate the current problem, is compelling.[271] But the Commission is unwilling to speed ahead with Trigen's proposal, as it would also reduce rates even more for Small and Large General Service customers who, as Staff witness Watkins said, may not even have a rate design problem at all.

Trigen touts parity among the classes' rate of return as a reason for the Commission to choose its proposal. But parity and just and reasonable rates may not necessarily be the same. As the Commission discussed earlier, different customer classes have different levels in risk, with a large industrial or commercial customer being a riskier customer to serve than a residential customer because, for example, the industrial or commercial customer could close down, go bankrupt, thus depriving KCPL of revenue until rates are reset.[272] What is more, because Trigen is a competitor of KCPL,[273] a customer could also leave KCPL's system and go to Trigen's system.

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[270] Tr. Vol. 13, p. 976.

[271] Trigen witness Herz refers to the discounted all electric general service tariff rates and the separately metered space-heating rate discounts are sometimes collectively referred to herein as 'space-heating rate discounts", "discounted rates related to space-heating", or simply "discounted rates". *See* Ex. 702, p. 1, fn. 2. *See* Ex. 118, p. 8.

[272] Tr. Vol. 11, p. 781.

[273] Ex. 701, p. 3.

As will be discussed later, a wiser approach is to adopt Staff's approach, and require KCPL to submit a class cost of service study in the next rate case. Then the parties and the Commission will have a better understanding of how, if at all, the Commission should re-allocate revenue responsibility among KCPL's customer classes.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

KCPL's general service all-electric tariff rates and separately metered space heating rates should be increased more (i.e., by a greater percentage) than KCPL's corresponding standard general application rates by rates by 10% on a revenue neutral basis, prior to any shifts in class responsibility. Also, any approved reduction in revenue responsibility for the Medium General Service Class should not be applied to the separately metered space heating rates. KCPL's first block of the all-electric rate's winter energy blocks should be increased by 10%. KCPL's second block of the all-electric rate's winter energy blocks should be increased by 5%.

13b. Should KCPL's general service all-electric tariffs and separately metered space heating rates be phased-out, and if so, over what period?

Discussion

The arguments and record citations from Trigen, Staff, and KCPL are virtually identical to their arguments and cites from the immediately preceding sub-issue. As such, the Commission will rule on this sub-issue as it did the one just decided, and will rule in Staff's favor.

Findings of Fact

For the reasons cited in the immediately preceding sub-issue, the Commission finds that the evidence supports Staff's position, and adopts the position of Staff is this sub-issue in favor of Staff.[274]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

KCPL's general service all-electric tariffs and separately metered space heating rates should be increased more (i.e., by a greater percentage) than KCPL's corresponding standard general application rates by rates by 10% on a revenue neutral basis, prior to any shifts in class responsibility. Also, any approved reduction in revenue responsibility for the Medium General Service Class should not be applied to the separately metered space heating rates. KCPL's first block of the all-electric rate's winter energy blocks should be increased by 10%. KCPL's second block of the all-electric rate's winter energy blocks should be increased by 5%.

13c. Should the availability of KCPL's general service all-electric tariffs and separately-metered space heating rates be restricted to those qualifying customers' commercial and industrial physical locations being served under such all-electric tariffs or separately-metered space heating rates as of the date used for the billing determinants used in this case (or as an alternative, the operation of law date of this case) and should

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[274] The sub-issue is: Should KCPL's general service all-electric tariff rates and separately metered space heating rates be increased more (i.e., by a greater percentage) than KCPL's corresponding standard general application rates and if so, by how much more? See, infra, pp. 70-74.

such rates only be available to such customers for so long as they continuously remain on that rate schedule (i.e., the all-electric or separately-metered space heating rate schedule they are on as of such date)?

Discussion

KCPL reminds the Commission that this issue was addressed in the 2006 Rate Case, and the Commission ruled against Trigen. One of the most significant effects of Trigen's proposal is the likely increase in rates for all other customers that would result if Trigen's position is adopted. By limiting, restricting, or curtailing the applications of electric heating, customers will likely turn to natural gas or steam heating. This will result in a reduction of electricity usage in off-peak periods and ultimately increased rates to cover the fixed investments previously being recovered by those customers.[275]

Trigen wants the Commission to restrict the availability of these discounted rates to those qualifying commercial and industrial customers' physical locations being served under such discounted rates currently, i.e., receiving the discounted rates in the test year billing determinants.[276] Only in this manner can the restriction be made meaningful.[277] Staff agrees with Trigen, and states that these discounted rates should only be available to those qualifying commercial and industrial customers' physical locations currently being served under such discounted rates for so long as they continuously remain on that schedule.[278]

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[275] Ex. 21, p. 7.

[276] Ex. 701, p. 18. As an alternative, the Commission could use the operation of law date for this case; however, Trigen believes that the date used for billing determinants should be used. (Ex. 701, Herz Direct, p. 18).

[277] *Id*. at p. 10, fn. 5.

[278] Ex. 117, p. 4.

Findings of Fact

The Commission finds that the competent and substantial evidence supports the positions of Staff and Trigen, and finds the issue in favor of Staff and Trigen. The Commission is persuaded by Trigen's argument that last year's Report and Order that limited these discounts to existing customers could exacerbate, rather than ameliorate, the actual or potential problems the discounts cause by allowing even more KCPL customers to migrate to those discounts. In a future rate case, the Commission might be willing to consider eliminating the discounts altogether. Allowing even more customers to use those discounts flies in the face of a possible move, supported by Staff,[279] towards eliminating them completely.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

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

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[279] Ex. 117, pp. 4-5.

13d.

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

Discussion

KCPL continues the mantra that anything other than an equal percentage increase to each customer class violates the Stipulation from Case No. EO-2005-0329. Also, it avers that the time to conduct the cost studies is at the conclusion of the last rate case anticipated by the Regulatory Plan, when Iatan 2 comes on-line.

Trigen asserts that the class cost of service study in KCPL's last rate case lumped all of the standard tariff customers, all-electric tariff customers, and separately metered space-heating commercial and industrial customers together into one of the three general service categories (small, medium and large).[280]

Staff agrees, asserting that KCPL should have the chance to justify its discounts. If KCPL cannot justify them, then KCPL should have the chance to propose a way to end them.[281]

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[280] Ex. 701, p. 11.

[281] Ex. 117, pp. 4-5.

Findings of Fact

As the Commission stated previously, it disagrees with KCPL's analysis of the meaning of the Stipulation in Case No. EO-2005-0329. The Commission has already stated that it finds, at a minimum, believes that waiting three to five years to get newer, fresher data from the parties, so that the Commission can begin at least considering narrowing the differences in the rates of return the different customer classes pay, is too long to wait.

In the last rate case, KCPL did not investigate or calculate the cost of serving the discounted rate customers, nor did it investigate or calculate the cost-effectiveness of the space-heating rate discounts; instead, it only looked at the general service standard tariff customers and the discounted rate customers as a whole.[282] In fact, the same is true for KCPL's prior class cost of service study in 1996. The standard tariff versus discounted rates are the result of maintaining the price differentials which were in effect prior to KCPL's 1996 class cost of service case.[283]

When KCPL files the cost of service and/or cost effectiveness studies, KCPL could propose an alternative phase-out plan for the remaining commercial and industrial customers served under the all-electric tariffs and separately metered space heating rates for consideration by the Commission.

Conclusions of Law

There are no additional conclusions of law for this issue.

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[282] *Id.*

[283] *Id.*

Decision

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

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

Discussion

KCPL states that it would be improper and unlawful for the Commission to require the Company to impute a higher rate for these services than the rate that has been lawfully approved by the Commission. Trigen states that the Commission should impute those revenues to give KCPL incentive to file the studies, and avoid further subsidies. Staff states revenues should not be imputed.

Findings of Fact

Because the Commission ruled in Trigen's favor in the immediately preceding sub-issue, there appears to be nothing in this sub-issue for the Commission to resolve.[284] But, to the extent a ruling is required, for the reasons listed in sub-issue 13d.i., the Commission finds that it should not impute revenues because the Commission is ordering KCPL to file a class cost of service study in the next rate case.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

Because the Commission ruled in Trigen's favor in the immediately preceding sub-issue, there appears to be nothing in this sub-issue for the Commission to resolve. But, to the extent a ruling is required, in the event that KCPL does not file such cost of service and/or cost-effectiveness studies before or as part of its next rate case, the Commission will not require KCPL to impute the revenues associated with the discounted rates in the all-electric general service tariffs and separately metered space heating provisions of its tariffs and impute revenues equal to KCPL's cost of administering these discounted rates as part of its next rate case.

13e Should the Commission require KCPL to (a) investigate and determine whether the commercial and industrial customers currently served under the general service all-electric tariffs and the separately-metered space heating provisions of the

[284] Of course, should KCPL fail to file the class cost of service study as ordered in this Report and Order, the Commission would consider any parties' motion, either in the next rate case or in a separate case, for sanctions against KCPL for failing to follow a Commission order, and would likewise give KCPL a chance to respond to those motions.

standard general service tariffs continue to meet the eligibility requirements for those discounted rates; (b) remove from the discounted rates those customers which KCPL's investigation determines are no longer eligible for such discounted rates; and (c) monitor and police the eligibility requirements of those customers receiving such discounted rates for reporting in KCPL's direct testimony in its next rate case filing?

Discussion

KCPL argues that such "eligibility investigations" are currently addressed through the internal processes of the Company for placing customers on the appropriate rates. KCPL believes that it has adopted the appropriate procedures and safeguards for correctly placing customers on the appropriate rates. No such further study is warranted.[285] Staff largely agrees, remarking on how time-consuming and awkward such a venture would be, and reminding the Commission the exercise would have little value, since those rates are likely going to be phased out, anyway.[286]

Trigen avers that KCPL's response to this issue is that it has the appropriate procedures and safeguards for *placing* customers on the appropriate rates.[287] But, Trigen argues that KCPL's response misses the point, because this issue deals with customers who are already being served under the discounted rates, and whether they continue to remain eligible for such rates – not with *placing* customers on appropriate rates initially. There is no indication – no record evidence – that KCPL has developed and implemented a

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[285] Ex. 20, pp.12-13.
[286] Ex. 117, p. 6.
[287] Ex. 20, p. 13.

process by which it would *remove* a customer from a discounted rate if the customer no longer meets the eligibility requirements.[288]

Findings of Fact

The Commission is already ordering KCPL to file a class cost of service study in the next rate case. The results of that study will aid the parties and the Commission in determining what steps, if any, might be needed to perhaps end the general service all-electric and the separately metered space heating discounts in the standard general service tariffs. Such a study is already a substantial burden; requiring KCPL and its customers to constantly to constantly monitor and report via an administrative process that involves gathering behind-the-meter information is too large a burden for the company and the customers.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission will not require KCPL to (a) investigate and determine whether the commercial and industrial customers currently served under the general service all-electric tariffs and the separately metered space heating provisions of the standard general service tariffs continue to meet the eligibility requirements for those discounted rates; (b) remove from the discounted rates those customers which KCPL's investigation determines are no longer eligible for such discounted rates; and (c) monitor and police the eligibility requirements of those customers receiving such discounted rates for reporting in KCPL's direct testimony in its next rate case filing.

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[288] Ex. 703, p. 10.

13f. Should the Commission approve KCPL's proposal to rename its general service "All-Electric" tariffs as "Space Heating" tariffs?

Discussion

KCPL simply argues such a name change would be appropriate.

Trigen argues that the Commission should not approve KCPL's proposal.[289] Trigen submits that renaming these all-electric tariffs as space-heating tariffs would be misleading *and* would not be consistent with the "Availability" section of the tariffs.[290] Furthermore, KCPL failed to provide any evidence why the tariffs should be renamed; therefore, KCPL's unsupported proposal cannot be adopted.

Staff agrees, stating that KCPL inadvertently filed proposed all electric tariff sheets on which the title had been changed from "All Electric" to "Space Heating." This change should not appear or be approved when KCPL files its compliance tariffs.[291]

Findings of Fact

KCPL pointed to no evidence to support its position. Therefore, the Commission will rule against KCPL.

Conclusions of Law

There are no additional conclusions of law for this issue.

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[289] Ex. 702, p. 6.
[290] *Id*.
[291] Ex. 117, p. 8.

Decision

The Commission should not approve KCPL's proposal to rename its general service "All-Electric" tariffs as "Space Heating" tariffs.

IT IS ORDERED THAT:

1. The motions for leave to file briefs out of time filed by the Staff of the Commission and the Office of the Public Counsel are granted.

2. The Motion to Strike filed by the Office of the Public Counsel, and the Motion to Strike Portions of Prefiled Surrebuttal Testimony of Staff Witness Janice Pyatte filed by Kansas City Power & Light Company are granted, and the portion of Ms. Pyatte's testimony to which the Office of the Public Counsel and Kansas City Power & Light Company object; namely, from page 9, line 19, to page 11, line 16 of Exhibit 111, shall be stricken from the record.

3. All pending motions and requests for relief not otherwise granted herein are denied.

4. The proposed tariff sheets filed by Kansas City Power & Light Company on February 1, 2007, Tariff No. YE-2007-0541, are rejected.

5. Kansas City Power & Light Company shall file tariffs that comport with this Report and Order no later than December 13, 2007.

6. The Staff of the Commission shall file a recommendation regarding the tariffs ordered in paragraph 5 no later than December 18, 2007. Any party that wishes to object to the tariffs ordered in paragraph 5 shall do so no later than December 18, 2007.

7. This Report and Order shall become effective on December 16, 2007.

BY THE COMMISSION

Colleen M. Dale
Secretary

(S E A L)

Davis, Chm., Murray, and Jarrett, CC., concur;
Clayton, C., dissents, with separate dissenting
opinion to follow;
and certify compliance with the provisions
of Section 536.080, RSMo.
Appling, C., not participating.

Dated at Jefferson City, Missouri,
on this 6^{th} day of December, 2007.