Exhibit No.:	
Issue:	*Construction Accounting*
Witness:	*Keith Majors*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*ER-2012-0175*
Date Testimony Prepared:	*September 12, 2012*

Filed
December 11, 2012
Data Center
Missouri Public
Service Commission

MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION
UTILITY SERVICES - AUDITING

REBUTTAL TESTIMONY

OF

KEITH MAJORS

KCP&L GREATER MISSOURI OPERATIONS COMPANY
CASE NO. ER-2012-0175

Staff Exhibit No. 280NP
Date 10/17/12 Reporter MM
File No ER-2012-0175

Jefferson City, Missouri
September 2012

** Denotes Highly Confidential Information **

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REBUTTAL TESTIMONY

OF

KEITH MAJORS

KCP&L GREATER MISSOURI OPERATIONS COMPANY

CASE NO. ER-2012-0175

Q. Please state your name and business address.

A. Keith Majors, Fletcher Daniels Office Building, 615 East 13th Street, Room G8, Kansas City, Missouri, 64106.

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

A. I am employed by the Missouri Public Service Commission (Commission) as a Utility Regulatory Auditor IV.

Q. Are you the same Keith Majors who contributed to Staff's Cost of Service Report filed on August 2, 2012 as part of this rate proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to address certain positions taken by Darrin R. Ives and John P. Weisensee in their GMO Direct testimony filed February 27, 2012. These GMO witnesses filed testimony concerning special accounting treatment for a proposed infrastructure improvement program for GMO's L&P rate district. This program is described in the GMO Direct Testimony of William P. Herdegen, III.

CONSTRUCTION ACCOUNTING PROPOSAL

Q. What is the construction accounting regulatory mechanism GMO has requested?

A. Company Witness John P. Weisensee states the following on page 52, lines 2 through 9 of his direct testimony:

> The Company is requesting construction accounting treatment for the infrastructure improvements. The treatment would allow for the deferral to a regulatory asset of depreciation on the infrastructure assets until the next rate case in which the costs are included in rate base, coupled with a carrying cost similar to Allowance for Funds Used during Construction. The amortization of the regulatory asset would be determined in a future rate case. The infrastructure assets are principally those assets recorded in the Distribution plant accounts (360s thru 370s). The requested treatment will not affect the normal recording of activity to the depreciation reserve, or the asset account.

Q. Does Staff recommend the Commission approve GMO's requested construction accounting regulatory mechanism?

A. No. Staff recommends the Commission reject GMO's request for several reasons:

1) The proposed regulatory mechanism may represent unjustified single-issue ratemaking.
2) GMO's proposal does not take into account any changes in revenues or expenses between rate cases.
3) GMO's proposal reduces management's incentive to efficiently control costs.
4) The proposal does not take into account any plant retirements or additions to depreciation reserve that reduce the Company's net investment.
5) The proposal does not fully address the accumulated deferred income taxes ("ADIT") associated with the investments.

Q. What is construction accounting?

A. Construction accounting is a regulatory mechanism authorized very infrequently to mitigate the impact on earnings related to large rate-based capital additions.

Under normal accounting, immediately following the completion of construction and in-service certification of electric utility assets, depreciation of the asset begins and Allowance for Funds Used during Construction (AFUDC) ceases to be accrued. Under construction accounting, an amount equal to the depreciation recorded to the depreciation reserve is recorded into a regulatory asset. Additionally, a carrying cost similar to AFUDC is recorded to the same regulatory asset account. In prior instances where construction accounting has been authorized by the Commission, the deferral of depreciation expense and carrying costs to the regulatory asset continues until the effective date of new rates.

Q. In what cases has construction accounting been authorized by the Commission?

A. For electric utilities, construction accounting has been authorized with large baseload coal-fired construction projects such as Iatan 1, Plum Point, and environmental upgrades to large baseload coal-fired units such as those at Iatan 2 and Sioux. In the case of Iatan 1 and 2, the Commission authorized construction accounting through approval of various stipulations and agreements including those made under utility experimental regulatory plans.

To Staff's knowledge, the first time the Commission used construction accounting for an electric utility was in the 1985 KCPL Wolf Creek and 1984 AmerenUE (Union Electric) Callaway rate cases. Both of these generating stations were their respective companies' sole nuclear generating assets, had significant cost overruns, and represented a significant portion of rate base at that time.

In comparison to other instances where construction accounting has been authorized by the Commission, none of the facts surrounding GMO's request are remotely related. The infrastructure improvements described by GMO witness Herdegen are not generating assets, are projected to cost $27.0 million over 5 years, or $5.4 million per year, and do not rise to the level of investment to which construction accounting should apply.

<u>SINGLE-ISSUE RATEMAKING</u>

Q. How is GMO's requested construction accounting mechanism unjustified single-issue ratemaking?

A. GMO's request represents an attempt to receive unjustified single-issue ratemaking treatment with regard to one aspect of costs while ignoring all other relevant factors. GMO requests this accounting treatment on a select group of investments in the St. Joseph area of GMO's L&P rate district, while ignoring other changes to its net investment, and its other costs and revenues. This St. Joseph-area planned investment is not of the size or scope of investments that the Commission has recently approved for construction accounting.

A utility's revenues, expenditures, capital investments, retirements, and taxes are in a constant state of change from one accounting period to the next. As a result of the regulatory process in Missouri, the information used to establish rates is but a snapshot in time using the best data available. Notwithstanding currently authorized ratemaking mechanisms that allow changes in utility rates outside the rate-case process, the utility is subject to fluctuations in all aspects of revenues and expenses. Additional investments between rate cases, such as the type

GMO requests construction accounting for here, are a part of the expenditures that are subject to constant change. Ignoring increases or decreases in the mix of revenues and expenses comprising a utility's cost of service while capturing the depreciation and carrying costs on additional investments where there is not a compelling reason to do so is inappropriate and would be a departure from traditional ratemaking.

Q. Has Staff recommended the use of construction accounting for GMO for other rate base additions?

A. Yes. Under the Stipulation and Agreement approved by the Commission in Case No. ER-2009-0090, GMO was authorized to create regulatory assets utilizing construction accounting for the Iatan 1 environmental upgrades not in service at April 30, 2009. GMO's affiliate, Kansas City Power & Light Company (KCPL) was also authorized to create regulatory assets utilizing construction accounting for the Iatan 1 environmental upgrades not in service at April 30, 2009 under the Stipulation and Agreement approved by the Commission in Case No. ER-2009-0089.

As part of KCPL's Experimental Regulatory Plan the Staff and other signatory parties recommended that the Commission authorize construction accounting for the construction of Iatan Unit 2 in the Stipulation and Agreement the Commission approved in Case No. EO-2005-0329. For GMO's portion of Iatan 2, construction accounting was authorized pursuant to the Commission's Order approving GMO's AAO request in Case No. EU-2011-0034. That case was filed pursuant to a Stipulation and Agreement dated July 29, 2010 that was ultimately approved by the Commission.

In these relevant examples, all of these Stipulation and Agreements concerning construction accounting were negotiated between the parties who signed them and were subsequently authorized by the Commission.

Q. Is the construction accounting mechanism that GMO is requesting in this case based on the same facts and circumstances that caused Staff to enter into stipulation and agreements that supported construction accounting in the past?

A. No. In the prior stipulations recommending construction accounting, Staff viewed that the size of the investment and its potential impact on the utility's access to reasonably priced capital justified disregarding any mitigating decreases in expenses or increases in revenues. In the case of Iatan 2 the construction accounting regulatory asset was reduced by the value of the energy provided to the system, or displacement cost, after its in-service date. These generating facilities represented significant enough investment that the addition to rate base and depreciation of these relatively large capital investments would have negatively and materially impacted the company's earnings absent construction accounting.

In this case, GMO is requesting this special treatment for capital investments of $27 million over 5 years, as discussed in witness Herdegen's Direct testimony. While these asset replacements and substation additions represent a significant investment to GMO, they do not rise to the level of recent investments approved for construction accounting. GMO witness Weisensee alludes to this fact on page 52 of his GMO Direct testimony:

> Without rate relief timed to when these costs are included in Plant and depreciation starts, GMO will experience earnings decline. In order to address this issue, construction accounting has been used on occasion for **major** plant additions, such as for the Iatan 2 costs incurred by GMO… (emphasis added)

Q. Do you agree with GMO witness Weisensee's contention that GMO will experience earnings decline without Commission approval of the requested special accounting authority?

A. I do agree that an earnings decline would occur on major plant additions such as Iatan 2. For GMO's L&P rate district, the most recent baseload generation added to rate base before Iatan 2 was Iatan 1 in 1980. Such rate base additions are infrequent, represent a significant capital investment relative to existing rate base, and are much better candidates for construction accounting - unlike programs such as the much less costly St. Joseph-area infrastructure improvements.

FAILURE TO MEASURE OTHER CHANGES

Q. In what way does GMO's requested construction accounting mechanism fail to measure any changes in revenues or expenses between rate cases?

A. The Company's request ignores all of the other relevant factors in the ratemaking process. While the specific investments have been identified by GMO in its request, no consideration has been given to decreases in expenses such as reduced maintenance costs resulting from equipment replacements or to increases in revenues from customer growth. The Company's request isolates the plant-in-service component of its cost of service calculation while ignoring other components of cost of service items.

Q. What investments does GMO request receive construction accounting?

A. Staff's understanding of the investments is based on what witness Herdegen describes as the "St. Joseph Infrastructure Program," on page 9, lines 25-28 of his GMO Direct Testimony:

> GMO is recommending implementation of the St. Joseph infrastructure program as set forth below, with future rate recovery allowed for all program costs. We are submitting a comprehensive five-year plan that will address the overall distribution reliability, condition and **future capacity needs of the City of St. Joseph electrical system**… (emphasis added)

Witness Herdegen testified that these additions in part address future capacity needs of the City of St. Joseph.

Q. What is significant about the use of this investment to support future GMO capacity needs?

A. Implicit in GMO's future capacity needs is that if they arise from increased energy sales GMO will necessarily receive additional revenues. These future revenues are clearly an offset to any increased investment and depreciation.

Witness Herdegen identified areas of growth in St. Joseph on page 13, lines 4-9:

> The North and East outskirts of the city of St. Joseph are experiencing areas of significant growth. The Industrial Park Substation at the southeast end of the city currently is at approximately 88% of its capacity, and **growing at a rate of approximately 4% per year**. In order to address these areas of growth and reduce the existing footprint of the 34kV system over time, several new 161kV/12kV substations are proposed for construction in the St. Joseph metro area… (emphasis added)

The growth witness Herdegen identified is but one example of increased revenues or decreased expenses that mitigate the impact of increased capital investment.

Q. Did GMO identify any decreased expenses that would result from the St. Joseph infrastructure program?

A. Not specifically. However, throughout witness Herdegen's GMO Direct Testimony there are references to improving customer service and reliability of the distribution system, both of which have significant potential to reduce maintenance expenses.

Of the $27.0 million estimated cost of the infrastructure program, $12.5 million is identified as replacement of aging and poor performing assets, the replacement of which should reduce maintenance expenses thereby mitigating the initial capital investment. Witness Herdegen on pages 19-20 of his Direct testimony identifies that the "worst performing laterals" are located in the St. Joseph metro area, hence the reason why they were targeted for this infrastructure program. Logically, as these assets are among the worst performing, they have a proportionately higher maintenance cost and the Company will realize lower maintenance and outage expenses with their replacement.

Q. Would these increases in revenues and decreases in expenses be captured in the rates that will result from the current GMO rate case?

A. The rates established in this case rely on historical information used to develop the cost of service going forward, but at a specific point in time using the test year ending September 2011 with known and measurable revenues and expenses updated through the true-up of August 31, 2012. The resulting cost of service represents the most appropriate revenue requirement on a going forward basis. No projected increases or decreases in revenues or expenses were included in the cost of service in this case, thus GMO would retain this positive regulatory lag—i.e. reduced maintenance expenses and customer growth.

Q. Does Staff recommend GMO not be allowed to retain the benefits of that positive regulatory lag?

A. No. Staff has made no effort to capture the positive regulatory lag that GMO expects from reduced maintenance expense and increased customer growth. Establishing the appropriate level of revenues and expenses in the cost of service at a point in time embodies the "matching principle". In this case, the test year recorded twelve months of historical revenues and expenses. Updating the test year for known and measurable events such as updated customer numbers, levels of annualized usages, payroll increases, and plant and depreciation reserve balances utilizes the most current information available to match revenues with expenses to form an overall cost of service. Under the examination of cost of service in the ratemaking process, all other relevant factors are taken into consideration to establish rates.

GMO's request distorts the matching principle by recognizing increases in expenses, or in this case plant investments, while it ignores any mitigating decreases in costs such as maintenance expenses and increases in revenues such as customer growth; all of which are relevant factors in the ratemaking process.

Q. If the Commission were to authorize construction accounting pursuant to GMO's proposal do the accruals have a specific ending date?

A. In the event GMO was authorized to accrue regulatory assets with depreciation and carrying cost the assets would continue to accrue in perpetuity until the associated assets are included in plant-in-service in the cost of service as the result of a rate filing by GMO. In other words, if GMO does not file for a rate increase request that includes the associated assets in rate base, the depreciation and carrying costs would continue to accrue with no recognition of relevant mitigating factors, such as accumulated deferred income taxes (ADIT), retirements, and decreased maintenance and outage expenses—all relevant factors considered in the pendency of a rate case.

EFFICIENT MANAGEMENT

Q. How does GMO's request reduce management's incentive to efficiently control costs?

A. Traditional utility ratemaking in Missouri requires that rates be set utilizing a historical test year, updated for known and measurable changes that capture all changes in revenues, expenses, and levels of investment. Regulatory lag is the time period between when an increase or decrease in a revenue or expense occurs and when that change is reflected in the cost of service through rates, and the effect of regulatory lag can have either a positive impact or a negative impact on a utility's earnings. Utilizing a single-issue ratemaking mechanism such as GMO's request before this Commission, reduces the Company's exposure to the risk of negative regulatory lag.

Q. Is regulatory lag detrimental to the Company?

A. Not necessarily. Regulatory lag is a natural result of historical cost of service ratemaking. Between rate cases, utility management has the incentive and responsibility to prudently manage expenses while providing safe, reliable, and adequate utility service. As the Commission recognized in its Report and Order in Case No. ER-2010-0356, page 151, the effect of regulatory lag can be a benefit or a detriment:

> 442. As a result of regulatory lag, if a utility experiences a cost decrease, there is a lag in time until that reduced cost is reflected in rates. During that lag, the Company shareholders reap, in the form of increased earnings, the entirety of the benefit associated with reduced costs. The Company shareholders also reap, in the form of decreased earnings, the entirety of the loss associated with increased costs.

GMO Witness Darrin Ives discusses regulatory lag in his direct testimony on pages 2-3 and 18 and casts it only in a negative light, recognizing only the effect of negative regulatory lag. However, GMO in the recent past has benefited significantly from positive regulatory lag. The Commission recognized an example of this fact in its Report and Order in Case No. ER-2010-0356:

> 448. KCP&L and GMO began to retain synergy savings, in the form of reduced costs, immediately upon the closing of the acquisition. Given that KCP&L and GMO did not have its next rate case completed until September 1, 2009, the Great Plains shareholders retained the entirety of these synergy savings for that period of time. [footnote omitted]
>
> * * * *
>
> 452. As of September 1, 2009, the shareholders of KCP&L and GMO had realized over $59.3 million in synergy savings. [footnote omitted]
>
> 453. As of June 30, 2010, the shareholders of KCP&L and GMO had realized approximately $121 million in retained synergy savings. [footnote omitted]

Even more recently, GMO retained all of the net savings from the employee reductions the Company refers to as "Organizational Realignment and Voluntary Separation" ("ORVS") program during the time between the employees left KCPL and when the reductions are reflected in GMO's rates. GMO has no employees; KCPL's employees provide services and part of their payroll expenses are allocated to GMO.

Q. Does traditional ratemaking incentivize utilities to prudently and efficiently manage construction costs?

A. Yes. In traditional ratemaking, capital additions to plant-in-service are depreciated immediately and AFUDC ceases to accrue. Thus the utility has sufficient incentive to minimize the amount of capital investment while providing safe, reliable, and adequate service. The lower the initial capital investment, the lower the depreciation expense, and all other things being equal, the lower the impact to earnings.

NET INVESTMENT

Q. How does GMO's request fail to take into account plant retirements and increases to the depreciation reserve that reduce the Company's net investment?

A. If GMO removes and replaces portions of its aging St. Joseph distribution system as described, GMO will retire the existing equipment and remove it from plant-in-service. The net investment of the new St. Joseph-area plant reduced by the amount of retired plant will be less than the gross amount of new investments being made. Without any recognition of retirements, the investment upon which carrying costs are calculated would be overstated.

Once depreciation begins, the depreciation reserve accrues reducing the net investment in plant assets, reducing the net rate base value of the assets. Staff's understanding is that the depreciation reserve associated with the GMO assets for which construction accounting is requested will be charged with ongoing depreciation accruals, even if the depreciation expense is deferred rather than being included on GMO's income statement, pursuant to construction accounting. Without any recognition of the increase in depreciation reserve of these assets once they are placed in service, the investment upon which carrying costs are calculated would be overstated.

On a broader scale, retirements and increases to depreciation reserve, as well as additions to plant-in-service in all categories of assets impact the net rate base on which GMO earns a return. In the normal operations of maintaining its electric production, transmission, and distribution system GMO is regularly adding to and replacing components of these systems without the need for construction accounting.

<u>ADIT</u>

Q. How does GMO's request fail to fully address accumulated deferred income taxes ("ADIT") associated with its St. Joseph-area investments?

A. ADIT represents the various timing differences between when depreciation is recognized for ratemaking purposes and when it is recognized for income tax purposes. As plant is placed into service the ADIT increases quickly as depreciation for income tax purposes is "front-loaded". The depreciation expense for tax purposes is higher at the beginning of the asset's useful life but is lower near the end of the asset's life. For accounting purposes, depreciation is often calculated on a "straight-line" basis over the useful life of the asset. The difference between these two methodologies is captured in the Company's ADIT balances. The amounts of accumulated ADIT serve as a reduction to the Company's investment and a reduction to rate base.

As plant assets are added, depreciation expense begins and ADIT begins to accumulate. GMO's request does not address the reduction to investment that these ADIT balances represent. Witness Weisensee does address the ADIT related to the regulatory assets themselves when GMO proposes to include them in rate base in future rate cases, but his testimony does not address taking into account the ADIT offset to the increased plant balances on which GMO requests to record carrying costs. Incorporating the reduction of ADIT to the plant investment base on which carrying costs would be accrued under GMO's proposal would reduce the amount of total carrying costs recorded to the regulatory asset. This issue is similar to the effects of retirements and increased depreciation reserve that I have discussed earlier in this testimony.

Q. Has GMO recently made substantial capital additions without the use of construction accounting?

A. Yes. Both the Jeffrey Energy Center ("JEC") Flue Gas Desulfurization ("FGD", or "scrubber") rebuild project and the Sibley 3 Selective Catalytic Reduction (SCR) project were recently placed into service without the use of construction accounting. Both of these environmental projects represented significant rate base additions when they were placed into service. The final cost of the Sibley 3 SCR project, according to Staff Data Request 109 S1, Case No. ER-2009-0090 was ** __________ **. The final cost of the JEC scrubber project was approximately ** __________ **, ** __________ ** of which is GMO's 8% ownership share. Neither of these projects received construction accounting treatment and consequently GMO was able to absorb their impact until they were reflected in rates.

Q. What is Staff's recommendation with regard to GMO's proposed construction accounting treatment on the proposed St. Joseph infrastructure program?

A. The Staff recommends the Commission reject GMO's request as it may constitute unjustifiable single-issue ratemaking, ignores mitigating increases in revenues and decreases in expenses, and reduces the incentive to efficiently manage construction expenditures and operating expenses. In addition, GMO's request does not recognize the effect of retirements and ADIT on the total investment and in the calculation of carrying costs.

Q. Does that conclude your rebuttal testimony?

A. Yes, it does.

NP

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement General Rate Increase for Electric Service	))))	Case No. ER-2012-0175

AFFIDAVIT OF KEITH MAJORS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Keith Majors, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Keith Majors

Keith Majors

Subscribed and sworn to before me this 12th day of September, 2012.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public