

**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

**INITIAL POSTHEARING BRIEF OF
MIDWEST ENERGY CONSUMERS' GROUP

(GMO ISSUES)**

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**INITIAL POST-HEARING BRIEF OF
THE INDUSTRIAL INTERVENORS**

COME NOW the Midwest Energy Consumers’ Group (collectively referred to herein as “MECG”) by and through the undersigned counsel, pursuant to the Commission’s November 20, 2012 Order Extending Time for Filing Initial Briefs, and provides its initial post-hearing brief. On October 19 and November 8, 2012, various unopposed stipulations were filed which limits the number of issues awaiting Commission resolution. Relative to the GMO case, the Commission is asked to decide the following issues: (1) return on common equity; (2) capital structure; (3) cost of debt; (4) Crossroads valuation / deferred taxes / transmission expense; (5) transmission tracker; (6) off-system sales margins; and (7) structure of the fuel adjustment clause.

Moreover, on October 29, 2012, several parties filed a Non-Unanimous Stipulation and Agreement Regarding Class Cost of Service / Rate Design. As that document sets forth, the issues of class cost of service and LGS / LP / Lighting Rate Design has been resolved. Recognizing that no opposition has been filed to that Stipulation, by Commission rule, it may be treated as unanimous. As such, the only rate design issues remaining concern residential rate design issues. Given its constituency, MECG takes no position on these residential rate design issues.

While MECG is concerned with the issues of cost of debt, off-system sales margins and structure of the fuel adjustment clause, as a result of time available for briefing and limited resources, MECG has chosen not to brief those issues and instead support the positions advanced by Staff. Instead, MECG provides its brief on the following issue in the KCP&L Greater Missouri Operations case: (1) Return on Equity; (2) Capital Structure; (3) Transmission Tracker; and (4) Crossroads including valuation, deferred taxes, and transmission expense.

I. INTRODUCTION

In the last several years, GMO customers have seen a significant increase in their rates. In large part, this increase in rates has come without any tangible benefit in the form of capital investment to ensure an appropriate mix of generating capacity for future customer needs. Rather, continuing the corporate policy implemented by Aquila almost two decades ago,¹ GMO refuses to invest the necessary capital to provide GMO customers with the capacity necessary.² Instead, GMO continues to rely on purchased power agreements in the hopes of making the Commission see some logic in the addition of the Mississippi Crossroads unit to the GMO generation portfolio.

As then-Chairman Davis appropriately recognized, “[t]here are ample grounds for questioning the prudence of Aquila’s management, past and present. These include: management decision to pursue unregulated business ventures that eventually caused Aquila to hemorrhage money, lose its investment grade status and some would say neglect its customers for years.” “There is no question Aquila’s decisions have been detrimental to its ratepayers.” “These issues will continue to haunt Aquila management for years to come regardless of who’s in charge.”³

This reliance on purchased power contracts has had a significant effect on GMO rates and their affordability. Worse still, the impact is not only seen in the permanent rate increases, but also in the persistent rate increases automatically permitted through the GMO fuel adjustment clause.

¹ Staff Exhibit 292, Featherstone Surrebuttal, page 63.

² See, Staff Exhibit 258, Staff Cost of Service Report, pages 84-85.

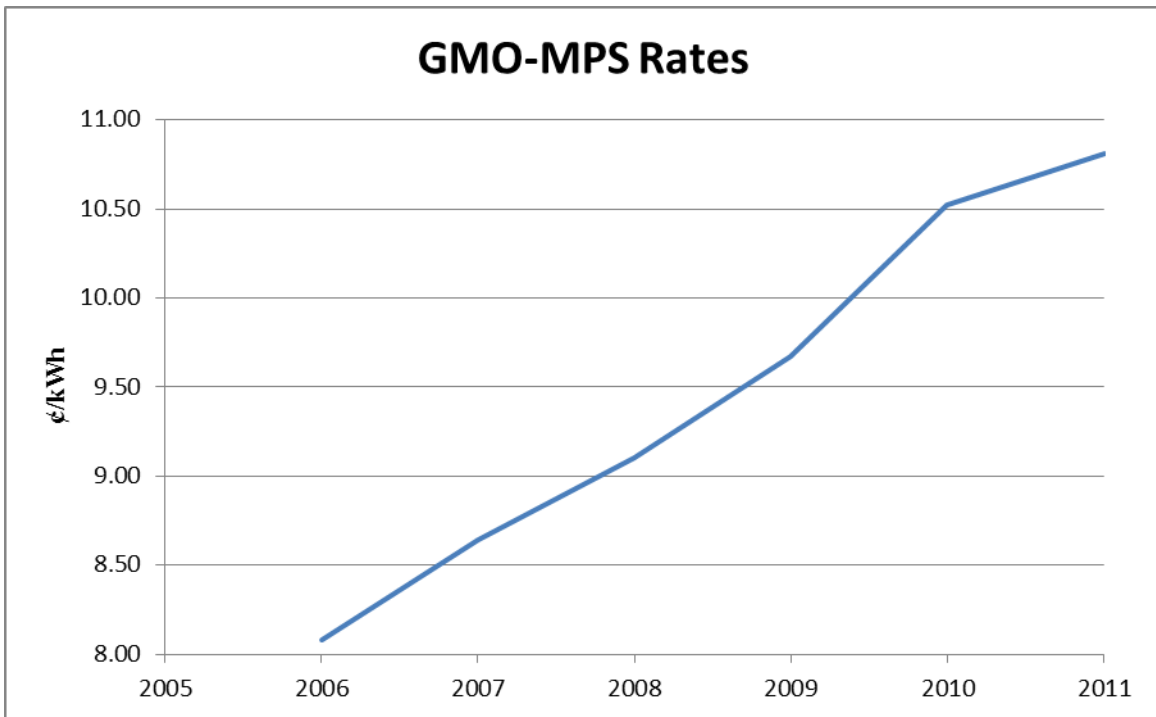
³ *Concurring Opinion of Chairman Davis*, Case No. ER-2007-0004, pages 11 and 12 (issued July 9, 2007).

A. AFFORDABILITY

Since 2007, GMO rates have skyrocketed. Specifically, since that date, the Commission has authorized the following rate increases.

	<u>MPS</u>	<u>L&P</u>
ER-2007-0004:	11.64% increase	12.79% increase
ER-2009-0090:	10.46% increase	11.85% increase
ER-2010-0356:	7.20% increase	15.80% increase ⁴

Recognizing that, through settlements, GMO-MPS is guaranteed an increase of \$16.1 million and L&P rates an increase of \$18.6 million,⁵ GMO-MPS rates will have increased by at least 36.3% in five years and GMO-L&P rates will have increased by at least 61.79% over the same period.⁶ Graphically, the increase in GMO-MPS rates can be seen:



⁴ See, Staff Exhibit 258, Cost of Service Report, at page 7.

⁵ See, Second Non-Unanimous Stipulation and Agreement as to Certain issues, filed November 8, 2012, at page 2.

⁶ Again, this is exclusive of the numerous rate increases realized through the GMO fuel adjustment clause.

GMO tries to brush off the 61.79% increase in L&P rates by noting that its rates are actually below the national average.⁷ GMO, however, fails to provide the Commission with the complete story. While the national average residential rate has increased by only 13.6% since 2006, GMO-MPS' (33.8%) and GMO-L&P's (36.95%) residential rates have increased by almost three times as much.⁸ More importantly to the economic well-being of Missouri, while the national average commercial and industrial rates has increased by 9.3% and 10.7% since 2006, GMO's commercial (MPS – 37.2% and L&P – 39.9%) and industrial (MPS – 37.1% and L&P – 41.0%) rates have increased four times faster.⁹

The unaffordability of GMO's rates is best seen while considering other economic data for the GMO service area. Specifically, while GMO rates will have increased as much as 62.8% since 2006, the increase in average wages over that period has only been 11.45%.¹⁰ While GMO utility rates may be lower than the national average, the impact of lower wages in this service area means that “utility expenses constitute a higher percentage of a Missouri resident's living expenses than the average U.S. resident.”¹¹ At the same time, counties served by GMO are experiencing a higher mortgage delinquency rate and a higher unemployment rate than the rest of the state.¹² Clearly then, GMO's rates have reached the point of being unaffordable.

⁷ See, KCPL Exhibit 2, Bassham Direct, at pages 5-6 and Tr. 102-103.

⁸ Staff Exhibit 258, Staff Cost of Service Report, at page 16-18.

⁹ *Id.*

¹⁰ *Id.* at page 6.

¹¹ *Id.* at page 7.

¹² *Id.* at pages 10-11.

B. UNCONTROLLED A&G COSTS

One of the primary factors behind the unaffordability of its skyrocketing rates is KCPL’s uncontrolled A&G costs. Without fail, among the Missouri and Kansas electric utilities, KCPL’s A&G costs are significantly higher than any other utility. The following chart is indicative of this ongoing problem.¹³

	KCPL	GMO	Combined KCPL and GMO	Empire District Electric	Westar Energy	Ameren Missouri
A&G Costs per Customer	\$339.18	\$225.46	\$296.07	\$222.05	\$255.06	\$231.17
A&G Costs per Mwh	\$8.53	\$8.27	\$8.45	\$6.35	\$5.38	\$5.72
A&G Costs as % of Revenues	11.15%	9.28%	10.54%	7.06%	7.59%	8.53%

By all three metrics, KCPL’s A&G costs are significantly higher than any other utility.

More disturbing is KCPL’s unwillingness or inability to control these costs. In the last case, the Commission warned KCPL that its A&G costs were higher than any other utility.¹⁴ While comparably sized utilities (Westar and Ameren) have been able to reduce their level of A&G costs, KCPL’s A&G costs have continued to grow.¹⁵

	KCPL	Ameren	Westar
A&G Costs as % of Revenues (change between 2009–2011)	+3.34%	-7.9%	-1.2%

Thus, not only are KCPL’s A&G costs outrageous, KCPL has apparently refused or is unwilling to take any steps to control these costs. In other words, while ratepayers continue to suffer, KCPL’s management’s salaries and bonuses remain unchecked.

¹³ Staff Exhibit 200, Staff Cost of Service Report, at pages 250-251.

¹⁴ *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 154.

¹⁵ Staff Exhibit 200, Staff Cost of Service Report, at page 252.

While the parties have limited the number of issues for Commission resolution, there is still a tremendous opportunity for the Commission to consider the notion of affordability through its decision on: (1) return on common equity; (2) capital structure; (3) the implementation of a transmission tracker and (4) Crossroads valuation. Not surprisingly, by agreeing with GMO's position on these issues, ratepayers will be confronted with higher rate increases both now and in the future. For this reason, MCEG asks the Commission, in light of the evidence regarding the affordability of GMO's rates and its excessive A&G costs, to make a renewed effort to focus on the customers in this case and reject GMO's requests for an inflated return on equity, an equity rich capital structure, the implementation of a transmission tracker; and inflated value for Crossroads.

II. OVERVIEW OF POSITIONS

- Return on Equity: In his testimony, Mr. Gorman recommends a return on equity of 9.10% - 9.50%. As set forth in Section IV of this Brief, MECG urges the Commission to recognize the unaffordability of GMO's rates and the uncontrolled nature of its A&G costs by awarding a return on equity at the low end of the Gorman range (9.10%). Furthermore, in the event that the Commission implements a transmission tracker, MECG urges the Commission to make an explicit 10 basis point reduction in its authorized return on equity to account for the significant shift in risk occasioned by the implementation of a tracker mechanism.
- Capital Structure: As detailed in Section V of this brief, MECG recommends a capital structure consisting of 50% common equity and 50% long term debt. In his testimony, Mr. Gorman notes that the KCPL / GMO consolidated capital structure has an excessive amount of common equity. The significant increase in common equity provides no benefit to customers and has the effect of increasing GMO's cost of service. In the past, the Commission has substituted a capital structure when the utility capital structure has an unrealistic amount of common equity. For this reason, MECG recommends that the Commission utilize a hypothetical capital structure consisting of 50% common equity and 50% long term debt.
- Transmission Tracker: As detailed in Section VI of this brief, MECG recommends that the Commission reject GMO's proposed transmission tracker. Tracker mechanisms, because they allow for the recovery of past losses in future rates, violate the doctrine against retroactive ratemaking. Furthermore, tracker mechanisms cause a significant shift in the risk that rates will be either excessive or inadequate. Finally,

GMO has not demonstrated that its transmission costs meet the Commission's stated criteria for implementation of an adjustment / tracker mechanism. In the event, however, that the Commission implements a transmission tracker, MECG urges the Commission to make an explicit 10 basis point reduction in return on equity to account for the significant shift in risk caused by the implementation of the tracker mechanism.

- Crossroads: In this case, the Commission is asked to repeat the decisions it made regarding Crossroads in the last case. Specifically, the Commission is again asked to decide: (1) the value of Crossroads; (2) whether deferred taxes should be treated as an offset to the Crossroads value; and (3) whether the transmission costs associated with transmitting energy from Crossroads in Mississippi to customers in Missouri should be disallowed. In the last case, the Commission valued Crossroads based upon a proxy sale of identical combustion turbines in an arms-length transaction with Ameren. That transaction resulted in a value of \$61.8 million for Crossroads. In addition, the Commission decided to reflect the entire accumulated deferred tax balance as an offset to the Crossroads rate base. In its proxy sale valuation, the Commission recognized that Ameren did not incur transmission costs because the Raccoon Creek / Goose Creek combustion turbines were located in the same RTO as the customers. Therefore, in order to maintain the viability of the surrogate sale concept, the Commission decided to disallow all transmission costs associated with bringing energy from Crossroads (now in MISO) to the Missouri customers (in SPP).

Because GMO has again raised these issues, MECG has returned to its previous position that the valuation of Crossroads is properly established based upon statements of "fair market value" made in Great Plains / Aquila SEC filings. That valuation was \$51.6

million. Furthermore, MECG continues to assert that the Commission should continue to recognize the entirety of the deferred tax balance as an offset to rate base. Finally, the Commission should continue to disallow all transmission costs. As with all other entities that were asked to bid on Crossroads, that facility has no value to GMO customers if they are required to pay these transmission costs. Aquila placed this unit in a congested transmission area in order to take advantage of high market prices. That same congestion has now led to GMO's difficulty in transmitting energy to Missouri. In fact, the location in a different RTO makes these transmission costs a prevalent factor. As such, the Commission should reject all transmission costs.

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III. BURDEN OF PROOF

Section 393.150(2) provides that, in any rate increase proceeding, the burden of proof is on the party seeking the increased rate. In considering the appropriate schedule in a recent proceeding, the Commission adopted KCPL's schedule based upon its acknowledged burden of proof.

Furthermore, the Commission will adopt the order of issues proposed by KCP&L. While the Commission understands the positions argued by Staff and MEUA, the Commission concludes that KCP&L has the burden to put on its case, and should be granted considerable leeway in the order in which it would like to present its evidence.¹⁶

Burden of proof, however, does not only mean that the utility gets the advantages when it comes to presenting its evidence. Burden of proof also means that the utility must accept the "burden" of proving its case.

In this regard, the Supreme Court has provided a great deal of insight regarding burden of proof. Specifically, as it applies to Commission proceedings, the Supreme Court has told us: (1) that burden of proof is a "substantial right" of the customers and (2) that burden of proof should be "rigidly enforced" by the Commission.

The rules as to burden of proof are important and indispensable in the administration of justice, and constitutes a substantial right of the party of whose adversary the burden rests; they should be jealously guarded and rigidly enforced by the courts.¹⁷

The Supreme Court has also provided definition for the burden of proof.

The burden of proof meaning the obligation to establish the truth of the claim by a preponderance of the evidence, rests throughout upon the party asserting the affirmative of the issue. The burden of proof never shifts during the course of the trial.¹⁸

¹⁶ *Order Setting Blocks of Exhibit Numbers*, Case No. ER-2010-0355, page 2 (issued January 12, 2011).

¹⁷ *Highfill v. Brown*, 320 S.W.2d 493 (Mo. 1959).

¹⁸ *Clapper v. Lakin*, 123 S.W.2d 27 (Mo. 1938).

As such, the burden of proof means that the proponent of higher rates in a Commission proceeding has the “obligation to establish the truth” of its need for the higher rates. In this regard, customers are given the benefit of the doubt that the utility only needs the lower rate and that the utility must “prove” that the higher rate is necessary. Therefore, if there is any question regarding the legitimacy of a cost or expense; if the Commission does not adequately understand an issue; or if the Company fails to adequately explain its need for the higher rate, then the utility has failed to meet its burden of proof.

Finally, the Supreme Court has provided insight as to the implications to a party that fails to meet its burden of proof: “the failure of the plaintiff to sustain such burden *is fatal* to his or her relief or recovery.”¹⁹

¹⁹ *Id.*

IV. RETURN ON EQUITY

Return on Equity: What return on common equity should be used for determining rate of return? (ISSUE II.3(a)).

Regulatory Policy and Economic Considerations: (ISSUE II.1)

A. INTRODUCTION AND OVERVIEW

It is well established that public utility commissions have several basic objectives. Foremost among these objectives is to ensure adequate earnings for the utility while preventing excessive (monopoly) profits.²⁰ Absent regulatory controls, the utility will inevitably seek to extract monopoly profits from the many (the ratepayers of Missouri) for the benefit of the few (the shareholders scattered across the nation).

The attempt to extract monopoly profits in this case is best seen in the Company's request for an inflated return on equity. Rather than seeking that level of return that is "sufficient to ensure confidence in the financial soundness of the utility,"²¹ KCPL / GMO seek to bolster their corporate profits. The Supreme Court has pointed out, however, that the utility has no "right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures."²²

In this case, KCPL / GMO request an inflated profit (the return on equity) of 10.30%.²³ In support of this request, KCPL / GMO presented the flawed testimony of Dr. Sam Hadaway. In contrast, OPC presented the testimony of Michael Gorman who recommends a return on equity of 9.10% - 9.50%.

²⁰ Phillips, Charles F. Jr., *The Economics of Regulation*, Rev. ed. (1969) at page 124.

²¹ *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692-693 (1923).

²² *Id.*

²³ GMO Exhibit 115, Hadaway Rebuttal, page 7.

As this brief demonstrates, Dr. Hadaway's analysis is fundamentally flawed and has been routinely rejected by other state utility commissions. More importantly, in its last decision in the GMO case, the Commission leveled several specific criticisms of Dr. Hadaway's analysis. Nevertheless, Dr. Hadaway has simply repeated those same flaws. In contrast to Dr. Hadaway's inflated recommendation, Mr. Gorman presents a reasoned analysis. This analysis is identical in application to those recently recommended by Mr. Gorman and expressly adopted by the Commission. As Mr. Gorman demonstrates, GMO's current investment grade credit rating would be fully supported at either end of his return on equity range. Furthermore, Mr. Gorman's recommendation is consistent with the continued decline in the cost of capital that has been experienced since the Commission authorized a 10.0% return on equity for GMO in April of 2011. In this brief, MECG urges the Commission to award GMO a return on equity that is at the lower end of Mr. Gorman's range. This recommendation reflects concerns with the affordability of GMO's utility service and GMO's continued intransigence in bringing its A&G costs in line with those incurred by other Midwest utilities.

B. THE RECOMMENDATIONS

Consistent with the approach that was recently adopted by the Commission, Mr. Gorman has prepared a return on equity analysis in this case which ensures sufficient and comparable earnings while avoiding concerns of monopoly profits. Specifically, Mr. Gorman has utilized: (1) a discounted cash flow and (2) a risk premium analysis in his determination of a just and reasonable return on equity.²⁴ The ultimate result of each of these models leads to a recommended range of 9.10% - 9.50%.²⁵

²⁴ Mr. Gorman also conducted a Capital Asset Pricing Model ("CAPM") analysis that resulted in a recommended return of 8.40%. (OPC Exhibit 307, Gorman Direct, pages 34-39. In an effort to be

MODEL		RESULT
DCF	Constant Growth	9.46% (OPC Exhibit 309, Gorman Direct, page 20)
	Sustainable Long-Term Growth	9.15% (OPC Exhibit 309, Gorman Direct, page 21)
	Multi-Stage Growth	9.30% (OPC Exhibit 309, Gorman Direct, page 29)
Risk Premium		9.10% (OPC Exhibit 309, Gorman Direct, page 34)
Recommendation		9.10% - 9.50% (OPC Exhibit 309, Gorman Direct, page 39)

The reasonableness of Mr. Gorman's analysis is best reflected by a simple comparison to the recommendations made by the other return on equity witnesses in this case.

<u>Party Witness</u>	<u>ROE Recommendation</u> ²⁶
Staff Witness Murray	9.0%
OPC Witness Gorman	9.1% - 9.5%
FEA Witness Kahal	9.5%
GMO Witness Hadaway	10.3% ²⁷

Clearly, Dr. Hadaway's recommendation on behalf of GMO is the outlier.²⁸

The problem with Dr. Hadaway's analysis is not in the models that he used. Rather, the ongoing problem with Dr. Hadaway's analysis is reflected in the assumptions that he employs. Once corrected, even Dr. Hadaway's analysis falls in line with the other recommendation. As part of his effort to show the reasonableness of his methodology, Mr. Gorman replicated Dr. Hadaway's DCF and risk premium analyses after accounting

conservative (i.e., to recommend a higher return), Mr. Gorman based his ultimate recommendation solely on his DCF analyses and his risk premium study. *Id.*

²⁵ OPC Exhibit 309, Gorman Direct, page 39.

²⁶ GMO Exhibit 115, Hadaway Rebuttal, page 2.

²⁷ GMO Exhibit 115, Hadaway Rebuttal, page 31.

²⁸ The Commission has previously looked at the consistency of the return on equity recommendations in rejecting outliers like the current Hadaway recommendation. See, *Report and Order*, Case No. ER-2011-0028, issued July 13, 2011, at page 70.

for and correcting the obvious flaws in Dr. Hadaway’s methodology. The results of Dr. Hadaway’s corrected analysis (9.40%) buttress the reasonableness of Gorman’s return on equity recommendation (9.10 – 9.50%).²⁹

	MODEL	HADAWAY RESULT ³⁰	ADJUSTED HADAWAY RESULT ³¹
DCF Analysis			
	CONSTANT GROWTH DCF (Analysts’ Growth Rates)	9.80%	9.53%
	MULTI-STAGE GROWTH DCF	9.90%	9.30%
	AVERAGE	9.80 – 9.90%	9.40%
Risk Premium Analysis			
	TREASURY	10.14%	9.37%
	UTILITY	9.87%	9.41%
Recommendation		9.80% - 10.30%	9.40%

As can be seen, when based upon more reliable assumptions (i.e., consensus economist projections), Dr. Hadaway’s analysis provides results that are virtually identical to Mr. Gorman’s recommendation as well as those of Mr. Murray and Mr. Kahal.³² As will be seen, this return on equity is consistent with the dictates of the Supreme Court. Specifically, this return is commensurate with the level of risk assigned to GMO and provides financial support for GMO’s investment grade credit rating.

C. GORMAN CREDIBILITY AND OBJECTIVE ANALYSIS

In its consideration of the return on equity issue in the last case, the Commission was presented with a choice between the objective, reasonable analysis provided by Mr. Gorman and the inflated, self-serving analysis provided by Dr. Hadaway. The

²⁹ OPC Exhibit 307, Gorman Direct, page 47.

³⁰ GMO Exhibit 115, Hadaway Rebuttal, Schedule SCH-12 and 13.

³¹ OPC Exhibit 308, Gorman Surrebuttal, Schedule MPG-SR-1.

³² Mr. Gorman’s recommendation is not only supported by the revised Hadaway analysis, it is also supported by return on equity recommendations made by Staff witness Murray (9.0%) and DOE witness Kahal (9.50%).

Commission was very clear in its view of the relative merits of the two studies. “The Commission finds Mr. Gorman’s testimony to be more credible than the testimony of Mr. Murray and Dr. Hadaway.”³³

The Commission’s obvious preference for Mr. Gorman’s objective analysis was repeated in recent AmerenUE decisions. In May of 2010, the Commission issued its decision in the AmerenUE rate proceeding. In that case, the Commission was confronted with the conflicting testimony of several return on equity witnesses. In its decision, the Commission expressly relied upon Mr. Gorman’s conclusions and recommendations in reaching its conclusion that AmerenUE’s return on equity recommendation was faulty.

For instance, in its analysis, AmerenUE relied solely upon a constant growth DCF methodology that resulted in a return on equity of 11.2%. Based upon Mr. Gorman’s conclusions, the Commission held that the AmerenUE DCF result is “overstated because it is based on a unsustainably high dividend yield and median growth rate.”³⁴ As the Commission recognized, Gorman took these “deficiencies into account and based [his] recommendation on additional sustainable growth DCF and multi-stage DCF models.”³⁵

The Commission then noted that, while Ameren failed to perform these other DCF analyses, Gorman “reworked [Ameren’s] constant growth DCF analysis as a multi-stage growth analysis.”³⁶ Relying upon this “reworked” analysis prepared by Gorman, the Commission found that “it is reasonable to believe that if [Ameren] had performed a multi-stage DCF analysis, as [it] should have, [its] recommendation might be in the low

³³ *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 117.

³⁴ *Report and Order*, Case No. ER-2010-0036, issued May 28, 2010 (“AmerenUE”) at page 21.

³⁵ *Id.* at page 22.

³⁶ *Id.*

10 percent area along with Gorman and Lawton.”³⁷ Clearly, then, the recommendations and conclusions provided by Mr. Gorman were critical to the decisions reached by the Commission in the Ameren case.

In this case, Mr. Gorman presents the same objective analysis relied upon by the Commission in both the recent KCPL / GMO and Ameren decisions. Here, noticing the Commission’s apparent interest in considering the results of multiple return on equity analyses, Mr. Gorman considered the results of four different analysis: (1) a constant growth DCF analysis using analysts’ 3-5 year growth rates; (2) a sustainable growth DCF analysis which considers the comparable companies’ retained earnings; (3) a multi-stage growth DCF analysis which relies on a long-term growth rate equal to the consensus analysts’ projection of gross domestic product; and (4) a risk premium analysis. The average of all of these analyses result in a recommendation of 9.10-9.50%.³⁸

Unique to his analysis, and consistent with the directives of the *Hope* and *Bluefield* decisions, Mr. Gorman then checks to ensure that his recommended return on equity will support an investment grade credit rating. Specifically, Mr. Gorman undertook certain financial analyses for KCPL / GMO based upon his recommended return on equity range.³⁹ Mr. Gorman then compared the financial results to the benchmarks for the three critical S&P financial ratios: (1) debt to EBITDA (Earnings Before Income Taxes, Depreciation and Amortizations); (2) funds from operations to total debt; and (3) total debt to total capital.⁴⁰ As Mr. Gorman’s analysis reveals, his recommended return on equity will allow both KCPL and GMO to meet the investment

³⁷ *Id.*

³⁸ OPC Exhibit 307, Gorman Direct, page 40.

³⁹ OPC Exhibit 307, Gorman Direct, pages 40-45 and MPG-17 and 18.

⁴⁰ *Id.* page 40-45.

grade credit metrics for each of these financial ratios. As Mr. Gorman concludes, therefore, “KCPL GMO’s financial credit metrics are supportive of an investment grade bond rating” at either end of the 9.10 – 9.50% return on equity range.⁴¹

D. HADAWAY ANALYSIS

In contrast to Mr. Gorman’s objective analysis, KCPL / GMO rely upon a return on equity analysis that is inherently flawed. As this brief points out, Dr. Hadaway’s testimony suffers from several shortcomings. First, after recognizing the value of certain models, Dr. Hadaway nonetheless summarily rejects the results of those models that are below his recommended return on equity. This has the effect of inflating KCPL / GMO’s recommendation. Second, Dr. Hadaway’s DCF analyses are flawed in that they rely on unrealistic assumptions. Despite repeated criticism from Missouri and other state utility commissions, Dr. Hadaway has failed to correct these flaws and has instead presented the same damaged study. Again, the use of these unrealistic assumptions leads to an inflated return on equity recommendation.

1. Arbitrary Rejection of Certain Model Results

Since leaving his role at the Texas Public Utility Commission, Dr. Hadaway has appeared hundreds of times in state ratemaking proceedings. Interestingly, in the past 25 years, Dr. Hadaway has always appeared on behalf of the utility.⁴² While the expectations may not be expressly stated, it is clear that, so long as he wants to keep receiving utilities’ business, Dr. Hadaway must be able to justify inflated returns for his clients.

⁴¹ *Id.* at pages 42.

⁴² GMO Exhibit 114, Appendix A, pages 2-7.

In this case, Dr. Hadaway delivered an inflated return by arbitrarily rejecting those analyses which did not conform to his recommendation. Specifically, in arriving at his inflated recommendation of 10.3%, Dr. Hadaway relies solely on his DCF analyses. In his testimony, Dr. Hadaway conducts a risk premium analysis and repeatedly recognizes the value of such an analysis.⁴³ Ultimately, his risk premium approach results in a return on equity of 9.87%.⁴⁴ Despite recognizing the obvious value of the risk premium model, Dr. Hadaway nevertheless conveniently disregards the result when it is below his recommendation of 10.30%.⁴⁵ While Dr. Hadaway claims that his rejection of the risk premium approach was due to “current market conditions,”⁴⁶ it appears that this is simply a continuation of an ongoing habit of disregarding those analyses that are lower than his predisposed position.⁴⁷

Dr. Hadaway’s rejection of analyses that reduce his recommendation is not limited solely to his risk premium analysis. Specifically, in his rebuttal to Mr. Gorman’s DCF analysis, Dr. Hadaway suggested that Mr. Gorman should have eliminated two companies that had low DCF results.⁴⁸ As Mr. Gorman notes, however, Dr. Hadaway never considered making a similar adjustment to eliminate those companies that had a

⁴³ See, GMO Exhibit 114, Hadaway Direct, page 27 (“The basic risk premium methods provide a useful parallel approach with the DCF model and assure consistency with other capital market data consistency in the cost of equity cost estimation process.”). See also, GMO Exhibit 114, Hadaway Direct, page 32 (“The risk premium approach is generally useful because it is founded on current market interest rates, which are directly observable.”).

⁴⁴ GMO Exhibit 115, Hadaway Rebuttal, page 31.

⁴⁵ Interestingly, Mr. Gorman also was seen to disregard the results of one of his analyses. After conducting a CAPM analysis, Mr. Gorman calculated a CAPM result of 8.40%. Rather than utilize those results to artificially reduce his return on equity recommendation, Mr. Gorman demonstrated objectivity and reasonableness by rejecting the result of his CAPM analysis as too low. OPC Exhibit 307, Gorman Direct, page 39.

⁴⁶ GMO Exhibit 114, Hadaway Direct, page 34.

⁴⁷ See, *Report and Order*, Case No. ER-2010-0355, pages 116-117. In that case, Dr. Hadaway initially utilized the risk premium approach, but when he updated his risk premium model for rebuttal testimony and it dropped by 56 basis points, he suddenly soured on its value.

⁴⁸ GMO Exhibit 115, Hadaway Rebuttal, page 17.

high DCF result. As such, like his rejection of the risk premium model, Dr. Hadaway's position is "one-sided and biased."

I do not disagree that it is appropriate to eliminate outlier estimates to enhance the integrity and reliability of the return on equity estimate. However, Dr. Hadaway has applied recommended methodologies to eliminate only low DCF return estimates. He has not proposed a methodology to identify and eliminate the high-end DCF return estimates. As such, his proposed modification is one-sided and biased.⁴⁹

2. Flawed Discounted Cash Flow Analyses

Given his refusal to recognize the results of his risk premium analysis, Dr. Hadaway is left solely with his DCF analyses to support his inflated recommendation. As will be seen, the results of each of Dr. Hadaway's DCF analyses are, nevertheless, fraught with problems and have been widely criticized and rejected by state utility commissions.

First, Dr. Hadaway undertakes a constant growth DCF analysis which relies on analyst growth rates. It is well established that constant growth DCF analyses have a tendency to be overstated in the current economy. While the constant growth DCF analyses is intended to be perpetual in nature, the underlying analyst growth estimates are usually only focused on the short-term (the next 3-5 years).⁵⁰ Ultimately, because of their short-term focus, these analysts' growth projections are not sustainable.⁵¹ Therefore, as the Commission has recently held, the constant growth DCF will collapse under the weight of these unsustainable growth projections.

[T]he constant growth DCF result is overstated because it is based on a unsustainably high dividend yield and median growth rate. Morin's

⁴⁹ OPC Exhibit 308, Gorman Surrebuttal, page 7.

⁵⁰ OPC Exhibit 307, Gorman Direct, page 20.

⁵¹ Current growth rates are based upon the expectation of increased earnings resulting from the large construction cycle currently seen in the electric industry. Such growth rates are not reflective of more normalized levels of constructions and are therefore not sustainable. *Id.* at page 22.

constant growth DCF suffers from the same deficiencies as Gorman described for his own constant growth analysis. . . . Gorman and Lawton took those deficiencies into account and based their recommendations on additional sustainable growth DCF and multi-stage DCF models. . . . In contrast, despite his belief that it is important to “use a whole bunch of techniques”, Morin relied on his constant growth DCF analysis and did not analyze any other form of DCF.⁵²

The same problems previously noted by the Commission in the constant growth DCF model are found within Dr. Hadaway’s analysis.⁵³ Despite the clarity of the Commission’s recent decision, Dr. Hadaway continues to give inappropriate weight to his constant growth DCF analysis.

Second, Dr. Hadaway undertakes a constant growth (GDP) DCF analysis that is not dependent on analyst growth estimates. In light of the obvious shortcomings of his initial constant growth analysis, Dr. Hadaway attempts to provide a long-term growth rate that is consistent with the perpetual nature of the constant growth DCF analysis. While Dr. Hadaway replaces the analysts’ growth rate with a gross domestic product (“GDP”) surrogate, he rejects all recognized measures of GDP growth and, instead, provides his own “estimate” of GDP growth.⁵⁴ In this regard, Dr. Hadaway’s “estimate” of GDP growth is based entirely on historical measures and ignores all forward-looking estimates of GDP growth. Dr. Hadaway’s analysis has been widely criticized by state utility commissions. The following excerpt from a Washington Utilities and Transportation Commission decision is reflective of this widespread criticism.

The principal disagreement between the Company and its expert critics centers on Dr. Hadaway’s use of nominal historical GDP growth rates in the DCF formula. We do not take issue with Dr. Hadaway’s opinion that the DCF formula requires a long-term growth rate or that growth in GDP may serve as a better measure of long-term growth than analysts’ forecasts

⁵² *Report and Order*, Case No. ER-2010-0036, pages 21-22.

⁵³ Ex. 1204, Gorman Rebuttal, page 7 (“These growth rates are not sustainable in the long run.”).

⁵⁴ GMO Exhibit 114, Hadaway Direct, page 38

in the short-term. **However, in this case, we find persuasive Mr. Gorman’s argument, that if growth in GDP is used for this critical input to the DCF formula, it should be a forward-looking, not an historical average.**⁵⁵

Thus, Dr. Hadaway’s reliance on a historical quantification of GDP growth, to the exclusion of forward-looking estimations has been commonly rejected in the ratemaking community.

Moreover, Dr. Hadaway’s reliance on his own subjective estimation of the GDP growth rate is also problematic. In its decision in the recent AmerenUE case, this Commission expressly stated a preference for the use of publicly available assumptions. The Commission rationale’s being that only such publicly available assumptions could be actually relied upon by the investment community in making its market decisions.

Murray’s reliance on analyst reports to support his recommendation is misplaced. **Most investors do not have access to the specific analyst reports that Murray examined and thus they cannot rely on them in deciding where to invest their money.**⁵⁶

Given that Dr. Hadaway’s GDP projections are not published, investors do not have access to this data and “cannot rely on [Hadaway’s estimate] in deciding where to invest their money.”

The practical effect of Dr. Hadaway’s subjective, historically-derived GDP growth estimate is not surprising – it significantly increases his recommended return on equity. As Mr. Gorman points out, Dr. Hadaway’s estimation of GDP growth rate is

⁵⁵ *Washington Utilities and Transportation Commission v. PacifiCorp*, 2006 Wash. UTC Lexis 156, 170 (Washington Utilities and Transportation Commission, April 17, 2006) (emphasis added). See also, *In re: Centerpoint Energy*, 245 P.U.R.4th 384 (Arkansas Public Service Commission, September 19, 2005); *In re: Commonwealth Edison Company*, 250 P.U.R.4th 161 (Illinois Commerce Commission, July 26, 2006); *In re: Fitchburg Gas and Electric Light Company*, 2008 Mass.P.U.C. Lexis 13 (Massachusetts Department of Telecommunications and Energy, February 29, 2008; and *In re: Public Service Company of New Mexico*, 2008 New Mexico P.U.C. Lexis 14 (New Mexico Public Regulatory Commission, April 24, 2008)

⁵⁶ *AmerenUE* at page 20, paragraph 18 (emphasis added).

5.8%.⁵⁷ In contrast, the “consensus economists’ projections” of GDP growth is 4.80%.⁵⁸ When Dr. Hadaway’s estimation of GDP growth is replaced with a more reliable measure, the results of his constant growth (GDP) DCF analysis drop from approximately 10.1% to 9.3%.⁵⁹

Finally, it should be noted that the use of any measure of GDP growth as an input to the constant growth DCF model is of questionable applicability to the electric industry. Specifically, the GDP growth reflects the overall growth in the U.S. economy and includes both high growth industries (biotech, healthcare, etc.) and industries expected to experience lower growth. Typically, given the maturity of the electric industry, it is not expected that the electric industry will actually experience the same level of growth experienced in the economy as a whole. As such, the use of any GDP growth rate estimate will likely result in an overstated return on equity. As the Arkansas Commission has pointed out:

With regard to Mr. Hadaway’s use of the Gross Domestic Product (GDP) growth rate, he is correct that investor-expected dividend growth rates overall are likely correlated with GDP growth rate. However, he has failed to demonstrate that industry-specific DCF investor-expected growth rates are also equal to the nominal GDP growth rate. This is a crucial distinction. For example, a mature industry may have a rich dividend yield and a small expected growth rate, while a young industry may, conversely, have a small dividend yield and a large expected growth rate. It would be reasonable to expect the mature industry’s expected dividend growth rate to be less than nominal GDP growth, while the young industry’s expected growth is greater than GDP growth.⁶⁰

Third, Dr. Hadaway combines his two previous DCF analyses and undertakes a multi-stage DCF analysis which relies upon the problematic analyst growth rates for the

⁵⁷ OPC Exhibit 307, Gorman Direct, page 49.

⁵⁸ *Id.* at page 50.

⁵⁹ *Id.*

⁶⁰ *In the Matter of Centerpoint Energy Arkla*, 245 P.U.R. 4th 384 (Arkansas Public Service Commission, September 19, 2005).

first stage and his overstated historical estimation of GDP growth for the final stage. As demonstrated previously, and as the Commission has recently acknowledged, “the constant growth DCF result is overstated because it is based on an unsustainably high dividend yield and median growth rate.” Furthermore, as demonstrated previously, Dr. Hadaway’s historical estimation of GDP growth rate is significantly overstated when compared against consensus economists’ projections of GDP growth rate. Therefore, it is not surprising that, when he combines these two overstated assumptions into a multi-stage analysis; Dr. Hadaway’s results are grossly overstated. As Mr. Gorman demonstrates, by simply replacing the GDP estimate, Dr. Hadaway’s multi-stage DCF analysis would decrease from 10.1% to 9.3%.⁶¹

Ultimately, when consensus analysts’ projections are used as assumptions in his models, Dr. Hadaway’s analysis is virtually identical to the 9.10 – 9.50% recommendation forwarded by Mr. Gorman.

E. GMO’S REQUEST SHOULD BE AT THE LOWER END OF THE REASONABLE RANGE OF RETURN ON EQUITY.

It is well established that the Commission can consider other factors in its determination of the appropriate return on equity within the reasonable range of return. For instance, in the 2006 KCPL case, the Commission increased the KCPL return on equity by 25 basis points to account for risk associated with the KCPL Regulatory Plan.⁶² Similarly, KCPL sought, but was denied, a 25 basis point increase in the last case to account for its alleged customer service excellence.⁶³

⁶¹ OPC Exhibit 300, Gorman Direct, page 50.

⁶² *Report and Order*, Case No. ER-2006-0314, issued December 21, 2006, at page 30.

⁶³ *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at pages 119-120.

In this case, MECG asks the Commission to consider several factors in authorizing a return on equity at the lower end of the reasonable range of return. Specifically, MECG points to: (1) ongoing concerns with the affordability of GMO's service as well as (2) the inflated nature of GMO's rates caused by its continued inability to control its administrative and general ("A&G") costs.

1. Affordability

As the Commission is well aware, this represents GMO's fourth rate increase in the last 5 years. Specifically, GMO has been granted these recent rate increases:

ER-2007-0004:	11.64% increase	12.79% increase
ER-2009-0090:	10.46% increase	11.85% increase
ER-2010-0356:	7.20% increase	15.80% increase ⁶⁴

Recognizing that, through settlements, GMO-MPS is guaranteed an increase of \$16.1 million and L&P rates an increase of \$18.6 million,⁶⁵ GMO-MPS rates will have increased by at least 36.3% in five years and GMO-L&P rates will have increased by at least 61.79% over the same period.⁶⁶ GMO rates will have increased by a minimum of 61.79% in just five short years. In contrast, while GMO rates have grown by 61.79%, the national average rate for electricity has only increased by 13.6%.⁶⁷ Therefore, GMO's rates have **increased at four times the rate** of the national average.

While GMO has seen its rates and profits skyrocketing over recent years, its customers have continued to suffer the crippling effects of a recessionary economy. As Staff notes, "the counties in the Missouri service area of KCPL have experienced

⁶⁴ See, Staff Exhibit 258, Cost of Service Report, at page 7.

⁶⁵ See, Second Non-Unanimous Stipulation and Agreement as to Certain issues, filed November 8, 2012, at page 2.

⁶⁶ Again, this is exclusive of the numerous rate increases realized through the GMO fuel adjustment clause.

⁶⁷ *Id.* at page 17 (national average rate increases for residential customers).

challenging economic times since 2007 due to the recession and a slow recovery.”⁶⁸ Specifically, while GMO rates will have increased up to 61.79%, average weekly wages for GMO customers have only increased by 11.45%.⁶⁹ Interestingly, during this troubling period, only GMO has sought to take advantage of its customers as the remainder of the Consumer Price Index has only risen by 11.58%.⁷⁰ As Staff notes, “general utility expenses [like KCPL rates] constitute a higher percentage of a Missouri resident’s living expenses than the average U.S. resident.”⁷¹

2. GMO’s Uncontrolled Administrative and General (“A&G”) Costs

The evidence provides reasons underlying KCPL’s rapid increase in rates. Of primary concern, is the uncontrolled increase in KCPL’s A&G costs. In its Cost of Service Report, Staff compared KCPL’s A&G costs against the same costs for neighboring utilities: Empire District Electric, Ameren Missouri and Westar Energy. Staff made its comparison using three different metrics. In all instances, KCPL’s A&G costs are significantly higher than any other utility.⁷²

	KCPL	GMO	Combined KCPL and GMO	Empire District Electric	Westar Energy	Ameren Missouri
A&G Costs per Customer	\$339.18	\$225.46	\$296.07	\$222.05	\$255.06	\$231.17
A&G Costs per Mwh	\$8.53	\$8.27	\$8.45	\$6.35	\$5.38	\$5.72
A&G Costs as % of Revenues	11.15%	9.28%	10.54%	7.06%	7.59%	8.53%

The inflated nature of KCPL’s A&G costs are not inconsequential. If KCPL, instead of being the worst in all three metrics, simply improved to the second worst, its rates would

⁶⁸ *Id.* at page 6.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at page 7.

⁷² *Id.* at pages 250-251.

be much more affordable. For instance, by improving to second worst, KCPL rates would be approximately \$42.78 million less.

If KCPL improved to second worst:

-on a per customer basis: savings = \$43.08 million⁷³

-on a per Mwh basis: savings = \$44.42 million⁷⁴

-on a % of revenue basis: savings = \$40.83 million⁷⁵

AVERAGE SAVINGS = \$42.78 million

In other words, virtually the entirety of this rate increase (at least \$53.5 million) is for the purpose of maintaining KCPL's uncontrolled A&G costs. Certainly, it is not unreasonable for the Commission to award KCPL a return at the lower end of the reasonable range in recognition of: (1) the unaffordability of its rates and (2) the inflated nature of and KCPL's continued inability to control its A&G costs.

In addition, the Commission should continue its previous decision to establish GMO's return on equity at 20 basis points below that granted to Ameren. On July 13, 2011, the Commission granted Ameren a return on equity of 10.2%.⁷⁶ At approximately the same time, the Commission granted GMO a return on equity of 10.0%.⁷⁷ This difference is undoubtedly based upon the different risk profiles between the two companies. There is no evidentiary basis to eliminate this differential and MECG asks the Commission to continue this risk differential in its authorized return on equity.

⁷³ KCPL (as the worst A&G costs) = \$339.18 / customer. Westar (as the second worst A&G costs) = \$255.06 / customer. Difference is \$84.12 * 512,125 customers = \$43.08 million.

⁷⁴ KCPL (as the worst A&G costs) = \$8.53 / Mwh. Empire (as the second worst A&G costs) = \$6.35 / Mwh. Difference is \$2.18 / Mwh * 20,374,583 Mwh's sold = \$44.42 million.

⁷⁵ KCPL (as the worst A&G costs) = 11.15% of operating revenues. Ameren Missouri (as the second worst A&G costs) = 8.53% of operating revenues. Difference is 2.52% of total revenues of \$1,558,265,703 = \$40.83 million.

⁷⁶ *Report and Order*, Case No. ER-2011-0028, issued July 13, 2011, at page 74.

⁷⁷ *Report and Order*, Case No. ER-2010-0356, issued May, 2011, at page 150.

F. RECENT PUC DECISIONS AND DECREASING CAPITAL COSTS

As the Commission has previously recognized, *Hope* and *Bluefield* require the Commission to consider the return earned by other businesses “which are attended by corresponding risks and uncertainties” in the “same general part of the country.”⁷⁸ In general, the Commission fulfills this charge through the expert witness’ reliance on comparable companies. Nevertheless, in previous decisions, the Commission has expressed interest in other state return on equity decisions.

Inevitably, KCPL / GMO will direct the Commission’s attention to national average return on equity decisions as reported by Regulatory Research Associates. Such comparisons are often misplaced. As the Arkansas Commission has noted:

This Commission gives no weight to such data for three reasons. First, there is an element of circularity involved if this Commission, as well as other state Commissions, rely upon rate of return determinations in other states for determining the appropriate allowed return for utilities in their states. Second, neither this Commission nor the parties have had an opportunity to probe the factors that made up the allowed return determinations in the other states. This Commission must make determinations based upon the evidence presented in testimony and hearings before this Commission, pursuant to the laws of the State of Arkansas. Third, this sort of comparison is akin to piecemeal ratemaking and is unacceptable. For example, we do not know the other state commissions’ policies regarding rate base, expenses, depreciation, etc. As noted by CEUG witness Staley: “Every natural gas utility has different needs, different risks, different load profiles, and different performance levels. Consequently, every natural gas utility should have a uniquely determined ROE.”⁷⁹

Given the logic of this argument, then, the only other state commission decisions which would hold any relevance would be: (1) other electric decisions in the State of Missouri – because they involve the same “state commission policies regarding rate base,

⁷⁸ *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923).

⁷⁹ *In the Matter of Centerpoint Energy Arkla*, 245 P.U.R. 4th 384 (Arkansas Public Service Commission, September 19, 2005).

expenses, depreciation, etc.” and (2) state commission decisions involving KCPL – because they involve the same utility with the same risks, load profiles and performance levels.

On May 4, 2011, the Commission issued its decision on the most recently completed GMO rate case.⁸⁰ In that decision, the Commission authorized a return of 10.0% for GMO. That decision was based upon a true-up period ending December 31, 2010.⁸¹ In contrast, the updated test year used in this proceeding ended on August 31, 2012.⁸² Therefore, the Commission should be acutely aware of the changes in the capital markets in the 21 months between these two cases and the impact on the Commission’s 10.0% return on equity for GMO.

It is unrefuted that the market cost of capital has declined sharply in the 21 months since the Commission authorized a 10.0% return on equity for GMO. “[C]apital market costs today are much lower than they were in 2011 when KCPL GMO’s rates were approved.”⁸³ Empirical evidence that the cost of capital has declined significantly is reflected in utility bond yields. Specifically, GMO’s debt is rated as “A” by Standard and Poor’s. Since the last case, the bond yield for “A” rated utility bonds has decreased by 148 basis points.⁸⁴ Similarly, GMO’s debt is rated “Baa” by Moody’s. The bond yield for “Baa” rated utility bonds has declined by 110 basis points since the Commission’s 10.0% return on equity decision.⁸⁵

⁸⁰ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011

⁸¹ *Order Approving Nonunanimous Stipulation and Agreement, Setting Procedural Schedule, and Clarifying Order Regarding Construction and Prudence Audit*, Case No. ER-2010-0356, issued August 18, 2010, at page 2.

⁸² *Order Determining Relevant Periods and Other Matters*, Case No. ER-2012-0175, issued April 19, 2012, at page 1.

⁸³ OPC Exhibit 307, Gorman Direct, page 3.

⁸⁴ OPC Exhibit 307, Gorman Direct, page 4.

⁸⁵ *Id.*

A 110 basis point reduction in the bond yield for utility bonds is not insignificant. In fact, the evidence allows for a direct correlation between this 110 basis point reduction in bond yield to GMO's return on equity. At pages 29-34 of his direct testimony, Mr. Gorman increased the risk premium over utility bond yield by 25 basis points. As such, a 110 basis point reduction in bond yield would equate to an 85 basis points reduction in recommended return on equity.⁸⁶

The decline in the cost of capital is also reflected in the fact that GMO's recommended return on equity, while still inflated, declined by 45 basis points from 10.75%⁸⁷ to 10.30%.⁸⁸ Furthermore, the average authorized return on equity for vertically-integrated electric utilities (like GMO) dropped by 31 basis points between the 2nd quarter of 2011 and the 2nd quarter of 2012 (the last reported quarter).⁸⁹

The bottom line, therefore, is that the authorized return on equity must be sharply lower than the 10.0% authorized in the last case. For instance, based solely on the reduction in bond yield in the twenty one months following its decision in the last GMO case, then the Commission's decision in this case should be approximately 9.15%. Again, this shows the reasonableness of Mr. Gorman's 9.10 – 9.50% return on equity recommendation.

The Commission by adopting Mr. Gorman's recommendation would be in good company with several recent public utility commission decisions. Specifically, on July 20, 2012, the Maryland Commission issued its decision in a Potomac Edison Power Company rate proceeding. In that case, the Maryland rejected the utility's request for a

⁸⁶ 110 basis point reduction in bond yield – 25 basis point increase in risk premium = 85 basis point decrease in return on equity.

⁸⁷ *Id.*

⁸⁸ GMO Exhibit 115, Hadaway Rebuttal, page 6.

⁸⁹ *Id.*

10.75% return on equity and instead authorized a return of 9.31%. In justifying its 9.31% return on equity, the Maryland Commission stated:

The return Pepco's investors will be allowed to earn in this case is appropriate, particularly under the present economic climate. We have no doubt that a monopoly company in a stable service territory with the potential of earning 9.31% on its equity will be able to attract the necessary capital in the current low interest rate environment to meet its statutory requirements to provide safe and reliable service to its customers.⁹⁰

This was followed in short order by the New York Commission rejecting Orange and Rockland Utilities request for an 11.25% and instead awarding a 9.50% increase⁹¹ as well as the South Dakota Commission granting Northern States Power Company a 9.25% return on equity.⁹²

G. CONCLUSION

MECG asks that the Commission set a return on equity for GMO at **9.10%**. This return on equity is justified for several reasons:

1. A 9.10% return is supported by the objective analysis provided by Mr. Gorman. Mr. Gorman's analysis relies upon three DCF and a risk premium analysis. In both a recent KCPL / GMO and AmerenUE decisions, the Commission expressly relied upon many of the conclusions and recommendations offered by Mr. Gorman. In fact, the Commission expressly stated "The Commission finds Mr. Gorman's testimony to be more credible than the testimony of Mr. Murray and Dr. Hadaway."⁹³

⁹⁰ *In the Matter of the Application of Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Case No. 9286, issued July 20, 2012 (Maryland PUC).

⁹¹ *Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Orange and Rockland Utilities, Inc. for Electric Service*, Case No. 11-E-0408, issued June 14, 2012 (New York PSC).

⁹² *The Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase its Electric Rates*, Case No. ER11-019, issued July 2, 2012 (South Dakota PSC).

⁹³ *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 117.

2. The analysis offered by Mr. Gorman avoids many of the shortcomings contained in GMO's recommendation. First, Mr. Gorman performs and considers the results of the DCF and risk premium analyses. In contrast, GMO's 10.3% recommendation relies solely upon its DCF analysis. Second, Mr. Gorman does not give undue weight to a DCF analysis dependent on analysts' short-term growth estimates. As has been demonstrated, and the Commission has previously found, these short-term growth estimates are not sustainable in the long-term. Therefore, a constant growth DCF based upon these analysts' growth estimates is overstated. Third, Mr. Gorman relies upon consensus analysts' estimates for his use of the GDP growth rate in his multi-stage DCF analysis. This growth rate is published and likely is utilized by investors as the basis for actual investment decisions. In contrast, Dr. Hadaway relies upon his subjective estimation of GDP growth that is based entirely on historical figures and fails to consider any of the widely considered future estimates of GDP growth. Dr. Hadaway's estimation has been widely criticized among state utility commission.

3. Mr. Gorman's analysis shows that the cash flows generated from a 9.10% return on equity are sufficient to support GMO's current investment grade credit rating. Through this fact, the Commission is assured that it is meeting the guidelines established by the *Hope* and *Bluefield* opinions.

4. MCEG's 9.10% recommendation is consistent with the Commission's most recent GMO decision, the average authorized return on equity for other vertically-integrated electric utilities and the continuing decline in the market cost of capital (approximately 85 basis points).

5. By awarding GMO a return on equity at the lower end (9.10%) of the reasonable range of return (9.10% - 9.50%), the Commission can explicitly consider the affordability of GMO's rates. Specifically, while the national average rate for electricity has increased by 13.6% over the last 5 years, GMO rates will have increased by almost four times as much. This rapid increase in GMO rates is largely a result of the uncontrolled nature of GMO's A&G costs.

6. In its last GMO decision, the Commission recognized a twenty point differential between the return on equity for GMO and that authorized for Ameren. There is no evidentiary basis to discontinue this differential and MECG asks that the Commission continue this reflection of risk by awarding GMO a return on equity that is 20 points below that authorized to Ameren.

For all these reasons, the Commission should grant GMO a return on equity of 9.10%.

7. As indicated at pages 46-49, the implementation of a transmission tracker results in a significant shift of risk from GMO to its ratepayers. If the Commission implements GMO's transmission tracker, it is incumbent that the Commission reflect this decreased risk in its return on equity decision. In such an instance, MECG urges the Commission to make an explicit 10 basis point reduction in GMO's return on equity.

V. CAPITAL STRUCTURE

Capital Structure: What capital structure should be used for determining rate of return? (ISSUE II.3(b)).

In order to apply the return on equity determined in the previous section, the Commission must establish an appropriate capital structure. Historically, a utility capital structure consists of both common equity and long-term debt. The difference in cost between equity and debt is significant.

The portion of common equity in a company's capital structure is important for ratemaking purposes because common equity is the most expensive form of capital. The cost differential between common equity and debt is even greater when the income tax treatment of debt is considered. Interest expense or the cost of debt is tax-deductible, while dividends to shareholders are not.⁹⁴

As the Commission has recognized, given this cost difference, "there is an optimum structure that will produce the minimum cost."⁹⁵ It is incumbent upon the utility, therefore, to manage its capital structure to this "optimum structure" and only include a reasonable amount of common equity.

In the past, the Commission has refused to recognize a utility's actual capital structure that deviated from the "optimum structure." In a *St. Joseph Light & Power* rate case, the Commission found that it was part of "its duty to protect the ratepayers" from rates that are based upon an equity-rich capital structure.

The evidence clearly demonstrates that Staff, Public Counsel and AGP support the position that SJLPC's capital structure is too heavily weighted with common equity. The Commission agrees that SJLPC's capital structure is too heavily weighted with equity. In comparing SJLPC's own assessment of its capital structure with that of its proxy group's average capital structure, the Commission cannot find that SJLPC's capital structure is even in line with its own proxy group. . . . The average

⁹⁴ *Report and Order*, ER-93-41 and EC-93-252, issued June 25, 1993, at page 252.

⁹⁵ *Id.* at page 249.

common equity of the proxy group is 53.3%, which the Commission, unlike SJLPC, does not believe places SJLPC's common equity of 57.93% reasonably close to its proxy group's average. The Commission cannot support a capital structure for a company such as SJLPC that is so heavily weighted with common equity. The Commission, in its duty to protect the ratepayers, cannot establish rates based on this skewed capital structure. The Commission is of the opinion that if SJLPC chooses to continue with its current debt/equity ratio then its stockholders should bear the burden of its management's decision and not the ratepayers. **Therefore, the Commission finds that the hypothetical capital structure as proposed by Public Counsel should be used in setting rates in this proceeding.**⁹⁶

As of March 31, 2012, GMO's capital structure included only 45.51% common equity.⁹⁷ This capital structure is reflective of that utilized by GMO throughout 2011 and most of 2012.⁹⁸ Suddenly, and without any financial justification, GMO's capital structure through the August 30, 2012 true-up increased to 52.56% common equity.⁹⁹ As will be seen, there is no justification for this sudden increase in common equity ratio other than to inflate GMO's revenue requirement.

As with its analysis that it undertook in the *St. Joseph Light and Power* case, the GMO actual capital structure contains much more equity than its comparable company group. The evidence indicates that 3 of 4 cost of capital witnesses (Hadaway, Gorman and Kahal) all utilized the same comparable company group.¹⁰⁰ The common equity ratio for the comparable company group is 49.6% as reported by Value Line.¹⁰¹ As compared to the comparable company group then, GMO's true-up capital structure of 52.56% is

⁹⁶ *Id.* at page 252.

⁹⁷ OPC Exhibit 307, Gorman Direct, page 13.

⁹⁸ *Id.* at pages 10-11.

⁹⁹ Staff True-Up Accounting Schedules, Accounting Schedule 12.

¹⁰⁰ OPC Exhibit 307, Gorman Direct, page 15 ("I relied on the same utility proxy group used by KCPL witness Dr. Hadaway to estimate GMO's return on equity."); Kahal Direct, page 7 ("This is the same proxy company group that was selected by Dr. Hadaway for his DCF study.").

¹⁰¹ OPC Exhibit 307, Gorman Direct, Schedule MPG-2. Mr. Gorman also included a common equity ratio of 46.6% as reported by AUS Utility Reports. AUS' common equity ratio is lower because it includes short-term debt while the Value Line common equity ratio excludes short-term debt. In this case, short-term debt has been removed from GMO's capital structure. As such, the appropriate comparison is to the 49.6% common equity ratio reported by Value Line.

clearly equity rich.¹⁰² In fact, GMO's proposed capital structure contains more common equity than 17 of the 21 entities included in the comparable company group.¹⁰³

Importantly, there are no benefits associated with this equity rich capital structure. Sometimes, there is a reduction in debt cost resulting from the decreased risk associated with a higher equity ratio. In this case, however, the higher equity ratio does not provide this benefit. The current S&P debt credit rating is "BBB" with a "Stable" outlook.¹⁰⁴ This credit rating and outlook are based upon a higher ratio of debt in the capital structure.¹⁰⁵ Even with the higher equity ratio, the S&P credit rating and outlook remain the same.¹⁰⁶ As such, there is no decrease in the cost of debt and "no justification for Great Plains' effort to increase its common equity ratio in this proceeding."¹⁰⁷

For this reason, MECG and Mr. Gorman recommend that the Commission utilize a hypothetical capital structure. As has been shown, the Commission has readily utilized such a capital structure "to protect the ratepayers" from an equity-rich capital structure. Specifically, Gorman recommends that the Commission utilize a capital structure consisting of 50% equity and 50% debt.¹⁰⁸ Such a capital structure is generous in that it includes more equity (50.0%) than that of the comparable company group (49.6%).¹⁰⁹ Furthermore, recognizing that the 50.0% hypothetical equity ratio is greater than that utilized by GMO over the past two years,¹¹⁰ it appears even more generous.

¹⁰² Staff True-Up Accounting Schedules, Accounting Schedule 12.

¹⁰³ OPC Exhibit 307, Gorman Direct, Schedule MPG-2.

¹⁰⁴ OPC Exhibit 308, Gorman Surrebuttal, page 4.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at page 5.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ OPC Exhibit 307, Gorman Direct, Schedule MPG-2.

¹¹⁰ *Id.* at page 10.

Moreover, GMO's increased common equity ratio in this case is illusionary because it excluded debt that is being used to support its rate base from its proposed true-up capital structure. GMO witness Bryant testified, in response to Mr. Gorman, that it used short-term debt to refinance maturing long-term debt during the true up period¹¹¹ and he excluded the short-term debt from the true up capital structure. Mr. Bryant testified that the utility plans to refinance the short-term debt back to long-term debt after the end of the true-up period.¹¹² This refinancing will be conducted after Great Plains accumulates short-term debt of at least \$300 million.¹¹³ Mr. Bryant testified that waiting to refinance its short-term debt until it has this target amount will lower the cost of the new long-term debt issuance.¹¹⁴ Therefore, after the refinancing or if \$300 million of short-term debt is included in the true up capital structure, GPE capital structure common equity ratio will return to approximately 50%.

Ultimately, GMO's proposal to artificially increase the equity ratio in its capital structure is contrary to other statements that GMO made in this case. Specifically, GMO claims to have taken steps to minimize its revenue deficiency in response to the "difficult economic times" currently being experienced in its service area.¹¹⁵ It appears, however, that GMO's claims are simple rhetoric. When given an opportunity to inflate its revenue deficiency, GMO readily included an excessive amount of common equity in its true-up capital structure. As Mr. Gorman notes:

This increased common equity ratio does not appear to be necessary. As noted above, the credit rating agencies currently view GMO's credit standing to be "Stable," with adequate utility cash flows. GMO's current

¹¹¹ GMO Exhibit 106, Bryant Rebuttal, pages 6-11.

¹¹² *Id.*

¹¹³ Tr. 360-363.

¹¹⁴ *Id.*

¹¹⁵ GMO Exhibit 101, Bassham Direct, at pages 8-10.

financial metrics, including its debt / equity ratio of approximately 54% [54% debt and 46% common equity], supports its investment grade bond rating. Hence, an increase in common equity ratio in this case seems to accomplish nothing more than increasing GMO's cost of service and income.¹¹⁶

Given the fact that GMO's capital structure has been shown to be equity rich and provides no benefits for ratepayers, the Commission should exercise its authority "to protect the ratepayers." Specifically, the Commission should refuse to utility the equity-rich GMO capital structure to establish rates. Instead, the Commission should, once again, exercise its discretion and utilize a hypothetical capital structure consisting of 50.0% equity and 50.0% debt.

¹¹⁶ OPC Exhibit 307, Gorman Direct, page 11.

VI. TRANSMISSION TRACKER

Transmission Tracker: Should the Commission authorize KCPL and GMO to compare their actual transmission expenses with the levels used for setting permanent rates in these cases, and to accrue and defer the difference for potential recovery in future rate cases, i.e., to employ a “tracker”? (ISSUE II.11)

OR

Transmission Tracker: Should the Commission authorize KCPL and GMO to compare their actual transmission expenses with the levels used for setting permanent rates in these cases, and to accrue and defer the difference into a regulatory asset? (ISSUE II.11)

A. INTRODUCTION

In its testimony, GMO has requested the implementation of a tracker mechanism to accrue and defer any differences between: (1) the amount of transmission costs included in rates resulting from this case and (2) the actual amount of costs incurred during the period in which rates are in effect. As GMO repeatedly points out in its testimony, the implementation of a tracker is designed to ensure the recovery of a certain cost item. “Use of a tracker ensures that in the years between rate cases the utility does not under-recover or over-recover its costs.”¹¹⁷

As this brief demonstrates, GMO’s proposed tracker is problematic for several reasons. ***First***, GMO’s requested tracker mechanism is contrary to the common law notion that the utility is merely presented an “opportunity” to recover its costs and earn a return on equity. Through the implementation of its tracker mechanism, GMO seeks to replace this “opportunity” for recovery with a “guarantee” of recovery. ***Second***, through the implementation of a tracker, the reflection of any past losses in future rates, violates that doctrine against retroactive ratemaking. ***Third***, the tracker mechanism disturbs the

¹¹⁷ GMO Exhibit 123, Ives Direct, page 12 (emphasis added). See also, “The Company requests that a transmission tracking mechanism be authorized in this case to ensure the appropriate recovery of transmission costs.” (Id at page 11) (emphasis added).

careful balance that normally helps to ensure that rates will not be either excessive or inadequate. By considering one single expense item in a vacuum and “ensuring” complete recovery of that expense, the balance is tipped and the probability that rates will be excessive is heightened. ***Fourth***, GMO has failed to show that transmission costs meet the criteria set forth by the Commission for implementation of an extraordinary ratemaking mechanism. Certainly, absent such a showing, the Commission would be remiss in implementing a tracker and removing any incentive GMO has to minimize such costs.

For all of the reasons set forth in this brief, the Commission must ultimately agree that GMO’s proposed tracker represents poor policy and will result in unlawful ratemaking. As such, GMO’s proposed transmission tracker must be rejected. It is important to realize, however, that by denying GMO’s proposed transmission tracker, the Commission is not disallowing the recovery of these costs. A normalized amount of transmission costs have been included in the revenue requirement already and will be recovered by GMO. The rejection of the transmission tracker only prevents GMO from tracking the difference against this normalized amount that is already being recovered.

B. TRACKER MECHANISMS SEEK TO REPLACE THE “OPPORTUNITY” FOR RECOVERY WITH A “GUARANTEE” OF RECOVERY.

It is well known doctrine of ratemaking that rates are established to provide the utility with an “opportunity” to recover its prudently incurred costs as well as a return on its invested capital.¹¹⁸ Recognizing that rates merely provide for this “opportunity,” there is no guarantee to the utility of earning any, or a stated level of, return on equity.

¹¹⁸ See, *State ex rel. Union Electric Company v. Public Service Commission*, 765 S.W.2d 618, 622 (Mo.App. 1989).

Through its tracker proposal, GMO seeks to turn this entire notion of ratemaking on its ear. Rather than an “opportunity” to recover this cost, GMO, through the implementation of its tracker, would instead have a guarantee of its recovery. Certainly, every time that traditional ratemaking is replaced with an automatic adjustment mechanism, a tracker or deferral and amortization accounting, the utility moves closer to its desired goal of “guaranteed” cost recovery and a “guaranteed” return on equity.

The Commission should be very careful in its implementation of extraordinary ratemaking mechanisms, like trackers. As the Commission has previously held, such mechanisms should be limited solely to those instances where they are necessary to protect the utility and ratepayers from volatile markets. With this in mind, the utility and consumers have agreed to the use of trackers for previous such instances. GMO’s proposal, however, is the first foray in their attempt to extend such mechanisms to an everyday expense that is not volatile, but instead simply projected to increase. In this case, GMO’s proposal has been opposed by every consumer group as well as the Commission’s Staff. GMO’s proposal represents a significant step on a slippery slope which the Commission should not hastily take.

C. TRACKER MECHANISMS VIOLATE THE DOCTRINE AGAINST RETROACTIVE RATEMAKING.

In the case of *State ex rel. Utility Consumers Council v. Public Service Commission of Missouri*,¹¹⁹ the Missouri Supreme Court considered the legality of the fuel adjustment clause. While holding that the Commission lacked statutory authority to implement a fuel adjustment clause, the Court also provided the preeminent discussion of the doctrine of retroactive ratemaking. There, the Supreme Court held that past expenses

¹¹⁹ 585 S.W.2d 41 (Mo. banc 1979).

“cannot be used to set future rates.” Such recovery would constitute retroactive ratemaking.

Past expenses are used as a basis for determining what rate is reasonable to be charged in the future in order to avoid further excess profits or future losses, but under the prospective language of the statutes, §§ 393.270(3) and 393.140(5) they **cannot be used to set future rates to recover for past losses due to imperfect matching of rates with expenses.**¹²⁰

To permit them to collect additional amounts simply because they had additional past expenses not covered by either clause is retroactive rate making, i.e., the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match expenses plus rate-of-return with the rate actually established.¹²¹

In the case at hand, GMO proposes a tracker mechanism that would use future rates to recover for past losses. Specifically, GMO envisions that a specific amount of transmission costs would be established in this rate proceeding.¹²² GMO would then track its actual transmission costs against the amount included in rates. To the extent that actual transmission costs are greater than that included in rates, GMO would treat the excess amount as a regulatory asset.¹²³ GMO asserts that the regulatory asset would be amortized in the next rate proceeding and recovered in future rates.¹²⁴

As such, GMO’s proposed transmission tracker would violate the doctrine against retroactive ratemaking due to the fact that GMO has included future ratemaking in its proposed tracker. Despite the Supreme Court holding that “past expenses” “cannot be used to set future rates to recover for past losses due to imperfect matching of rates with

¹²⁰ *Id.* at page 59. (emphasis added).

¹²¹ *Id.* (emphasis added)

¹²² GMO Exhibit 123, Ives Direct, page 13, lines 18-19.

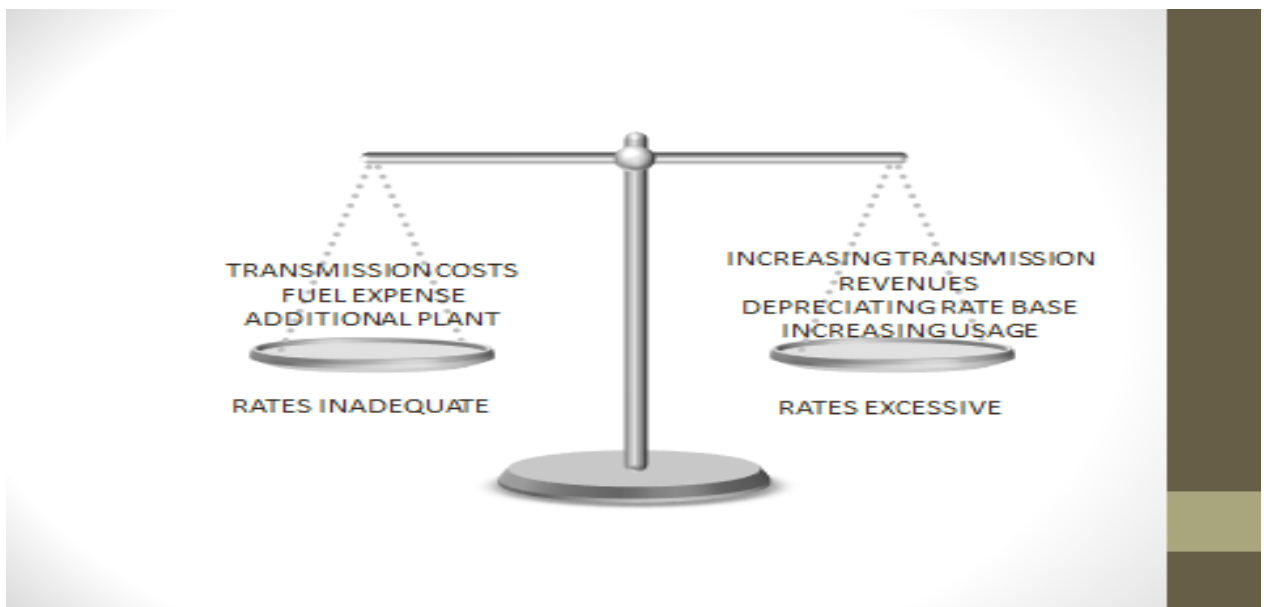
¹²³ *Id.* at lines 19-22.

¹²⁴ *Id.* at page 14, lines 13-15.

expenses,” GMO proposes the any lost associated with transmission costs would be recovered in future rates. For this reason, GMO’s transmission tracker is fatally flawed.

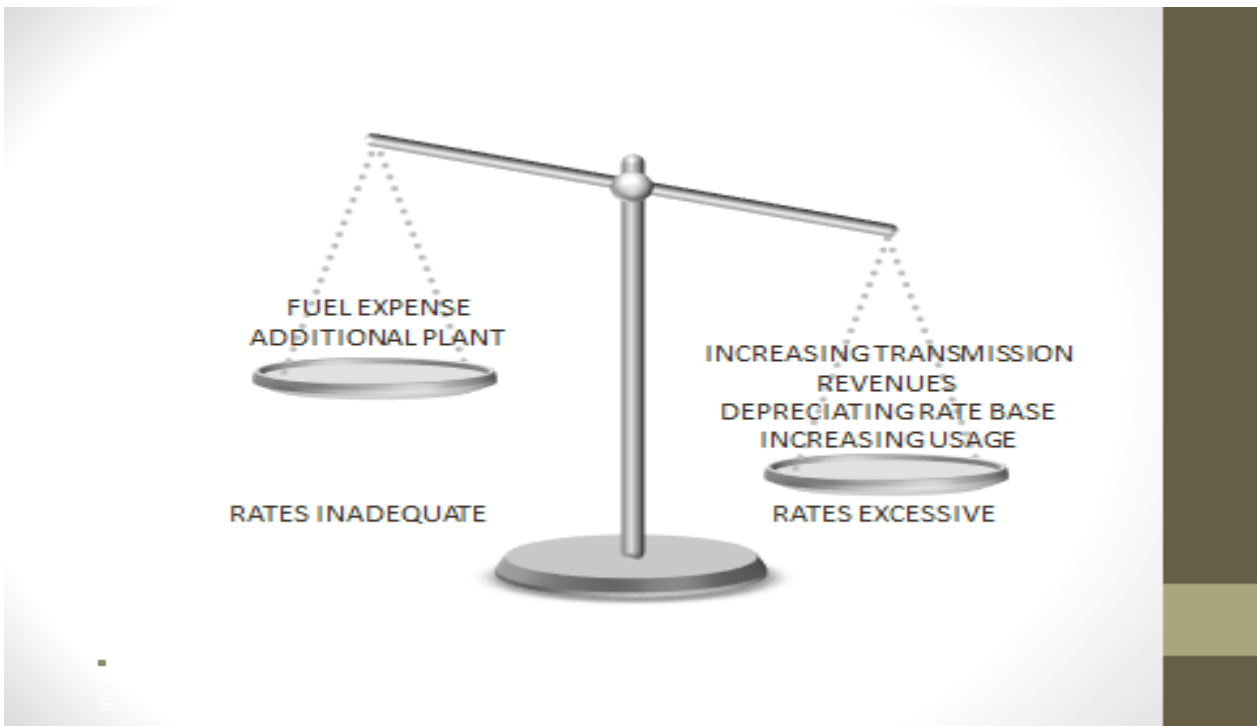
D. TRACKER MECHANISMS DISTURB THE BALANCING OF RISK AND INCREASE THE PROBABILITY THAT RATES WILL BE EXCESSIVE

Besides violating the doctrine against retroactive ratemaking, GMO’s proposed tracker mechanism represents a fundamental shift in the establishment of risk envisioned by the Missouri Supreme Court. In the previously discussed decision, the Supreme Court held that “[t]he utilities take the risk that rates filed by them will be inadequate, or excessive, each time they seek rate approval.”¹²⁵ As envisioned by the Supreme Court, then, there are constantly pressures which may increase or decrease the possibility that rates will be inadequate or excessive. As reflected in the following slide, among the factors that may increase the possibility that rates will be inadequate are increased transmission costs. That said, however, there are many other factors that tend to heighten the possibility that rates will be excessive including increasing transmission revenues, increasing numbers of customers and usage and the utility’s constantly depreciating rate base.



¹²⁵ *State ex rel. Utility Consumers Council v. Public Service Commission of Missouri*, 585 S.W.2d 41, 59 (Mo. banc 1979).

Under its transmission tracker proposal, GMO wants to single out one cost item for special treatment without consideration of other offsetting items. The practical effect of this special treatment is to remove this item (transmission costs) from the risk balancing, thereby decreasing the chance that rates will be inadequate. The other side of this proposal, however, is that all of the items that tend to cause rates to be excessive still remain. Therefore, GMO has shifted the carefully balancing of risk envisioned by the Supreme Court.



As MECCG witness Dauphinais points out, the GMO transmission tracker proposal is flawed in that it fails to consider “whether the utility would simultaneously be receiving offsetting decreases in expenses or offsetting increases in revenues for those expenses and revenues that are not being tracked. To put it more simply, allowing a

tracker can break the synchronism between revenues, expenses and rate base leading to a utility over-recovering its costs.”¹²⁶

The Commission itself has recognized this fundamental flaw in tracker mechanisms. When it first considered a tracker mechanism for Ameren’s fuel costs, the Commission rejected the proposal and cited the same problems now found in GMO’s tracker proposal. Under a tracker mechanism, “the utility would be able to pass on increased costs in one area, in this case fuel and purchased power, without an examination of all the other areas in which its costs may have decreased or its revenues increased. As a result, ratepayers could be required to pay increased rates while the company enjoys increased profits.”¹²⁷

Because a tracker mechanism represents poor regulatory policy and results in a significant shift in utility risk to the ratepayers, MECG urges the Commission to reject GMO’s transmission tracker proposal. That said, if the Commission did implement this proposal, it is incumbent that the Commission reflects this decreased risk in its return on equity for GMO. As Mr. Gorman points out, “[i]f the Commission modified KCPL GMO’s existing regulatory mechanisms to reduce KCPL GMO’s investment risk, then any related risk reduction should be considered in determining a fair risk-adjusted return on equity for KCPL GMO.”¹²⁸ In the first case in which the Commission authorized a fuel adjustment clause for Ameren, several witnesses agreed that the implementation of such a mechanism would reduce Ameren’s risk and the associated return on equity by 25

¹²⁶ MECG Exhibit 429, Dauphinais Direct, page 8.

¹²⁷ *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 18.

¹²⁸ OPC Exhibit 307, Gorman Direct, page 3.

basis points.¹²⁹ Certainly, if a fuel adjustment clause reduces a utility's risk profile by 25 points, then the implementation of GMO's transmission tracker should be worth a reduction of at least 10 basis points.

E. GMO'S TRANSMISSION COSTS DO NOT MEET THE CRITERIA FOR EXTRAORDINARY RATEMAKING MECHANISMS

Given the extraordinary nature of tracking mechanisms, including fuel adjustment clauses, the Commission has set forth strict criteria to be applied to its consideration of such an extraordinary mechanism. In a previous Ameren decision, the Commission stated that such an extraordinary mechanism is only appropriate where the cost meets three criteria.

1. Substantial enough to have a material impact upon revenue requirements and the financial performance of the business between rate cases;
2. Beyond the control of management, where utility management has little influence over experienced revenue or cost levels; and
3. Volatile in amount, causing significant swings in income and cash flows if not tracked.¹³⁰

The evidence in this case demonstrates that GMO has not met the Commission order criteria.

Substantially Large: In its consideration of Ameren's fuel adjustment clause, the Commission noted that Ameren's fuel and purchased power expense is approximately 44% of the utility's operations and maintenance cost.¹³¹ Similarly, GMO's combined

¹²⁹ *Report and Order*, Case No. ER-2008-0318, issued January 27, 2009, at pages 16-17 (Ameren witness Morin quantified at 25 basis points; MIEC witness Gorman quantified at 25 basis points; and MEG witness Leconte quantified at 20 basis points).

¹³⁰ *Id.* at pages 20-21.

¹³¹ *Id.* at page 21.

fuel and purchased power expense of \$275,155,465¹³² represents 50.8% of GMO's total O&M costs.¹³³

GMO's transmission costs are dwarfed in contrast to the fuel and purchased power expenses previously deemed worthy of tracking. Currently, SPP Transmission Costs are approximately \$7 million.¹³⁴ Current costs are expected to increase by \$10 million.¹³⁵ Therefore, the incremental increase in transmission costs that GMO seeks to track is only 1.8% of GMO's total expenses.

Certainly, transmission costs do not meet the Commission's first criteria for the use of an extraordinary ratemaking mechanism. As such, the Commission should reject GMO's request. As will be seen, GMO fails to meet the other two criteria as well.

Beyond Management Control: In the Ameren case, the Commission not only considered management's control of costs, but extended its review to a consideration of the relative control of management versus ratepayers. In that case, while it found that Ameren "clearly cannot control the markets", the Commission also correctly decided that Ameren "has more ability to influence the prices it pays for fuel and purchased power costs than do its ratepayers who must simply pay the rates allowed by this Commission." Given their ability to influence such prices, the Commission held that "removing AmerenUE's financial incentive to control its fuel costs by allowing those costs to be passed through to ratepayers will not serve the interests of those ratepayers."

In the immediate case, the evidence indicates that transmission costs are subject to some influence by GMO's management. For instance, the vast majority of costs in

¹³² Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 2).

¹³³ Total O&M cost = \$541,799,447, Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 12).

¹³⁴ MCEG Exhibit 429, Dauphinais Direct, page 9.

¹³⁵ *Id.*

question concern SPP administration and transmission costs. Given its ability to participate in SPP and FERC, GMO can certainly influence the magnitude and timing of these costs. “It can to a degree be managed by the Company by being active in the SPP stakeholder process and, as necessary, at FERC, to help ensure, working with other stakeholders, the SPP’s costs are maintained within reasonable levels.”¹³⁶

Moreover, even to the extent that the transmission costs do change, given the forewarning provided through SPP projections, GMO can effectively manage these costs through necessary rate increases. “[T]he increase is well forecasted by SPP and occurs in stairs steps much like the rate base of a utility increases as new major capital projects are brought into service.”¹³⁷ Therefore, these costs can certainly be influenced by GMO, but also management is certainly capable of timing rate cases to match when these costs are incurred. It is certainly not necessary to implement a tracker which would eliminate all incentive GMO has to minimize these costs.¹³⁸

Volatile: In a previous decision, the Commission held that volatility is more than simply an expectation that a cost will increase. Rather, volatility is characterized unpredictable increases and decreases in costs. As such, extraordinary mechanisms may be necessary to protect both the utility and the ratepayers from this volatility.

Markets in which prices are volatile tend to go up and down in an unpredictable manner. When a utility’s fuel and purchased power costs are swinging in that way, the time consuming ratemaking process cannot possibly keep up with the swings. As a result, in those circumstances, a fuel adjustment clause may be needed to protect both the utility and its ratepayers from inappropriately low or high rates.¹³⁹

¹³⁶ MCEG Exhibit 429, Dauphinais Direct, page 9.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 23.

GMO's transmission costs cannot be characterized as volatile. As the evidence indicates, "it cannot reasonably be said that the [SPP] administration charge is volatile like, for example, the market price of a commodity may be."¹⁴⁰ In fact, in its 18 pages of direct testimony supporting the implementation of a tracker mechanism, GMO itself never characterizes transmission costs as "volatile."¹⁴¹

Rather, like other aspects of GMO's cost portfolio, transmission costs are simply projected to increase. Unlike other cost items, however, the increases in transmission costs are "well forecasted" and "occurs in stairs steps" which allows the Company to include the costs in a rate case.¹⁴²

Ultimately, none of the Commission's criteria for the implementation of an extraordinary ratemaking tool like an adjustment mechanism or a tracker have been met by GMO. Unlike fuel expenses that have previously been addressed by the Commission, GMO's transmission costs are relatively small and are not large enough to have a material impact on GMO's financial performance. Also, unlike costs for items purchased in a commodity market, GMO's transmission costs can certainly be influenced and managed by GMO. Specifically, this is done through its participation in both SPP and at the FERC. Finally, while the costs are projected to increase, they are not volatile. Rather, the stair step increases and the lead time provided by SPP for such increases make these costs perfect for timing and inclusion in a rate case. Ultimately, the Commission should realize that transmission costs do not deserve the implementation of

¹⁴⁰ MEGC Exhibit 429, Dauphinais Direct, page 9.

¹⁴¹ See, GMO Exhibit 123, Ives Direct, pages 11-15; GMO Exhibit 108, Carlson Direct, pages 1-11 and Schedule JRC-1.

¹⁴² MEGC Exhibit 429, Dauphinais Direct, page 9. See also the stair step projected increases in GMO Exhibit 108, Carlson Direct, Schedule JRC-1.

a tracker mechanism. Such a mechanism would eliminate any incentive GMO currently has to minimize such costs.

F. CONCLUSION

As this brief demonstrates, GMO's transmission tracker represents a significant step towards the utility's goal of guaranteed cost recovery and a guaranteed return on equity. Such a proposal, however, not only violates good ratemaking principles it also is contrary to recent legal doctrine. Specifically, the Supreme Court has stated that the Commission cannot use future rates for the recovery of past losses. This is exactly the point of GMO's proposed tracker mechanism. In addition, GMO's proposal represents a significant shift in the balancing of risk envisioned by the Supreme Court. Finally, GMO has failed to show that its proposal meets the criteria set forth by the Commission for the implementation of such an extraordinary mechanism. Again, by rejecting the transmission tracker, the Commission is not disallowing any portion of these transmission costs. Rather, a normalized level of transmission costs have already been included in GMO's revenue requirement. By rejecting the tracker, the Commission is only disallowing GMO's ability to tracker differences against this normalized amount and recover these differences in future rates. For all these reasons, the Commission should reject GMO's proposal. In the event that the Commission does implement the GMO transmission tracker, it should make an explicit 10 basis point reduction in GMO's return on equity to account for the significant shift in risk caused by the implementation of the tracker mechanism.

VII. CROSSROADS

ISSUE III.1: Crossroads:

- a. What should be the value of Crossroads included in rate base?
- b. What amount of accumulated deferred taxes associated with Crossroads should offset the value of Crossroads in rate base?
- c. Should depreciation expense be based upon the authorized gross plant value for Crossroads?
- d. What transmission costs for energy from Crossroads should be included in revenue requirement?

A. INTRODUCTION

It is well established that the utility must be permitted to earn a return on the property devoted to the public convenience.

The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. . . . We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation . . . must be the ***fair value of the property being used by it for the convenience of the public.*** What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be extracted from it than the services rendered by it are reasonably worth.¹⁴³

Thus a critical aspect of any ratemaking decision is the “fair value” to be placed on the property devoted to the public convenience.

As in the last case, the Commission is again asked to calculate the “fair value” of the Crossroads units, located in Mississippi, that are now providing service to ratepayers in Missouri. Despite the virtually identical nature of the issues, and the clarity of the previous Commission decision, GMO again asks that the Commission set rates based

¹⁴³ *Smyth v. Ames*, 169 U.S. 466, 546-547 (1898) (emphasis added).

upon depreciated, net book value of those units. In making this request, GMO ignores: (1) the previous Commission findings and (2) all evidence of the true “fair market value” of the units.

In its previous decision, the Commission made the following finding regarding the value of Crossroads and the viability of GMO’s assertion that Crossroads should be valued at net book value.

When conducting its due diligence review of Aquila’s assets for determining its offer price for Aquila, GPE [Great Plains Energy] would have considered the transmission constraints and other problems associated with Crossroads. It is *incomprehensible* that GPE would pay book value for generating facilities in Mississippi to serve retail customers in and around Kansas City, Missouri. And, it is a *virtual certainty* that GPE management was able to negotiate a price for Aquila that considered the distressed nature of Crossroads as a merchant plant which Aquila Merchant was unable to sell despite trying for several years. Further, it is equally likely that GPE was in as good a position to negotiate a price for Crossroads as AmerenUE was when it negotiated the purchases of Raccoon Creek and Goose Creek, both located in Illinois, from Aquila Merchant in 2006.¹⁴⁴

In reaching this decision, the Commission relied on a litany of evidence that demonstrated the rapid deterioration in value of deregulated generating units between 2002, when Crossroads was constructed, and 2008, when it was purchased by Great Plains. In fact, in its decision, the Commission referenced the sale of identical units by Aquila that resulted in Aquila writing down the value of those deregulated units. Nevertheless, GMO continues to ignore all evidence of the depressed value of these units and asks that ratepayers be required to pay rates based upon the cost of the units at the time they were initially constructed by a non-regulated merchant affiliate of MPS.

In contrast, MECG asserts that the Commission’s affiliate transaction rule dictates that the Commission value the Crossroads unit based upon the lesser of: (1) fair market

¹⁴⁴ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 94.

value or (2) fully distributed cost.¹⁴⁵ In this case, given the significant decrease experienced in the value of combustion turbines prior to the time that the Crossroads units were devoted to regulated service, fair market value is significantly less than GMO's net book value. The use of fair market value, therefore, is not only consistent with the Commission's affiliate transaction rule, but also consistent with the Supreme Court dictate that ratepayers only be required to compensate the utility for the "fair value of the property being used."

B. PREVIOUS COMMISSION DECISION

In the last GMO case, the Commission was also asked to determine the value of Crossroads to include in rate base. In that case, the Commission was presented with virtually identical evidence as in this case. As in this case, the Commission was presented with substantial evidence as to the fair market value that Great Plains placed on Crossroads at the time of its acquisition of Aquila. Specifically, referencing at least three different SEC filings, the consumer groups urged the Commission to set the fair market value at \$51.6 million consistent with Great Plains / Aquila's quantification of fair market value in its SEC filings.

The preliminary internal analysis indicated a fair value estimate of Aquila's non-regulated Crossroads power generating facility of approximately \$51.6 million. This analysis is significantly affected by assumptions regarding the current market for sales of units of similar capacity. The \$66.3 million adjustment reflects the difference between the fair value of the combustion turbines at \$51.6 million and the \$117.9 million book value of the facility at March 31, 2007. Great Plains Energy management believes this to be an appropriate estimate of the fair value of the facility.¹⁴⁶

¹⁴⁵ 4 CSR 240-20.015(2)(A).

¹⁴⁶ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at pages 92-93 (emphasis added).

Despite this admission of the Crossroads fair market value, the Commission, in a unanimous decision, utilized a proxy sale concept for its valuation of Crossroads. Specifically, the Commission noted that the Crossroads units consisted of combustion turbines that were “identical”¹⁴⁷ to those used by Aquila when it constructed its Raccoon Creek and Goose Creek facilities in Illinois.¹⁴⁸ Given the deterioration in the deregulated energy market and its effect on its financial viability, Aquila was forced to sell Raccoon Creek and Goose Creek at “substantially below book value”¹⁴⁹ necessitating a write-off of \$99.7 million.¹⁵⁰ Specifically, the Commission found that Ameren purchased the 850,000 kW Raccoon Creek and Goose Creek facilities for a total of \$175 million.¹⁵¹ This equates to \$205.88 / installed kW.¹⁵²

The Commission held that this sale of identical turbines to a willing third-party purchaser “are not only a good indicator of the fair market value, but also clearly show that the fair market value of [Crossroads] was significantly below the net book value.”¹⁵³ Given this good indication of fair market value, the Commission determined that Crossroads also had a value of \$205.88 / installed kW. Therefore, given its 300,000 kW capacity, the Commission held that Crossroads had a fair market value of \$61.8 million.¹⁵⁴

The \$61.8 million valuation was only one component of the Commission’s three-prong valuation for Crossroads. As the second prong of its valuation approach, the Commission held that deferred taxes should be treated as an offset to this rate base

¹⁴⁷ *Id.* at page 93.

¹⁴⁸ *Id.* at pages 78-79.

¹⁴⁹ *Id.* at page 79.

¹⁵⁰ *Id.* at page 94.

¹⁵¹ *Id.* at page 80.

¹⁵² *Id.*

¹⁵³ *Id.* at page 94.

¹⁵⁴ *Id.* at pages 94-96.

valuation. The Commission found that “[i]n all instances, KCPL and GMO use deferred income taxes relating to regulated investment assets as an offset (reduction) to rate base.”¹⁵⁵ Recognizing that Aquila’s non-regulated entity was only able to take the accelerated depreciation that caused the deferred taxes because of its affiliation to the profitable regulated operations,¹⁵⁶ the Commission held that the recognition of accumulated deferred taxes was one of the “relevant factors” it considered in its valuation¹⁵⁷ and therefore the entirety of the accumulated deferred taxes should be treated as an offset to rate base.¹⁵⁸

Finally, as the third-prong of its valuation analysis, the Commission held that GMO should not be permitted to recover transmission expenses associated with transmitting the energy from the Crossroads facility in Mississippi to the Missouri service area.¹⁵⁹ “It is not just and reasonable to require ratepayers to pay for the added transmission costs of electricity generated so far away in a transmission constricted location. Thus, the Commission will exclude the excessive transmission costs from recovery in rates.”¹⁶⁰ While the Raccoon Creek / Goose Creek provided a good surrogate value for Crossroads, the Commission also noted that Ameren was only willing to pay the \$205.88 / kW price because Raccoon Creek and Goose Creek were located in its service area [MISO footprint]. Since Crossroads was not located in the same service area [SPP footprint] as GMO, GMO incurs significant transmission expenses in bringing the energy from Missouri to Mississippi. In order to account for this difference from the Raccoon

¹⁵⁵ *Id.* at page 96.

¹⁵⁶ *Order of Clarification and Modification*, Case No. ER-2010-0356, issued May 27, 2011, at pages 2-3.

¹⁵⁷ *Id.* at page 3.

¹⁵⁸ *Report and Order*, Case No. ER-2010-0355, issued May 4, 2011, at pages 96, 99 and 100.

¹⁵⁹ *Id.* at pages 87, 88, 91 and 100.

¹⁶⁰ *Id.*

Creek / Goose Creek surrogate sale valuation, the Commission also disallowed any transmission expenses associated with this unit. “In addition to the valuation, the Commission concludes that but for the location of Crossroads customers would not have to pay the excessive cost of transmission.”¹⁶¹ As such, “[t]he Commission further determines that it is not just and reasonable for GMO customers to pay the excessive cost of transmission from Mississippi and it shall be excluded.”¹⁶²

While the Commission rejected its request to value Crossroads based upon the fair market value in the SEC filings, MECG admits that the Commission’s decision was a well-considered approach that addressed all aspects of Crossroads and its cost portfolio. Had GMO been willing to accept the Commission’s previous decision, MECG also would have abided by that decision. Since GMO has asked the Commission to reconsider its decision, MECG also believes that the Commission should reconsider and reduce the \$61.8 million value to that stated in the SEC filings. MECG will address this matter in greater detail in this brief.

C. HISTORICAL BACKGROUND OF CROSSROADS UNIT AND MPS ONGOING NEED FOR ELECTRIC CAPACITY

1. INTRODUCTION

Given that the Commission is being asked to reconsider its previous decision on Crossroads, it is important that the Commission have a thorough understanding of the events that precipitated Crossroads becoming a Missouri regulated generating facility. Specifically, the Commission should understand that Aquila had a long-standing policy not to build any generating capacity for its regulated operations. Given this policy, Aquila went over 20 years without adding any capacity for the MPS operations. Instead,

¹⁶¹ *Id.* at page 99.

¹⁶² *Id.* at page 100.

Aquila devoted all of its capital to the construction of non-regulated generating facilities. Included in its deregulated generation portfolio were the Crossroads facility in Mississippi and two Illinois facilities, Raccoon Creek and Goose Creek.¹⁶³ This continued until the collapse of the deregulated energy market.

By now, the Commission is well aware of the financial problems confronted by Aquila in the early 2000s. While many would believe, or ask the Commission to believe, that those financial problems were left behind by Great Plains Energy's acquisition of Aquila, the evidence on this issue clearly demonstrates that Missouri ratepayers are still suffering from Aquila's refusal to invest capital in its regulated operations as well as the implications of Aquila's ill-conceived foray into the deregulated energy market. As then-Chairman Davis appropriately recognized, "[t]here are ample grounds for questioning the prudence of Aquila's management, past and present. These include: management decision to pursue unregulated business ventures that eventually caused Aquila to hemorrhage money, lose its investment grade status and some would say neglect its customers for years." "There is no question Aquila's decisions have been detrimental to its ratepayers." "These issues will continue to haunt Aquila management for years to come regardless of who's in charge."¹⁶⁴

As this brief will show, Aquila initially sought to build all future generation as deregulated units. Once constructed, non-regulated Aquila Merchant would then extract maximum profits from the ratepayers through the execution of purchased power agreements with the regulated affiliate. With the collapse of Enron and the implosion of

¹⁶³ It should be noted that the locations of these units was not to serve Aquila regulated retail load but to take advantage of areas where power supply was limited due to transmission congestion.

¹⁶⁴ *Concurring Opinion of Chairman Davis*, Case No. ER-2007-0004, pages 11 and 12 (issued July 9, 2007).

the deregulated business model, Aquila was left with significant financial problems. As a direct result of these financial problems, Aquila no longer had the financial resources to build the generating units needed to serve its regulated operations' native load.¹⁶⁵ Instead, Aquila's Missouri operations became increasingly reliant on purchased power agreements.

In the past 10 years, Missouri operations have been in desperate need of "steel in the ground." Over that period of time, Missouri Staff has continually imputed the costs of generating units that Aquila should have built, but was financially incapable of building. Even today, GMO customers are still short the necessary capacity to provide the safe and adequate service necessary.¹⁶⁶

Today, GMO seeks to finally provide the generating capacity long-craved by Missouri ratepayers. That said, however, GMO seeks to have these long-suffering ratepayers pay an inflated price for the proposed generating solution, a price that the Commission has recognized was not paid by Great Plains in its acquisition of Aquila. In the final analysis, the fine print associated with GMO's solution (Crossroads) is problematic for multiple reasons and must again be fixed by the Commission.

- The value placed on Crossroads by GMO is based entirely on the cost Aquila Merchant originally paid for the plant as part of its non-regulated operations.¹⁶⁷ GMO continues to ignore the significant deterioration that occurred in the value of other

¹⁶⁵ "It could be argued that investments should have already been made, but simply weren't made because Aquila did not have the cash flow to make them." *Id.* at page 10.

¹⁶⁶ See, Staff Exhibit 259, Staff Cost of Service Report, pages 84-85.

¹⁶⁷ Staff Exhibit 271, Featherstone Rebuttal, page 23.

deregulated assets during the intervening period of time.¹⁶⁸ As such, GMO's desired solution ignores "fair market value" and is significantly overpriced.

- The Crossroads unit is essentially a leftover of Aquila's former deregulated activities that GMO seeks to force upon Missouri regulated customers.¹⁶⁹ This unit was originally constructed in Mississippi to take advantage of high wholesale electric costs that Aquila Merchant perceived would occur in that market. As such, the unit is plagued by all the disadvantages that come with a unit that is located 9 hours and 525 miles away from its actual service territory.¹⁷⁰

- The Crossroads unit was initially placed in Mississippi to take advantage of the high market prices that resulted from the transmission congestion that was prevalent in this area. As such, the same transmission congestion¹⁷¹ that made its location advantageous to serving in that area also made it virtually impossible for GMO to get the energy out of Mississippi without substantial transmission upgrades and cost.

- In the meantime, Aquila Merchant sold a number of combustion turbines that were identical to those employed at Crossroads. Specifically, Aquila Merchant sold combustion turbines located in Illinois,¹⁷² Nebraska¹⁷³ and Colorado,¹⁷⁴ and therefore much closer to the Missouri ratepayers, at significantly deflated prices. Despite these real life examples of the value of such combustion turbines, GMO now asks Missouri ratepayers to happily accept this leftover vestige of Aquila's deregulated activities at a price that hasn't been seen in over a decade.

¹⁶⁸ *Id.* at page 26.

¹⁶⁹ *Id.* at pages 21-22.

¹⁷⁰ Staff Exhibit 258, Cost of Service Report, at page 74.

¹⁷¹ Staff Exhibit 271, Featherstone Rebuttal, page 20.

¹⁷² Staff Exhibit 258, Cost of Service Report, at pages 76-78.

¹⁷³ *Id.* at page 79.

¹⁷⁴ *Id.*

● Finally, the evidence shows that, following the closing of the Aquila acquisition, Great Plains Energy repeatedly attempted, without any success, to sell the Crossroads units.¹⁷⁵ In fact, given the lack of any market for Crossroads, Great Plains has admitted in several filings with the Securities Exchange Commission that the “fair market value” of the Crossroads unit approximates the actual salvage value of that unit.¹⁷⁶

Clearly, Missouri ratepayers continue to be treated as the undesirable little brother to the former beloved big brother – Aquila Merchant. What was once a shiny new toy bought for the big brother has now been passed along to the deprived little brother. While GMO would have these ratepayers believe that they are the recipient of a great gift, ratepayers, like the perceptive little brother, recognize differently. While ratepayers have long desired a generating solution for their energy needs, there is nothing beneficial in receiving a unit that is located 525 miles away, with transmission constraints,¹⁷⁷ at a greatly inflated price. If these are the strings that come with receiving this gift, ratepayers ask that the Commission give the gift back to the spoiled older brother and require GMO to find another electric capacity solution.

2. AQUILA’S ENTRY INTO THE NON-REGULATED ENERGY MARKET

In its testimony, Staff paints an accurate picture of the Aquila business decisions that led to the capacity planning problems that still plague Missouri ratepayers. In 1978, Congress passed the National Energy Act. One part of this act was the implementation of the Public Utility Regulatory Policies Act (“PURPA”). Among other things, PURPA required regulated monopoly utilities to buy power from non-regulated entities if that

¹⁷⁵ *Id.* at pages 74-75. See also, Staff Exhibit 271, Featherstone Rebuttal, pages 32-33.

¹⁷⁶ Staff Exhibit 258, Cost of Service Report, at pages 78-79. See also, Staff Exhibit 271, Featherstone Rebuttal, page 22, 30-31.

¹⁷⁷ Staff Exhibit 258, Cost of Service Report, at page 83.

power was less than the utility's own "avoided cost."¹⁷⁸ This free market approach to electric generation provided an opportunity for independent power producers to build generating stations and force the energy upon the regulated utility.

Suddenly, with the implementation of PURPA, opportunities arose for utilities, acting through non-regulated affiliates, to make profits much greater than those realized in the staid regulated marketplace. Consistent with the business plan utilized by Enron, Aquila formed a non-regulated affiliate (Aquila Merchant) and sought to take advantage of the seductive profits offered in the deregulated market.

In 1997, Aquila formulated a plan by which it would transfer all of its Missouri regulated generating units to Aquila Merchant and sell the energy back to the regulated entity at market rates.¹⁷⁹ By pricing the energy at market rates, Aquila Merchant would be permitted to extract greater profits from Missouri ratepayers. After receiving significant resistance from Staff and other parties, Aquila ultimately withdrew its application.¹⁸⁰

Aquila's efforts to enjoy the heightened profits being realized in the deregulated market did not end with this failed attempt. In 1998, Aquila's MPS division realized a need for generating capacity.¹⁸¹ With this in mind, MPS moved towards construction of the Aries unit. That unit was originally conceived, planned, designed, and engineered by the regulated MPS division.¹⁸² Once Aquila realized that it may be able to realize unregulated profits, the project was quickly turned over to the unregulated affiliate,

¹⁷⁸ See, 4 CSR 240-20.060.

¹⁷⁹ See, Commission Case No. EM-97-395.

¹⁸⁰ *Id.*

¹⁸¹ Staff Exhibit 292, Featherstone Surrebuttal, page 84.

¹⁸² *Id.* at page 63.

Aquila Merchant to be operated as a non-regulated asset.¹⁸³ As Staff notes, because of Aquila's then "corporate policy to not build generating assets for its regulated utility operations," Aquila decided this unit would be a non-regulated non-rate based EWG [exempt wholesale generator] operating within MPS's service area."¹⁸⁴

Ultimately, Aquila Merchant, along with its deregulated partner Calpine, built the 585 MW Aries combined cycle generating plant in Pleasant Hill, Missouri.¹⁸⁵ Since it was no longer going to be the owner of the Aries unit, the MPS regulated operations were instead required to take the energy from that unit through a five year purchased power agreement running through May 31, 2005.¹⁸⁶

Aquila's foray into the deregulated energy market was not limited solely to the construction of Aries. During this time, Aquila Merchant also negotiated for the purchase and subsequent construction of several other non-regulated units. For instance, Aquila Merchant built the 340 MW Raccoon Creek and 510 MW Goose Creek generating stations in Illinois.¹⁸⁷ Aquila Merchant also designed and built the Crossroads Energy Center in Clarksdale, Mississippi.¹⁸⁸ In addition, Aquila Merchant also purchased three combustion turbines that were to be constructed as Aries II.¹⁸⁹ Ultimately, while Aries II was never constructed and the combustion turbines were instead placed in storage,¹⁹⁰ Aquila still had high hopes. Aquila intended to install them [three combustion turbines] at its Aries site and sell power from them to MPS. It was expected that once Aries II went into service, MPS would enter into a purchased power agreement with

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at page 63.

¹⁸⁷ Staff Exhibit 258, Cost of Service Report, at page 77.

¹⁸⁸ *Id.* at page 74

¹⁸⁹ *Id.* at page 92.

¹⁹⁰ *Id.* at page 109.

Aquila Merchant, a wholly owned non-regulated affiliate. The term for the agreement was to be for 15 years starting June 1, 2005, to coincide with the expiration of the Aries agreement May 31, 2005. Thus, Aquila had grand plans to maximize profits received from Missouri ratepayers through the use of purchased power agreements with Aquila Merchant.

3. COLLAPSE OF DEREGULATED ENERGY MARKET AND EFFECT ON AQUILA

In late 2001, the largest participant in the deregulated energy market (Enron) unexpectedly collapsed under the weight of numerous accounting improprieties. In the wake of the scandal which called into question the business practices of all deregulated energy companies, Aquila suddenly began experiencing significant financial pressures. As a result of this financial pressure and the questions now surrounding the deregulated business model, Aquila began to divest itself of its deregulated assets. While this section provides interesting historical background, it is also supremely relevant in that it demonstrates the significant decrease in the fair market value of deregulated assets like the Crossroads Energy Center.

Despite having a guaranteed load (Missouri regulated operations) to which to sell its energy from Aries, Aquila Merchant made the decision to sell the Aries generating station in 2004. Ultimately, Aquila Merchant received nothing for this asset.

Shortly afterwards, in 2005, Aquila Merchant agreed to sell its combustion turbine facilities in Illinois.¹⁹¹ Known as Raccoon Creek and Goose Creek, the combustion facilities were sold to AmerenUE “as distressed property.”¹⁹² As Staff notes,

¹⁹¹ Staff Exhibit 258, Cost of Service Report, at page 77.

¹⁹² Staff Exhibit 292, Featherstone Surrebuttal, page 88.

these units were sold at highly discounted values.¹⁹³ In fact, Aquila later noted in an SEC filing, that it incurred a loss of \$99.7 million on the sale of Raccoon Creek and Goose Creek.¹⁹⁴

Continuing its efforts to divest itself of deregulated assets, Aquila Merchant also attempted to sell the Crossroads Energy Center.¹⁹⁵ As Aquila noted in response to a Staff Data Request, it contacted ****__**** parties in 2005 in an attempt to sell the Crossroads unit.¹⁹⁶ Reflecting the depressed value of these type of assets and the transmission constraints surrounding the Crossroads unit, ****_____**** for the Crossroads unit.¹⁹⁷

As Section G, *infra*, demonstrates, Aquila's response to the collapse of the deregulated energy market not only involved the sale of its non-regulated assets. Ultimately, Aquila undertook a comprehensive sale of its regulated assets, culminating in the sale of the remainder of the Company (Missouri electric operations and Crossroads) to Great Plains in 2008.

4. STAFF'S EFFORTS TO FORCE AQUILA TO CONSTRUCT A MISSOURI REGULATED GENERATING STATION

During this time, Aquila routinely ignored the efforts of Staff to build regulated generating stations for Missouri ratepayers. This was clearly the prudent approach. As Chairman Davis has recognized:

PSC staff has taken positions in favor of Missouri electric utilities owning their own electric generation because it is more reliable to have generation facilities located near the customers being served and cheaper once the costs are depreciated over a period of thirty years or longer. Companies

¹⁹³ Staff Exhibit 258, Cost of Service Report, at page 77.

¹⁹⁴ *Id.*

¹⁹⁵ Staff Exhibit 271, Featherstone Rebuttal, page 32.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

that followed this strategy and built excess generation capacity, like KCP&L and AmerenUE, have used off-system sales of their excess electricity to subsidize costs to their regulated utility customers.

Both utilities and customers have benefited under this regulatory framework. AmerenUE and KCP&L generated earnings for their investors and avoided rate increases for almost two decades, while actually reducing the rates paid by their customers over that same period. This accomplishment is no small feat and **provides strong support for the long-term approach espoused by Mr. Schallenberg and the rest of the PSC staff in this regard.**¹⁹⁸

As Staff continues to point out, “steel in the ground” is preferable to relying on short-term PPA’s.¹⁹⁹ There are multiple reasons for this preference. **First**, the utility realizes advantages of ownership in terms of reliability.

Utilities are able to control the operations of the generating facilities if they own and operate those assets. Utilities will not be subjected to the volatility of the marketplace with cost increases related to purchase power if they operate their own generating assets. **Also, utilities are able to provide a much more reliable source of energy when the regulated company has its generation under its authority.** The regulated entity can operate the unit in a prudent and economic manner and can maintain and make capital improvements to prolong the life of this valuable asset.²⁰⁰

Interestingly, management for Aquila’s regulated entity recognized this advantage. There are “significant advantages in both owning and operating the generation equipment in developing maintenance expertise.”²⁰¹ The regulated entity also recognized advantages in “the areas of costs, manpower and staffing and dispatch flexibility.”²⁰²

Second, the advantages of ownership of the generating station are also realized by the ratepayers in the form of lower revenue requirements over the life of the asset.

Generally, the costs (revenue requirements) are higher in the early years of ownership. The capital costs of the plant investment require a return

¹⁹⁸ *Concurring Opinion of Chairman Davis*, Case No. ER-2007-0004, pages 8-9 (issued July 9, 2007).

¹⁹⁹ Staff Exhibit 282, Mantle Rebuttal, page 8; Staff Exhibit 292, Featherstone Surrebuttal, page 94.

²⁰⁰ Staff Exhibit 292, Featherstone Surrebuttal, page 111.

²⁰¹ *Id.*

²⁰² *Id.*

(return on investment) and the utility is entitled to a recovery of the investment (return of investment). As the plant investment is recovered through depreciation – (the return of investment) – the rate base return required – (return on the investment) – decreases. At some point in the future . . . the customers will have the benefit of the plant while the rate base investment is very low. The return on investment declines which causes the revenue requirements to decline dramatically through ownership.²⁰³

Therefore, for almost 15 years we have seen an ongoing, unresolved conflict. While ratepayers clamored for the benefits associated with construction of a Missouri regulated generating station, Aquila’s management ignored their pleas and opted in favor of the false promise of heightened profits in the deregulated market. Ultimately, this unresolved conflict has led to the capacity shortage that Missouri operations are still experiencing today. “Staff believes that had Aquila built Aries as a regulated generating station and rate based it in the traditional manner, Aquila likely would not have the capacity issues it has today.”²⁰⁴ While Aquila continually rejected the notion of regulated generating units, Staff consistently urged Aquila to make these regulated investments.

Staff has had issues with Aquila’s decision making regarding building generating units since Aquila’s 2001 rate case, Case No. ER-2001-672. In each rate case since the 2001 through the last Aquila rate case, Case Nos. ER-2004-0034, ER-2005-0436 and ER-2007-0004, Staff expressed its concerns on the Company’s decision not to build generating units and relying on purchase power agreements to meet capacity.²⁰⁵

5. AQUILA’S INTEGRATED RESOURCE PLAN REPEATEDLY CALLED FOR THE CONSTRUCTION OF GENERATION

In 1992, the Commission first implemented its integrated resource planning rule.²⁰⁶ As designed, that rule is intended to provide a process by which utilities analyze an optimal mix of supply side resources and demand side management to meet expected

²⁰³ *Id.* at page 112.

²⁰⁴ *Id.* at page 96.

²⁰⁵ *Id.*

²⁰⁶ 4 CSR 240-22.

electric needs. Consistent with the construction option that has been repeatedly advocated by Staff, Aquila's 1992 preferred plan called for the construction of ** _____

_____.²⁰⁷ While the regulated operations initially proceeded with the planning for this combined cycle unit, Aquila opted to build the unit as a deregulated unit [Aries] and sell the power to MPS through a 5-year purchase power agreement expiring on May 31, 2005.²⁰⁸

Subsequent integrated resource plans came to similar conclusions. Given the expiration of the purchase power agreement for the energy from Aries, Aquila's 2004 integrated resource plan again called for the construction of generating capacity. In this case, the least cost plan dictated the construction of five combustion turbines in 2005.²⁰⁹ Given the collapse of the deregulated energy market, Aquila was no longer adamant against the construction of regulated generating units. Now, however, given the losses suffered by its foray into the deregulated market, Aquila no longer had the financial means to build the needed regulated units. Instead, Aquila felt financial pressures to forego the capital costs associated with constructing these regulated units and instead opted in favor of purchase power agreements.²¹⁰ Still, Staff persisted.

Realizing that the three combustion turbines that originally were designed to be Aries II had been sitting in storage for over three years, Staff insisted that Aquila construct these CTs as regulated capacity. Interestingly, personnel for Aquila's regulated operations were not even aware of the existence of these stored combustion turbines. Only when informed of the existence of these turbines did the regulated employees even

²⁰⁷ Staff Exhibit 292, Featherstone Surrebuttal, page 55.

²⁰⁸ *Id.* at page 63.

²⁰⁹ *Id.* at page 71.

²¹⁰ *Id.* at page 91 ("From the time Aquila signed the Aries agreement in February 1999, it started considering replacing the Aries capacity, but only with purchased power agreements.")

inquire as to their availability. Given its financial problems, however, Aquila hesitated and instead sought to sell these combustion turbines. Reflecting the depressed market for these turbines, Aquila was unsuccessful in selling the CTs. Finally, Aquila relented and agreed to construct the three combustion turbines as the South Harper unit.²¹¹

6. CONSTRUCTION OF SOUTH HARPER AND CONTINUING CAPACITY SHORTAGE

As indicated, Aquila's 2004 integrated resource plan called for the construction of five combustion turbines. Given the collapse of the deregulated electric industry, Aquila was no longer opposed, in principle, to the construction of regulated units. Now, however, Aquila no longer had the financial means to construct such units. Therefore, while its integrated resource plan called for the construction of five combustion turbines, Aquila initially intended to fill its energy and capacity needs solely through the use of purchase power agreements.²¹² Only after being notified that Aquila Merchant had three combustion turbines in storage for over three years did Aquila relent and agree to the construction of three combustion turbines. Ultimately, these three combustion turbines became the South Harper units.

While the initial book value of these three combustion turbines was significantly higher, Aquila conceded the depressed state of the market for CTs. Given the requirement in the affiliate transaction rule to only reflect the "fair market value" of any assets transferred from a non-regulated affiliate, Aquila agreed to a significant write-off on the value of the South Harper turbines.²¹³

²¹¹ *Id.* at page 91.

²¹² *Id.* at page 41.

²¹³ Exhibit 293, page 93, lines 9-17

Recognizing that Aquila had refused to construct any regulated generation since 1983,²¹⁴ the construction of the three South Harper turbines represented a significant step forward. That said, however, it did not completely fulfill the needs set forth in the 2004 integrated resource plan. Remember, while South Harper consisted of three combustion turbines, the preferred resource plan demanded the construction of five combustion turbines. Therefore, for the past seven years, Aquila had continued to recognize a shortfall for the capacity originally anticipated by the other two missing turbines.

7. KCPL ACQUISITION AND INTRODUCTION OF CROSSROADS

As indicated, given the collapse of the deregulated energy market and the subsequent impact that it had on Aquila's financial condition, Aquila began to sell off various assets. Initially starting with deregulated assets, Aquila eventually turned to selling its regulated service areas as well. In early 2006, Aquila sold its natural gas operations in Michigan, Minnesota and Missouri. In February 2007, Aquila entered into an agreement by which it would sell its gas assets in Iowa, Nebraska, Kansas and Colorado as well as its electric assets in Kansas.²¹⁵ In 2008, the remainder of Aquila's assets, consisting primarily of Aquila's Missouri operations and the 340 MW Crossroads Energy Center in Mississippi would be purchased by Great Plains Energy.²¹⁶ With its acquisition of Aquila, Great Plains Energy inherited the "issues" (lack of generation capacity) that Chairman Davis predicted would "haunt Aquila management for years to come regardless of who's in charge."

²¹⁴ Staff Exhibit 292, Featherstone Surrebuttal, pages 62, 92, 110, 112,

²¹⁵ *Report and Order*, Case No. EM-2007-0374, page 8 (issued July 1, 2008). See also, Ex. 216, page 3.

²¹⁶ Staff Exhibit 271, Featherstone Rebuttal, page 21.

As the following section indicates, throughout that acquisition process, Great Plains Energy repeatedly sought to sell the Crossroads unit.²¹⁷ Given the depressed nature of the market for deregulated generating assets as well as the transmission constraints associated with exporting the energy out of that unit, Great Plains Energy repeatedly failed to find a buyer for the unit.²¹⁸ Given its inability to find a purchaser for Crossroads, Great Plains made several filings with the Securities Exchange Commission noting the value of Crossroads to be only \$51.6 million.²¹⁹ Recognizing the requirement that assets be transferred from a non-regulated affiliate at the lesser of cost or fair market value, this statement plays a significant role in determining the fair market value of the Crossroads units.

C. FAIR MARKET VALUE OF CROSSROADS

As this brief has demonstrated, Aquila was the self-inflicted victim of bad timing. Aquila entered the deregulated market when Enron was flying high and the value of deregulated assets was at their highest point. Thus, Aquila Merchant paid full book value when it built the Aries unit, Raccoon Creek, Goose Creek and Crossroads. Aquila Merchant also paid full book value for the three combustion turbines that were placed in storage for three years before eventually being constructed at South Harper.

It is undisputed, however, that between the time that these deregulated assets were purchased or constructed (1999-2002) and the time that Great Plains Energy purchased the remaining remnants of Aquila (2008), the value of these same deregulated assets declined significantly. Nevertheless, GMO completing ignores the Supreme Court's holding in *Smyth* as well as the Commission's affiliate transaction rule and asks that the

²¹⁷ *Id.* at page 32.

²¹⁸ *Id.* at page 33.

²¹⁹ *Id.* at page 22, 27-28.

Commission place the Crossroads unit in rate base at the depreciated, net book value of the assets. Specifically, GMO requests that the Commission place Crossroads in rate base at a value of \$91.3 million.²²⁰

As this section of the brief will demonstrate, however, the depreciated net book value of Crossroads is not an accurate measure of the “fair value of the property being used by it for the convenience of the public.”²²¹ Nor, is depreciated net book value of Crossroads an accurate measure of the “fair market price” required by the Commission’s affiliate transaction rule. Instead, quantification of “fair value” necessary to fulfill these requirements are found in: (1) filings made by Great Plains Energy with the Securities Exchange Commission at the time it acquired Aquila; (2) the value of other identical combustion turbines actually being sold by Aquila Merchant to third parties at that same time; and (3) the fact that neither Aquila nor Great Plains could find a single entity interested in purchasing the Crossroads unit.

1. GREAT PLAINS ENERGY SEC FILINGS

In February 2007, Great Plains Energy announced that it was acquiring the remaining assets of Aquila.²²² These assets consisted of the Missouri electric operations and the Crossroads Energy Center. This acquisition announcement followed several months of due diligence by Great Plains as to the value of the assets that it was acquiring.

Almost immediately upon announcing the acquisition, but before the acquisition had even closed, Great Plains made three filings with the Securities Exchange Commission as to the fair market value of the Crossroads Energy Center.²²³ In that

²²⁰ *Id.* at page 23.

²²¹ *Smyth v. Ames*, 169 U.S. 466, 546-547 (1898).

²²² *Id.* at page 21.

²²³ *Id.* at page 22.

filing, Great Plains announced that, despite a net book value at the time of \$117.9 million, Crossroads had a “fair value” of only \$51.6 million.²²⁴

The pro forma adjustment represents the adjustment of **the estimated fair value of certain Adjusted Aquila non-regulated tangible assets** and reduction of depreciation expense associated with the decreased fair value. The adjustment was determined based on Great Plains Energy’s estimates of fair value based on estimates of proceeds from sale of units to an unrelated party of similar capacity in the current market place. **The preliminary internal analysis indicated a fair value estimate of Aquila’s non-regulated Crossroads power generating facility of approximately \$51.6 million.** This analysis is significantly affected by assumptions regarding the current market for sales of units of similar capacity. The \$66.3 million adjustment reflects the difference between **the fair value of the combustion turbines at \$51.6 million** and the \$117.9 million book value of the facility at March 31, 2007. Great Plains Energy **management believes this to be an appropriate estimate of the fair value of the facility.**²²⁵

Great Plains and Aquila repeated this same \$51.6 million fair market value for Crossroads in at least two subsequent SEC filings.²²⁶ Thus, at the time of acquisition by Great Plains, the value of Crossroads had to be reduced by \$66.3 million to reflect “fair value.” That said, however, GMO refuses to recognize this fair value. Instead, GMO returns to the original net book value for ratemaking purposes.

2. VALUE OF OTHER COMBUSTION TURBINES

The Crossroads Energy Center is a 300 MW natural gas combustion turbine generating site, consisting of four 75 MW General Electric model 7 EA combustion turbines.²²⁷ Given its plans to enter the deregulated market in many locations throughout the nation, Aquila Merchant purchased a total of eighteen (18) of these General Electric

²²⁴ Staff Exhibit 258, Cost of Service Report, at pages 78-79; Staff Exhibit 271, Featherstone Rebuttal, pages 27-28.

²²⁵ Staff Exhibit 258, Cost of Service Report, at pages 78-79 (citing to Great Plains Energy & Aquila Joint Proxy Statement / Prospectus, filed with the SEC on May 8, 2007, at page 175) (emphasis added).

²²⁶ Staff Exhibit 271, Featherstone Rebuttal, page 22.

²²⁷ Staff Exhibit 258, Cost of Service Report, at pages 74 and 77.

combustion turbines.²²⁸ Therefore, after the deregulated electric industry collapsed in late 2001, Aquila Merchant had significant experience selling the remaining fourteen (14) combustion turbines that were identical to those now located at Crossroads. That real market experience provides direct evidence that the “fair market value” for these General Electric turbines is significantly less than that now claimed by GMO, and is actually in line with the “fair value” previously noted by Great Plains.

For instance, of the 18 General Electric Turbines, six turbines were installed at the 510 MW Goose Creek Energy Center in Illinois.²²⁹ An additional four turbines were installed at the nearby 340 MW Raccoon Creek facility.²³⁰ Following the onset of the financial problems caused by the entry into the deregulated market, Aquila Merchant immediately began seeking third parties that were interested in purchasing these units. As documented by Staff, the final sale price for both units (10 combustion turbines for a total capacity of 850 MWs) was \$175 million.²³¹ As such, the final purchase price amounted to **\$205.88** per installed kilowatt.²³² This sale was closed in 2006 and is, therefore, contemporaneous with the Great Plains acquisition in 2007.²³³

As it later revealed in an SEC filing, Aquila Merchant suffered an after-tax loss on the sale of Goose Creek and Raccoon Creek of \$99.7 million.²³⁴ Interestingly, despite its regulated operations expressed need for capacity, and despite the fact that these units

²²⁸ *Id.* at page 77.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.* (citing to Aquila’s SEC Form 8K filing with the Securities Exchange Commission, filed December 16, 2006).

²³³ *Id.*

²³⁴ *Id.*

were significantly closer than Crossroads, Aquila never gave the regulated operations an opportunity to buy these depressed assets.²³⁵

While Aquila Merchant suffered large losses associated with the sale of the 10 General Electric combustion turbines located at Raccoon Creek and Goose Creek, Aquila Merchant suffered even larger losses associated with subsequent sales. For instance, Aquila Merchant sold three other General Electric turbines to utilities in Nebraska and Colorado.²³⁶ The total purchase price for these three General Electric turbines was ** _____ **. ²³⁷ Given the total capacity of 225 MWs, the purchase price for these turbines, identical to those installed at Crossroads, was only ** _____ ** per kilowatt.²³⁸

Finally, Aquila Merchant released the last combustion turbine back to General Electric. In doing so, Aquila Merchant received no money, and lost the entirety of the reservation (option) payment that it had previously made.²³⁹

As can be seen then, the fair value of General Electric 7 EA combustion turbines being sold to third-parties was in the range of ** _____ ** and \$205.88 / kw.

3. NO WILLING PURCHASERS

The “fair market value” of Crossroads is also impacted by the fact that Aquila, and later Great Plains Energy, despite their professed desires to sell the Crossroads Energy Center, was unable to find a single interested bidder. As previously indicated, shortly following the implosion of the deregulated electric industry, Aquila Merchant began to divest itself of its deregulated assets. In short order, Aquila Merchant sold its

²³⁵ Staff Exhibit 259, Staff Cost of Service Report, page 80; Staff Exhibit 293, Featherstone Surrebuttal, page 93.

²³⁶ *Id.* at page 79.

²³⁷ *Id.* at page 80.

²³⁸ *Id.*

²³⁹ Staff Exhibit 259, Staff Cost of Service Report, page 80.

ownership interest in the completed Aries, Raccoon Creek, and Goose Creek units. Furthermore, Aquila sold its ownership interest in three combustion turbines that had been purchased, but not yet installed by Aquila Merchant.²⁴⁰

Given its dire cash needs, Aquila Merchant was anxious to sell the remainder of its deregulated assets as well. Ultimately, Aquila Merchant succeeded in divesting every deregulated asset except Crossroads. In a data request, GMO acknowledges that Aquila Merchant attempted to sell Crossroads in both **_____**. ²⁴¹ Both times, however, Aquila Merchant was unsuccessful in finding a purchaser. In fact, **_____

_____** for the Crossroads unit.²⁴²

Later, following its announced acquisition of Aquila, Great Plains also attempted to sell the Crossroads unit. In a webcast call with investors, Great Plains management was asked specifically about its intentions for the Crossroads unit. In response, Great Plains Chief Financial Officer indicated “[w]e looked at the ability to utilize that or sell it. Our preference would be probably to get value through monetizing it.”²⁴³ As Staff notes, the fact that Great Plains did not sell Crossroads, despite its stated preference, “means that like Aquila, it could not find a buyer.”²⁴⁴

4. FAIR MARKET VALUE

Aquila Merchant’s sale of the General Electric 7 EA combustion turbines, identical to those located at Crossroads Energy Center, provides real-life evidence of the depressed value of these turbines. Importantly, given the dates of these sales (2004-

²⁴⁰ *Id.* at page 80.

²⁴¹ Staff Exhibit 271, Featherstone Rebuttal, page 32.

²⁴² *Id.*

²⁴³ *Id.*

²⁴⁴ *Id.*

2006), they provide contemporaneous evidence of this depressed value. Therefore, the “fair market value” of General Electric 7 EA combustion turbines is within the range of **** _____ **** per kilowatt (the sales to the Nebraska and Colorado utilities) to \$205.88 per kilowatt (the sale of Goose Creek and Raccoon Creek). Recognizing that the Crossroads unit was installed and capable of generating, its value lies closer to the high end of that range. That is to say, since they are installed, they are more comparable to the installed Goose Creek and Raccoon Creek units, than to the uninstalled Nebraska / Colorado sales.

Therefore, one measure of Crossroads “fair market value” is based upon Aquila Merchant’s contemporaneous sale of other General Electric 7 EA combustion turbines. Using a value of \$205.88 / kilowatt, Crossroads then has a “fair market value” of **\$61.76 million.**²⁴⁵ The other, and probably more dependable, measure of the “fair market value” of Crossroads is taken from Great Plains Energy filings with the SEC in which it states that the “fair value estimate of Aquila’s non-regulated Crossroads power generating facility is approximately **\$51.6 million.**” It is important to realize, however, that both of these quantifications reflect the value at the time of the acquisition by Great Plains (2008). Therefore, either figure should be reduced for the effect of five years of subsequent depreciation. Ultimately, both of these quantifications of “fair market value” show the greatly inflated nature of the net book value that GMO believes should be used as the rate base for Crossroads.

Ultimately, the \$51.6 million fair market value placed on Crossroads in SEC filings is consistent with internal Aquila documents developed at the time that Aquila attempted to sell Crossroads in 2005. Specifically, on December 14, 2004, Aquila hired Lehman Brothers to solicit offers for the sale of Raccoon Creek, Goose Creek and

²⁴⁵ \$205.88 / installed kw * 300,000 kw at Crossroads = \$61.76 million.

Crossroads.²⁴⁶ At the time that it kicked off its solicitation on February 2, 2005, Aquila indicated that Crossroads had a value as low as ** _____ ** or a total value of ** _____ **.²⁴⁷ Two and a half months later after soliciting bids and further evaluating the market, Aquila had lowered its valuation of Crossroads to as low as ** _____ **²⁴⁸ equating to a total value of ** _____ **.²⁴⁹

In fact, in its valuation document, Aquila specifically referenced ** _____
_____ **²⁵⁰ These transactions,
** _____
_____ **²⁵¹ Ultimately, Aquila concluded that the ** _____
_____ **²⁵²

D. DEFERRED TAXES

In its last decision, the Commission undertook a three-prong approach to the valuation of Crossroads. As Staff notes:

When deciding whether to include Crossroads in GMO’s rate base in GMO’s 2010 rate case, the Commission considered ***together*** the value of Crossroads and the deferred income tax and transmission costs associated with Crossroads, all of which were contested amounts. ***Viewing these items together, not independently,*** the Commission decided the amount for the associated deferred income taxes was \$15 million and that GMO’s customers should not bear the transmission costs for transporting energy from Crossroads in Clarksdale, Mississippi to GMO’s service territory.²⁵³

²⁴⁶ Staff Exhibit 395, Appendix Project Spark, at page 3.
²⁴⁷ *Id.*
²⁴⁸ *Id.*
²⁴⁹ *Id.*
²⁵⁰ *Id.* at page 4.
²⁵¹²⁵¹ *Id.*
²⁵² *Id.* at page 2.
²⁵³ Staff Exhibit 258, Cost of Service Report, at pages 73 (emphasis added).

The fact that all three items were considered part of an interdependent valuation package, is also demonstrated by the Commission's characterization of all three elements as "relevant factors" it considered in its valuation²⁵⁴

Again, despite the clarity of the Commission's previous order, GMO again asks that the Commission reverse its previous decision and ignore the accumulated deferred taxes.²⁵⁵ Under GMO's theory, accumulated deferred taxes should flow from the Commission's valuation instead of being part of that valuation.²⁵⁶ And, under no scenario does GMO believe that deferred taxes generated prior to the transfer of Crossroads to MPS be included as an offset to rate base.²⁵⁷

As with the last case, GMO's argument is misplaced.

GMO fails to recognize that the deferred taxes were not simply a mathematical calculated that flowed out of the Commission's adoption of the Raccoon Creek / Goose Creek valuations. In that case, deferred taxes were not designed to be simply "synchronized" with the Raccoon Creek / Goose Creek valuation. Rather, the deferred taxes were part and parcel of three unique aspects of the Commission's Crossroads valuation.²⁵⁸

The Commission's decision in the last case, to reflect the entirety of accumulated deferred taxes, was correct. ***First***, the accumulated deferred taxes in question arose out of the accelerated tax deduction provided by the income tax code. As with other deductions, the accelerated tax deduction is permitted only to the extent that the entity had income. Given the deterioration of the deregulated energy market as reflected by the significant decrease in fair market value reflected in the Great Plains SEC filings, it is apparent that this unit was not profitable. As such, on a stand-alone basis, Crossroads

²⁵⁴ *Id.* at page 3.

²⁵⁵ GMO Exhibit 119, Hardesty Surrebuttal, pages 8-9.

²⁵⁶ GMO Exhibit 118, Hardesty Rebuttal, page 3.

²⁵⁷ GMO Exhibit 119, Hardesty Surrebuttal, pages 8-9.

²⁵⁸ MCEG Exhibit 426, Meyer Surrebuttal, pages 17-18.

and Aquila Merchant would not have been able to recognize the accelerated depreciation deduction. Instead, the ability to take the accelerated depreciation deduction comes from the fact that Aquila Merchant was affiliated with the profitable regulated operations. For this reason, the existence of the regulated ratepayers and the profits derived from them provided the basis for the accelerated tax deduction and the deferred taxes that exist today.

Second, it is unquestioned that Great Plains Energy undertook significant due diligence as part of its acquisition of Aquila. One part of that due diligence would necessarily have been into the quantification of deferred taxes for all parts of the remaining Aquila operations including Crossroads. It is “incomprehensible” that Great Plains would not have considered this accumulated deferred tax balance as part of its final acquisition price for Aquila.

Third, as the Commission found, “[i]n all instances, KCPL and GMO use deferred income taxes relating to regulated investment assets as an offset (reduction) to rate base.”²⁵⁹ Given that this is now a regulated generating facility, the deferred income tax balance associated with this facility should also be reflected as “an offset (reduction) to rate base.”

Clearly, the Commission carefully considered this issue in the last case. GMO has provided no new evidence to undermine the logic of the Commission’s decision in that case. For this reason, the Commission should reaffirm its use of the Crossroads accumulated deferred tax balance as an offset to rate base.

²⁵⁹ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 96.

E. TRANSMISSION COSTS

The third prong of the Commission's comprehensive Crossroads valuation decision was the elimination of any expenses associated with transmitting electricity from Crossroads in Mississippi to the Missouri service area. As the Commission held,

It is not just and reasonable to require ratepayers to pay for the added transmission costs of electricity generated so far away in a transmission constricted location. Thus, the Commission will exclude the excessive transmission costs from recovery in rates. . . . GMO's MPS retail customers should bear neither the costs nor risks associated with the transmission limitations in getting electricity from Crossroads to MPS.²⁶⁰

The Commission made a similar finding:

In addition to the valuation, the Commission concludes that but for the location of Crossroads, customers would not have to pay the excessive cost of transmission. Therefore, transmission costs from the Crossroads facility, including any related to OSS [off-system sales] shall be disallowed from expenses in rates and therefore also not recoverable through GMO's fuel adjustment clause ("FAC").²⁶¹

1. Background

As the Commission recognized in its previous decision, Crossroads is located in Clarksdale, Mississippi.²⁶² While GMO has included Crossroads as a designated resource for its capacity requirements in SPP, it is not located within the contiguous footprint of SPP. Rather, Crossroads is entirely surrounded by Entergy service area. As such, GMO must incur transmission expenses across Entergy in order to get this energy to SPP and ultimately to its Missouri service area.²⁶³

Previously, Entergy did not belong to any Regional Transmission Organization ("RTO"). Instead, Entergy was a stand-alone transmission entity with FERC approved

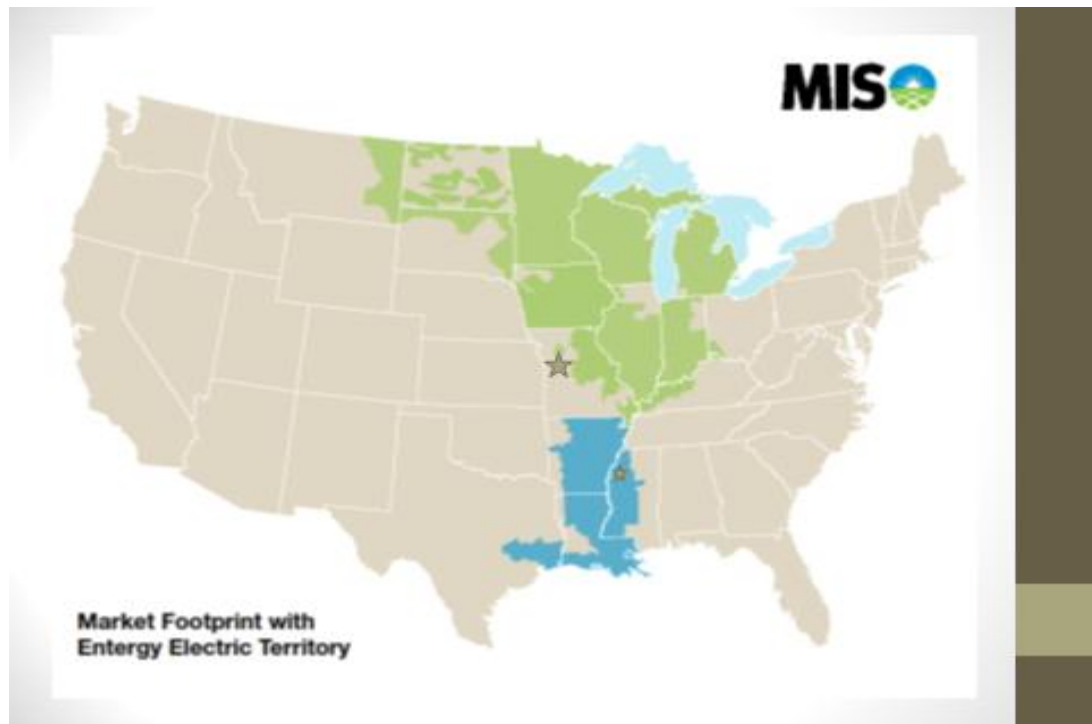
²⁶⁰ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at pages 87-88.

²⁶¹ *Id.* at page 99.

²⁶² *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 78.

²⁶³ MEGC Exhibit 426, Meyer Surrebuttal, page 16; Tr. 931.

transmission rates. Therefore, in order to ensure the capacity and energy from Crossroads, GMO paid a firm transmission rate to Entergy.²⁶⁴



Recently, however, Entergy joined the Midwest Independent System Operator (“MISO”).²⁶⁵ In fact, the formal approval was announced on November 16, 2012²⁶⁶ with Entergy formally joining in December, 2012.²⁶⁷ As such, where GMO previously paid Entergy rates for transmission of energy from Crossroads to SPP, now GMO will pay MISO rates for the transmission of that energy.²⁶⁸

2. Transmission Costs Are Significant and Escalating

The logic underlying the Commission’s disallowance of transmission costs is more prevalent in the pending case. In the last case, the Commission referenced these

²⁶⁴ GMO Exhibit 112, Crawford Surrebuttal, page 3.

²⁶⁵ Tr. 931-932.

²⁶⁶ *Entergy Gets Final Nod for MISO*. Published November 16, 2012. <http://finance.yahoo.com/news/entergy-gets-final-nod-miso-160910712.html>

²⁶⁷ *Id.*

²⁶⁸ Tr. 932.

costs. “The annual energy transmission cost was estimated as \$406,000 per month.”²⁶⁹

Evidence in this case shows that these costs are escalating rapidly.

2011	** _____ **
2010	** _____ **
2009	** _____ **
2008	** _____ **
2007	** _____ ** ²⁷⁰

Interestingly, however, GMO did not provide any forecasted costs of transmission. Undoubtedly, this was done because of concern with the implications of Entergy joining MISO.

As mentioned, GMO previously paid FERC approved rates for Entergy for the transmission of energy from Crossroads to SPP. Now, with the inclusion of Entergy in MISO, GMO will be paying the MISO transmission rates. During the hearing, evidence was garnered that the MISO rate for transmission would be “double” the Entergy approved transmission rate.²⁷¹ As such, it is probable that the \$4.7 million cost of transmission in 2011 will double to approximately \$9.5 million in 2013.

Interestingly, Aquila was well aware of the problems with getting energy from Crossroads when it placed the facility in Clarksdale. Specifically, Aquila placed Crossroads in Clarksdale, a point of known transmission congestion, as an attempt to take advantage of the high market prices for energy in this congested area. The location of the generator in an area in which Aquila sought to take advantage of congestion is now requiring the payment of excessive transmission costs.

²⁶⁹ *Id.* at page 86.

²⁷⁰ Staff Exhibit 259, Cost of Service Report, at page 83.

²⁷¹ Tr. 932.

What Mr. Crawford and GMO fail to understand is that Aquila made deliberate business decisions to locate these generators where there were known congestion issues on the transmission network. Aquila Network believed placing peaking units in areas of transmission constraints would allow the non-regulated operations to enjoy the benefits of high priced power when there were times of restrictions of the network. In other words, Crossroads was placed in a location where it would ultimately be costly to transport power out of the region. Of course, Aquila never intended to use the power generated from Crossroads for GMO customers, so the transmission costs and the ability to transport electricity from Mississippi never was a concern – that is until KCPL took over operating GMO.²⁷²

3. GMO Does Not Incur Transmission Costs for Plants Located in the SPP Service Area

As the Commission is undoubtedly aware, given its ongoing participation in SPP, participants in the SPP RTO do not incur costs associated with transmitting energy from its designated generating resources within the RTO to its service area in that RTO. As the Commission previously held, “GMO does not incur any transmission costs for its other production facilities that are located in its MPS district that are used to serve its native load customers in that district.”²⁷³ For this reason, all of the GMO generating facilities, except Crossroads, are located in the SPP footprint.²⁷⁴ As Staff notes,

All of KCPL’s and GMO’s generating facilities do not need firm transmission service because, as a member of the Southwest Power Pool (SPP) except for one power plant – Crossroads, all other generating units are able to transport power to their retail customers without incurring firm transmission costs. Since all other generating units in the KCPL and GMO fleets are within the SPP transmission territory there is no cost for transmission service when the electricity is used by retail customers. The single exception is Crossroads. Since this Mississippi generating plant is located 525 miles away from GMO’s load centers, GMO has decided for the Crossroads facility to have firm transmission to get power back to its retail customers in Missouri.²⁷⁵

²⁷² Staff Exhibit 272, Featherstone Rebuttal, page 37.

²⁷³ *Report and Order*, Case No. ER-2010-0356, issued May 4, 2011, at page 87.

²⁷⁴ GMO Exhibit 110, Crawford Direct, Schedule BLC-7; Staff Exhibit 258, Staff Cost of Service Report, page 71.

²⁷⁵ Staff Exhibit 272, pages 35-36.

4. The Crossroads Transmission Costs are Inherently Unreasonable

In an effort to make the Crossroads Transmission costs appear more reasonable, GMO offers a misplaced comparison. Recognizing that the Commission's proxy sale for valuation (the third party sale of the Raccoon Creek / Goose Creek), involved combustion turbines located in Illinois, GMO maintains that the Crossroads transmission costs must be reasonable because the cost of transmitting power from the Illinois facilities would have been more expensive.²⁷⁶ Again, GMO's comparison to Illinois transmission costs is misplaced.

The Commission did not reference the sale of the Raccoon Creek / Goose Creek as a suggestion that GMO should have kept these plants and incurred the costs of transmitting energy from these plants to its Missouri service area. Rather, the Commission made the comparison to the sale of these combustion turbines as a surrogate for the price of combustion turbines located in the same service area as the utility customers. Just as in the surrogate sale of Raccoon Creek / Goose Creek, a sale of the combustion turbines in the same service area would incur no transmission costs.²⁷⁷

As such, the fact that GMO would have incurred costs to transmit energy from the surrogate Illinois plants, also located outside of SPP, to Missouri is irrelevant. As Staff points out:

Now GMO would have the Commission believe Crossroads is actually a bargain compared to the cost of transporting power in other parts of the country. GMO seems to suggest that if other parts of the country have higher transmission costs than the Crossroads transmission costs from Mississippi to west-central Missouri that somehow makes the Crossroads

²⁷⁶ GMO Exhibit 110, Crawford Direct, page 13.

²⁷⁷ "For AmerenUE there are no transmission costs for it to obtain power from Raccoon Creek and Goose Creek to serve its retail customers in Missouri since the power from those units is being used to serve native load customers [in the same RTO]." Staff Exhibit 272, Featherstone Rebuttal, page 38.

transmission costs reasonable and, therefore, they should be included in the revenue requirement for MPS. But GMO misses the point of the Commission decision in the last case. I don't believe the Commission was suggesting with its decision that it disallowed the Crossroads transmission costs because they are high to transport electricity out of Mississippi to Missouri. It is not that these costs are in Mississippi that makes them unreasonable. If Crossroads had been located elsewhere outside GMO's service area and the transmission costs for it were costly, those costs should be disallowed. . . . The fact of the matter is that no regulated utility located in Kansas City would build power plant facilities so far away from where customers needing the power are located – not in Mississippi, not in Illinois, now where the power has to travel extremely long distances resulting in substantial transmission costs.²⁷⁸

Clearly, the fact that transmission costs from the surrogate plants in Illinois to the Missouri ratepayers would have been higher is irrelevant. The relevant fact is that, given the diminished price of combustion turbines located in the same RTO as the customers, it is unreasonable to incur the costs to transmit energy from outside of SPP. This is the basis underlying the Commission's last order and should be reaffirmed.

5. Crossroads Transmission Costs are not Offset by Natural Gas Transportation Costs

As with the last argument, GMO attempts to cobble together an argument regarding natural gas costs designed to make the Crossroads transmission costs appear reasonable. Specifically, GMO falsely claims that the Crossroads natural gas costs are lower than similar facilities in Missouri. As such, GMO argues that it is reasonable to have a generating facility in Mississippi and, given the natural gas savings, incur the transmission costs. Again, GMO's argument is misplaced and contrary to the overwhelming weight of the evidence.

As Staff points out, GMO's argument that Gulf natural gas is cheaper than Midcontinent natural gas is contrary to historical prices.

²⁷⁸ Staff Exhibit 272, Featherstone Rebuttal, pages 37-38.

Historically, the Mississippi based Crossroads has experienced higher natural gas costs when compared to natural gas prices and costs in Kansas City, Missouri. GMO gets its natural gas in the area known as Midcontinent region of the United States – a location where natural gas prices tend to be lower than most of the other parts of the country and in the Gulf region, Mississippi in particular. The Midcontinent region includes portions of Texas, Oklahoma and Kansas. Historically, natural gas prices in the Midcontinent region have been significantly lower than at the Henry Hub area in Louisiana.²⁷⁹

In fact, the following table shows the natural gas price (\$\$ / MMBtu) with the relevant variable transportation rate for the GMO South Harper, Greenwood and Crossroads units.²⁸⁰

**

**

The best evidence, however, that natural gas costs in Mississippi are not sufficient to offset the accompanying transmission costs is found in the fact that KCPL and GMO have many natural gas units, but every other generating facility is located within the SPP footprint. More specifically, all twenty-one (21) natural gas generating units²⁸¹ are located within the KCPL and GMO service area.²⁸² According to GMO's logic, these other units should have been located in Mississippi to take advantage of the alleged low cost natural gas. Yet, KCPL and GMO never even studied a Mississippi location for these other natural gas facilities.

²⁷⁹ Staff Exhibit 293, Featherstone Surrebuttal, page 117.

²⁸⁰ *Id.* at page 119.

²⁸¹ Staff Exhibit 258, Staff Cost of Service Report, pages 70-71.

²⁸² Tr. 894-895.

6. Any Commission Allowance of Transmission Costs Would Reduce Fair Market Value of Crossroads to Zero

MECG believes that the Commission appropriately disallowed all transmission costs associated with bringing energy from a Mississippi facility (now physically located in MISO) to its Missouri customers (located in SPP). The evidence indicates that these costs are likely to double and were not prudently incurred given that all other KCPL and GMO generating facilities are located in SPP.

Nevertheless, if the Commission decides to allow any portion of the Crossroads transmission costs, it should be accompanied by a significant reduction in the valuation of Crossroads. As was previously recognized, the proxy sale valuation assumes that the generating facility is located within the same RTO as the customers. It is unquestioned that Ameren would have paid far less for those surrogate combustion turbines if it were required to transmit the energy from a different RTO.²⁸³

For AmerenUE there are no transmission costs for it to obtain power from Raccoon Creek and Goose Creek to serve its retail customers in Missouri since the power from those units is being used to serve native load customers. GMO incurs high costs to obtain power from Crossroads because it is well outside the Southwest Power Pool area within which GMO, and KCPL, is located. Therefore, if the Commission were to include any transmission costs for Crossroads in the revenue requirement for MPS and rely on the values that AmerenUE placed on Raccoon Creek and Goose Creek for valuing Crossroads, it should discount the \$61.8 valuation that it found in GMO's 2010 rate case because of the higher costs of transporting power from Crossroads to GMO's retail customers than AmerenUE's cost of transporting power from Raccoon Creek and Goose Creek to its retail customers.²⁸⁴

In fact, simple math indicates that if the Commission allows GMO to recover its transmission costs, the fair market value to GMO customers is **zero**. For instance, the

²⁸³ Interestingly, GMO asked Ameren to bid on Crossroads, but Ameren refused to even offer a bid. Staff Exhibit 395, Appendix Project Spark, pages 2, 5 and 7.

²⁸⁴ Staff Exhibit 272, Featherstone Rebuttal, pages 38-39.

present value of paying the **_____** current transmission costs for 19 years (assuming a 4.0% discount rate) would be exactly \$62.4 million. Therefore, the fair market value of Crossroads to GMO customers would be negative. In other words, if forced to pay these transmission costs for 19 years, Crossroads should have a negative rate base. If the transmission costs double as a result of Entergy moving to MISO, then the fair market value of Crossroads would be zero if ratepayers are required to pay these transmission costs for these transmission expenses for less than eight years. Of course, as transmission costs increase, the period of time will decrease.

This mathematical computation should not be surprising. As indicated previously, Aquila tried repeatedly to sell Crossroads. In 2005, immediately prior to their acquisition by Great Plains, Aquila hired Lehman Brothers to solicit offers for Crossroads and their other deregulated generating facilities. **_____

_____**²⁸⁵ Ultimately, not a single party presented a **_____**.²⁸⁶

F. CONCLUSION

As has been demonstrated, the Commission has been charged, by the Supreme Court and its own affiliate transaction rule, with determining the “fair market value” of the Crossroads Energy Center. In this regard, there are two readily available surrogates for Crossroads’ fair market value. ***First***, upon announcing the acquisition of Aquila, Great Plains Energy made a filing with the SEC in which they assert that the “fair value” estimate of Crossroads is \$51.6 million. ***Second***, there are real-life examples of sales of identical General Electric 7 EA combustion turbines by Aquila Merchant to third party

²⁸⁵ Staff Exhibit 395, Appendix Project Spark, at page 2.

²⁸⁶ *Id.*

purchasers. Those purchases indicate that the fair market value falls within a range of \$157.30 to \$205.88 / kW. Therefore, the fair market value of Crossroads is no more than \$61.7 million. If the Commission decides to reconsider its valuation methodology from the last case, MECG urges the Commission to adopt the \$51.6 admitted “fair market value” from the Great Plains / Aquila SEC filings.

In contrast, GMO requests that the Commission ignore all evidence of fair market value and use a net book value of \$91.3 million. In the final analysis, it is ludicrous to believe that Great Plains Energy actually paid this inflated costs for Crossroads when it purchased Aquila. Instead, given its stated belief that the “fair value” was only \$51.6 million, it is likely that Great Plains purchased Aquila using a Crossroads value of \$51.6 million.

Long and short, GMO’s requested net book value is in direct violation of the Commission’s affiliate transaction rule. Contrary to the stated purpose of that rule, GMO’s request will not provide “the public the assurance that their rates are not adversely impacted by the utilities’ nonregulated activities.” Given all the reasons stated herein, the Commission should set a value for Crossroads in 2008 of \$51.6 million.

In addition, consistent with the Commission’s finding from the last case, the Commission should continue to reflect the entire accumulated deferred tax balance as an offset to Crossroads rate base. As the Commission has previously recognized, accumulated deferred taxes is used as an offset to all other regulated units. Furthermore, this deferred balance is part and parcel of the Commission’s three-prong valuation of Crossroads. Finally, it is unquestioned that the accumulated deferred taxes were part of Great Plains due diligence when it purchased Aquila and those deferred taxes were

generated primarily because of the profits generated by the regulated operations and not because of the loss generating Aquila Merchant.

Finally, the Commission should recognize, as the many entities that were solicited for bids on Crossroads have already recognized, that Crossroads has no value if the purchaser is required to pay transmission costs to export energy from this congested area. Furthermore, given Crossroads is located in MISO, these costs are likely to double in order to bring energy from MISO to the service area in SPP. For this reason, the Commission should continue to protect ratepayers and disallow, as part of its valuation, the entirety of the Crossroads transmission costs.

In the final analysis, the Commission must admit that GMO, contrary to the case law set forth in Section III, has failed to meet its burden of proof for any of the valuations or costs pertaining to Crossroads. In contrast, as this brief demonstrates, there is an abundance of evidence supporting MEEG's position and the Commission's previous decision.

VIII. CONCLUSION

For all the reasons expressed in this brief, and based upon the substantial and competent evidence in the record, MECG recommends that the Commission adopt the following positions:

1. As set forth in Section IV, MECG urges the Commission to authorize a return on equity at the low end of Gorman's range of reasonable return on equity (9.10% - 9.50%). Specifically, MECG urges the Commission to award a return on equity of 9.10% to account for the unaffordability of GMO's rates and GMO's continued failure to control its escalating A&G costs. In the event that the Commission implements GMO's transmission tracker, MECG urges the Commission to make an explicit 10 basis point reduction in return on equity to account for the significant shift in risk caused by the implementation of the transmission tracker.

2. As set forth in Section V, MECG urges the Commission to reject GMO's equity heavy capital structure that existed as of the end of the true-up period. That equity rich capital structure provides no benefit to ratepayers and is solely designed to inflate GMO's revenue requirement. As the Commission has done in previous cases, MECG urges the Commission to implement a 50% common equity hypothetical capital structure.

3. Reject GMO's proposal to implement a transmission tracker. As demonstrated in Section VI, because it allows for the recovery of past losses through future rates, a transmission tracker violates the doctrine against retroactive ratemaking. Furthermore, tracker mechanisms result in a significant shift in the balancing of risk envisioned by the Missouri Supreme Court. Finally, GMO has failed to show that transmission costs meet the criteria set forth by the Commission for the implementation

of an adjustment / tracker mechanism. In the event, however, that the Commission implements a transmission tracker, MECG urges the Commission to make an explicit 10 basis point reduction in GMO's authorized return on equity to account for this shift in risk from shareholders to ratepayers.

4. MECG urges the Commission, consistent with Section VII, to maintain its valuation methodology from the last case including a \$61.8 million valuation, recognition of all accumulated deferred taxes and disallowance of all Crossroads transmission costs. In the event that the Commission reconsiders its previous decision, MECG urges the Commission to adopt the admitted fair market value of \$51.6 million as contained in the Great Plains / Aquila SEC filings from the time of the acquisition.

Furthermore, given the recognition of deferred taxes with all other facilities, MECG asserts that the Commission should continue to reflect the entirety of the accumulated deferred tax balance. This recognition further considers the fact that the accelerated depreciation deduction that forms the basis for the accumulated deferred tax balance was only possible because of the profits provided by the regulated customers.

Finally, the Commission should continue to disallow the transmission costs associated with transmitting energy from Crossroads (in MISO) to the customers (in SPP). These costs are escalating and should not be borne by customers.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing pleading by email, facsimile or First Class United States Mail to all parties by their attorneys of record as provided by the Secretary of the Commission.



David L. Woodsmall

Dated: November 28, 2012