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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES - AUDITING

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

KANSAS CITY POWER & LIGHT COMPANY

CASE NO. ER-2014-0370

Jefferson City, Missouri
May 2015

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Q. Please state your name and business address.

A. Charles R. Hyneman, Fletcher Daniels State Office Building, 615 East 13th Street, Kansas City, Missouri.

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

A. I am a Regulatory Auditor with the Missouri Public Service Commission ("Commission").

Q. Are you the same Charles Hyneman who filed certain sections of the Staff's Cost of Service Report in this rate case?

A. Yes, I am.

Q. Please explain the purpose of your rebuttal testimony.

A. The purpose of this testimony is to respond to the direct testimony of Kansas City Power & Light Company ("KCPL") witness Darrin Ives' discussion of regulatory lag.

OVERALL CONCERNS WITH KCPL WITNESS DARRIN IVES' DIRECT TESTIMONY

Q. What is your overall concern with Mr. Ives' direct testimony?

A. My overall concern is that Mr. Ives provides the Commission with an incomplete and narrowly-focused discussion of regulatory lag.

Q. Why is Mr. Ives' testimony incomplete and narrowly-focused?

A. Regulatory lag and its effects are not a simplistic ratemaking issue that can be adequately examined and discussed in a vacuum. Mr. Ives attempts to do precisely this in his direct testimony. Mr. Ives' incomplete and deficient analysis and review of regulatory lag and its impact on KCPL provides very little benefit to the Commission in its very important responsibility to set fair and reasonable utility rates in this case.

Q. What specifically causes you to conclude that Mr. Ives' testimony is deficient?

A. As an example, nowhere in his testimony does he specifically address the very significant beneficial effects of regulatory lag on KCPL and its shareholders. These beneficial effects of regulatory lag allowed KCPL's shareholders to enjoy past actual returns on equity (ROE) significantly higher than KCPL's actual cost of equity and significantly higher than the average ROEs awarded to U.S. electric utilities by regulatory commissions over a period of many years.

In addition, Mr. Ives does not address at all the very real and very serious side effects of trackers and other single-issue ratemaking mechanisms that can distort the inherent and natural workings of regulatory lag. Trackers and other single-issue ratemaking mechanisms can work as a strong disincentive to utility management to control costs, and use of these mechanisms is only appropriate in very limited circumstances.

Q. Are the negative effects of distorting the natural workings of regulatory lag, that is, the elimination of cost minimization incentives, just your opinion and the opinion of the Staff?

A. No. This negative effect of attempts to manipulate regulatory lag is well recognized in the utility industry and by highly recognized industry experts, whose published work I will address in this testimony.

Q. Please distinguish your rebuttal testimony on regulatory lag and single-issue ratemaking mechanisms, such as trackers, from Mr. Ives' direct testimony on these issues.

A. My rebuttal testimony provides the Commission with a more balanced, transparent, and helpful discussion of regulatory lag. This testimony describes both the benefits and detriments of regulatory lag and the circumstances when any adjustments to the natural workings of regulatory lag may be appropriate.

In stark contrast to the testimony of Mr. Ives, I explain why the current ROEs recently experienced by KCPL are not unreasonable and moreover, why these returns are reasonable given the performance of the economy and issues present in the electric utility industry in general, and for KCPL in particular, from 2008 through 2014. I explain why the "lower" ROEs experienced by KCPL from 2008 through 2014 were not "unreasonable" simply because they were <u>lower</u> than Commission-authorized ROEs, just as the "higher" ROE's earned by KCPL during the period 2000-2007, were not "unreasonable" simply because they were <u>higher</u> than the Commission-authorized ROEs.

Q. Please summarize your position and your testimony on regulatory lag.

A. In this testimony, I recommend the Commission find that regulatory lag is a necessary component of cost of service regulation. Regulatory lag is actually how cost of service regulation works and regulatory lag is one ingredient that makes cost of service regulation work effectively.

Attempts to manipulate regulatory lag with more than minor and short-term adjustments risks breaking down the very fundamental basis of rate regulation that has served the Missouri Commission well in its quest to ensure just and reasonable utility rates. It is through this type of rate regulation that the Commission has protected the interests of the utility's shareholders and ratepayers by doing its best to ensure that utility rates are just and reasonable.

Q. Do you have significant experience working with the issue of trackers and other single-issue ratemaking mechanisms?

A. Yes, I have been involved in numerous cases involving the issue of regulatory lag and mechanisms designed to address regulatory lag, such as accounting authority orders (AAOs), and both natural gas and water utility Infrastructure System Replacement Charge ("ISRS") cases I also testified before the Commission in KCPL Greater Missouri Operations' ("GMO") Fuel Adjustment Clause (FAC) Case EO-2011-0390.

Q. Have you previously filed expert witness testimony on the issue of regulatory lag?

A. Yes. The most recent testimony I filed on the issue of regulatory lag was rebuttal and surrebuttal testimony in KCPL's most recent rate case, Case No. ER-2012-0174.

REGULATORY LAG IS A POSITIVE ADVANTAGE TO REGULATION

Q. Please describe regulatory lag.

A. "Regulatory lag" has been defined as "the time between the incurrence of a cost or revenue by a utility and the reflection of that expense or revenue in rates". Another definition is provided by Alfred E. Kahn in his book *The Economics of Regulation: Principles and Institutions* as follows:

> The regulatory lag - the inevitable delay that regulation imposes in the downward adjustment of rate levels that produce excessive rates of return and in the upward adjustments ordinarily called for if profits are too low - is thus to be regarded not as a deplorable imperfection of regulation but as a positive advantage. Kahn, A.E., The Economics of Regulation: Principles and Institutions (New York: John Wiley & Sons, 1970, Chapter 2, p. 48).

Q. What did Dr. Kahn believe about the role of regulatory lag?

A. Unlike Mr. Ives who appears to consider regulatory lag as a "deplorable imperfection" of cost of service regulation, Dr. Kahn shares the same opinion of the Staff that regulatory lag is a "positive advantage" of regulation.

Dr. Kahn believes that the use of regulatory lag is a method by which a regulatory body encourages positive utility management behavior. In *The Economics of Regulation: Principles and Institutions (chapter 2, page 48)* he states that "freezing rates for the period of the lag imposes penalties for inefficiency, excessive conservatism, and wrong guesses, and offers rewards for their opposites: companies can for a time keep the higher profits they reap from a superior performance and have to suffer the losses from a poor one." The ability to reap higher profits referred to here by Mr. Kahn is exactly what KCPL did for many years in the past but more specifically for the period (2000-2007) immediately preceding the 2008 downturn in the US economy.

William Baumol, a respected professor at New York and Princeton University first explained the benefits of regulatory lag in the 60s.

> The idea of using "regulatory lag", the delay between rate cases, for incentive benefits came from Baumol (1968). He argued that the regulated firm would have incentive to control its costs while it was stuck with unchanging prices between rate cases, the fixed prices essentially serving as a stick. So he proposed a specific time period between rate cases, such as three years or five years, when prices would remain fixed. [Review of Network Economics Vol.2, Issue 4 – December 2003]

HOW REGULATORY LAG WORKS

Q. Why is regulatory lag a critical ingredient in cost of service rate regulation?

A. As noted by many experts in the field of economics, especially regulatory economics, regulatory lag is a necessary, if not critical component of utility cost of service regulation. In fact, regulatory lag is not only a critical component of cost-of-service regulation; it is the "cornerstone", the very foundation of cost-of-service regulation.

Regulatory lag creates the "quasi-competitive environment" for utilities, similar to the environment in which competitive firms operate. Without trackers and other single-issue ratemaking mechanisms to fall back on, utility managers have strong incentive to keep costs as low as possible once rates are set in a rate case.

This is the same incentive encountered by any manager of a business who strives to operate the business more efficiently and profitably. Just as competitive firms cannot raise prices of their goods and services at will, regulatory lag places this same constraint on utilities. Due to the existence of regulatory lag, utility managers must work under the constraint of a "fixed price" or "regulatory lag" for a period of time.

The existence of this "fixed price" incentive or "regulatory lag" incentive causes utility managers to work like managers of competitive businesses. Both utility managers working with regulatory lag and managers of competitive businesses working with fixed prices of its goods and services seek to find ways to operate the business more efficiently to counteract inevitable expense increases or potential revenue decreases during the period of time of the fixed price, or regulatory lag. This is exactly why regulatory lag is the critical ingredient in cost of service rate regulation and this is exactly what Professor Baumol was describing in his quoted comments.

Q. What happens when regulatory lag is reduced or eliminated through the use of expense trackers or other single-issue ratemaking mechanism?

A. When the use of trackers and other single-issue ratemaking mechanisms eliminate the “quasi-competitive” forces of regulatory lag, utility managers are no longer under the pressure to act as efficiently and to keep expenses as low as possible. Expenses are now tracked and recovery is almost guaranteed. This lack of regulatory lag's quasi-competitive pressure results first in utility manager inefficiencies and gradually leads to imprudent utility management behavior.

Q. Would you characterize this removal of cost minimization incentives to be the most disturbing aspect of expense trackers and other single-issue ratemaking mechanisms?

A. Yes. The main detriment of the use of expense trackers is manipulation of the normal process of cost of service regulation and elimination of utility managers' incentives to minimize cost of service.

Q. Please continue.

A. There is no question that utility senior management's first obligation is to its shareholders. The Board of Directors operating as agents of the utility's shareholders solely control a utility executive's employment, compensation and benefits. Reducing the cost of providing utility service in a period between rate cases results in higher profits to the shareholders and utility management will strive to achieve increases in profit in this circumstance. Reducing an expense that has an almost guarantee of reimbursement through a tracker mechanism does not increase profits. Shareholder indifference at the level of this expense means that management will likely focus its attentions to revenues and expenses that are not under a special ratemaking mechanism such as a tracker or a fuel adjustment clause.

REGULATORY LAG MUST BE TREATED IN A BALANCED SYMMETRICAL MANNER

Q. Does regulatory lag affect utilities in a symmetrical or balanced manner when allowed to work as designed?

A. Yes. When allowed to work as designed, regulatory lag provides benefits to shareholders through higher ROEs in good economic times and benefits ratepayers through slower rate increases in bad economic times. The unbiased ups and downs of the economic cycle primarily determined who will benefit from regulatory lag and for how long the benefits will be enjoyed. This process is symmetrical, balanced and unbiased. Only through the implementation of artificial and biased adjustment mechanisms, such as expense trackers, do benefits of regulatory lag become asymmetrical and unbalanced, and in my view, unfair and unreasonable.

Q. Why is the inherent symmetry and inherent unbiased nature of regulatory lag such an important component of regulatory lag in a utility rate-setting environment?

A. The hallmark of utility rate setting is that it is fair and unbiased and there are no predetermined winners and losers. And it is the role of the Commission, through its efforts to create and maintain a "pseudo-competitive" environment for the utilities under its jurisdiction, that helps assure the utility rates it sets are fair and reasonable to all parties and that they are biased toward no party.

Rates that are fair and reasonable are also symmetrical and balanced because all parties have an equal chance of benefitting or experiencing detriments from changes in economic conditions, just as competitive markets and their customers in times of changing economic conditions.

This symmetry and unbiased nature represents the inherent equity or fairness embedded in regulatory lag. It is the symmetry, the ability to respond to economic factors in an unbiased manner, not showing favor to any party, that is exactly what needs to be protected about regulatory lag. This inherent equity, the ability to operate without bias, is so embedded in regulatory lag that it is inextricable, that is, not able to be separated without causing distorted outcomes.

Q. Is this inherent equity, embedded in regulatory lag, mentioned anywhere in Mr. Ives's testimony to this Commission?

A. No, it is not in his testimony. Mr. Ives only presents the Commission with his views that regulatory lag is a "bad thing" because of KCPL's reduced profits during this period when the economy is performing poorly.

Q. Do you agree that KCPL's reported ROEs may be affected in some manner by the impact of current economic conditions?

A. Yes, utilities like KCPL do experience some short-term negative consequences of regulatory lag when expenses grow faster than normal and revenues or other technological advances are not, at that time, sufficient to compensate for these changes.

However, utilities like KCPL are protected to the extent that they control the effect of regulatory lag, and most importantly, this effect of regulatory lag is limited. While it may be time consuming and require the incurrence of additional costs, utilities have total control over when they file for rate increases to offset any negative effects of regulatory lag.

On the other side of the regulatory lag equation, ratepayers have no such defense and are completely powerless to mitigate when regulatory lag works to the utilities' advantage with higher than authorized ROEs such as experienced by KCPL over past periods, including the eight-year period of 2000-2007.

Q. Turning to KCPL's argument that regulatory lag lowered their ROEs; did you complete an analysis of KCPL's actually achieved ROEs over the past several years?

A. Yes, I did. Using data publicly available in KCPL's Form 10-K, filed with the Securities and Exchange Commission ("SEC") each year, I calculated KCPL's annual ROE. My calculation used KCPL's reported net income available for common stockholders as the numerator and KCPL's beginning common stock equity as the denominator.

Q. What was the result of your analysis?

A. The result is presented below.

Year	KCPL ROE Per SEC Form 10-K
1993	12.0%
1994	11.7%
1995	13.6%
1996	11.6%
1997	8.0%
1998	13.3%
1999	8.8%
2000	18.2%
2001	12.9%
2002	12.9%
2003	15.7%
2004	17.0%
2005	12.9%
2006	13.0%
2007	11.3%
2008	8.5%
2009	7.9%
2010	8.4%
2011	6.8%
2012	6.9%
2013	8.1%
2014	7.5%

Q. Do you believe that KCPL's earnings during the period 1993-2014 are reasonable?

A. Yes, I do.

Q. Did you also complete an analysis that compared KCPL's actually achieved ROEs over the past 22 years with the average ROE authorized by state regulatory commission in the United States over this same period?

A. Yes, I did. From the October 10, 2014 *Regulatory Focus* published by Regulatory Research Associates ("RRA"), I obtained the average ROE authorized electric utilities for the period 1993 through the 3rd quarter of 2014. I then compared these RRA ROEs with the actual earned ROEs reported by KCPL to the SEC in its Form 10-K. The result of this comparison is shown below:

Year	KCPL ROE Form 10-K	RRA - Electric Utility Authorized ROE
1993	12.0%	11.4%
1994	11.7%	11.3%
1995	13.6%	11.6%
1996	11.6%	11.4%
1997	8.0%	11.4%
1998	13.3%	11.7%
1999	8.8%	10.8%
2000	18.2%	11.4%
2001	12.9%	11.1%
2002	12.9%	11.2%
2003	15.7%	11.0%
2004	17.0%	10.8%
2005	12.9%	10.5%
2006	13.0%	10.4%
2007	11.3%	10.4%
2008	8.5%	10.5%
2009	7.9%	10.5%
2010	8.4%	10.3%
2011	6.8%	10.3%
2012	6.9%	10.2%
2013	8.1%	10.0%
2014	7.5%	10.0%
Avg	11.2%	10.8%

Q. Do you believe that regulatory lag may have contributed to KCPL's earnings over the 15-year period (1993-2007) exceeding the average ROE authorized electric utilities in the United States in all except two years?

A. Yes. During this period, regulatory lag worked without manipulation and contributed to KCPL enjoying high levels of shareholder profit.

Q. Does KCPL consider its ROE's during this period to be reasonable?

A. Yes, I believe it does. I would note that KCPL made no regulatory filings to the Commission to lower the price it charged its customers during this period of high ROEs, and during the period 1993 through 2007, KCPL did not propose any tracker or other single issue ratemaking mechanism that would serve to protect its customers from its very high earnings levels during this period. If KCPL felt its earnings were unreasonable during this time period, I believe it had a responsibility to its customers to seek an adjustment to any rates that it considered unreasonable. Since I also do not believe that KCPL's high profit levels were unreasonable, I do not think that KCPL should have sought any adjustment to its rates during this period.

Q. Were there any regulatory lag mitigation measures put into place to protect KCPL’s ratepayers from excessive negative regulatory lag from a ratepayer's perspective?

A. No, there were none. KCPL witness Ives recognized regulatory lag has always existed in the Missouri regulatory framework. The difference now is that when the business environment in which KCPL operates no longer produces positive regulatory lag (from the shareholder perspective) and excess earnings, KCPL calls for strong and drastic regulatory lag mitigation measures which, if not carefully controlled and if allowed to remain in place for the long term, have a very high probability of significantly skewing the proved and prudent

Missouri regulatory framework. As reflected in response to Staff Data Request No. 485 in Case No. ER-2012-0174, KCPL's last rate case, Mr. Ives states:

> There has always been regulatory lag inherent in the Missouri regulatory framework. In the past, however, the impact of regulatory lag for the recovery of eligible costs was offset by the increase of revenues resulting from customer growth. For the past several years, there has been minimal customer growth in the company's Missouri service territory. Additionally, certain costs have been increasing more dramatically than in prior periods, reflecting the changing regulations under which the Company must operate.

This is why I believe it is important to view all current utility regulatory lag mitigation measures with a keen awareness and understanding of the past. With this perspective of the past one notes that regulatory lag is a naturally occurring phenomenon, it is affected by changes in economic conditions and it benefits, at differing times depending on the current economic and market conditions, both shareholders and ratepayers. Any attempt to adjust the symmetrical nature of regulatory lag should be done very carefully and on a very limited and short-term basis so as not to significantly alter the inherent fairness and balance in naturally occurring regulatory lag.

Q. How did the Staff and Commission address the positive benefits of regulatory lag experienced by KCPL's shareholders in the past?

A. The Staff and the Commission allowed KCPL to enjoy the benefits of regulatory lag during this period. Neither the Staff nor the Commission sought to implement any ratemaking mechanism to prevent KCPL from enjoying 100 percent of the benefits of regulatory lag. The Staff of the Commission did, on occasion seek to reduce KCPLs base rates. Pursuant to various stipulations and agreements with the Commission, KCPL reduced Missouri retail rates at least four times as noted below. None of these four rate decreases exceeded $15 million annually, and none were significant compared to the rate increases that KCPL has sought and obtained since 2006.

KCPL MO Percentage Rate Decrease	Effective Date
2.67	January 1994
2.00	July 1996
2.5	January 1997
3.2	March 1999

Q. Was the Staff's periodic review and proposed rate decreases an appropriate response to long-term and consistent regulatory lag?

A. Yes. Rate filings by KCPL and Earnings Complaint Cases by the Staff are the appropriate means of adjustment regulatory lag when it is significant and in place for an extended period of time.

Q. While KCPL did not ask the Commission to approve any single-issue ratemaking mechanisms or any rate reduction adjustments during the period 1993-2005, are you aware of any party to KCPL's rate proceedings seeking any type of single-issue ratemaking mechanism or alternative regulation mechanism to protect KCPL's ratepayers during this good economic period?

A. No. The only changes with KCPL rates that occurred during this period, that I am aware of, is small and periodic rate decreases. It was my experience, participating as an auditor in at least some of Staff's review of KCPL's earnings during this period, that KCPL, at best, begrudgingly accepted relatively minor rate decreases. These small rate decreases, much smaller than the excess earnings actually calculate by the Staff, were the result of

Stipulations and Agreements to KCPL Earnings Review cases initiated by the Staff and possibly other parties.

Q. Please elaborate on the reasons that you conclude that KCPL's earnings during the above periods, 1993-2014, are reasonable?

A. Over the period 2000 through 2007, KCPL's earnings exceeded the average authorized RRA ROEs by an average of 339 basis points (bps). This 339 bps average includes 670 bps in 2000 when KCPL earned a ROE of 18.2%, 475 bps in 2003 when KCPL earned an ROE of 15.7% and 620 bps in 2004 when KCPL earned a ROE of 17%.

In contract, a review of the current period, 2008 through 2014, shows that KCPL's earnings were less than the average authorized ROEs by a significantly lower average of only 253 bps. During this period, the highest negative deviation from the average authorized ROE was in 2011 when KCPL earned 350 bps less than the averaged authorized ROE for electric utilities.

Q. Please summarize your conclusions on the reasonableness of KCPL's earnings over the period 1993-2014.

A. My simple mathematical analysis shows that if the ROE's experienced by KCPL in 2000-2007 were reasonable, there is a strong logical and reasonable basis for concluding that the ROE's earned by KCPL, in the period 2008-2014, were also reasonable.

As I explained above, regulatory lag is a critical part of cost-of-service rate regulation. To work effectively it has to be symmetrical, having a balanced impact of both the utility company's investors and the utility company's customers. The use of ratemaking mechanisms by one party to modify only the part of regulatory lag they do not like is inherently unfair to other parties affected by changes in utility rates. This principle of ratemaking equity applies to everyone.

If the Office of the Public Counsel ("OPC") or the Staff attempted to impose regulatory lag adjustment mechanisms that work to the benefit of consumers in very good economic times, it would be equally unfair as the regulatory lag adjustment mechanisms proposed by Mr. Ives and KCPL in this rate case.

Q. Turning now to KCPL’s focus on their lower than authorized ROE, does Mr. Ives address some of the factors that he believes are affecting KCPL's past earnings levels and ROE in his direct testimony?

A. Yes.

Q. What are some of additional factors that may have impacted and may still currently be impacting KCPL's achieved ROE since 2008?

A. Several factors working together impacted KCPL's ROE over the last several years. KCPL's ROE in 2006 was 13%, in 2007 it was 11.3%, and in 2008 it dropped to 8.5%. In my view, three significant events occurred starting around the 2008 time frame that likely significantly impacted the ability of KCPL's management to focus on KCPL's regulated operations and ultimately on KCPL's earnings.

The three factors were: 1) the acquisition and integration of the Missouri electric properties of Aquila, Inc., now referred to as KCPL-Greater Missouri Operations, or GMO, 2) the start of KCPL's major construction program, which covered the period 2009 through 2014; and 3) the downturn in the economy which began in 2008.

Q. Do you have direct and significant knowledge of the events that you listed above?

A. Yes. I have been significantly involved in each of KCPL's five rate cases since 2006. These rate cases were Nos. ER-2006-0314, ER-2007-0291, ER-2009-0089, ER-2010-0355 and ER-2012-0174. I addressed issues in KCPL rate cases related to the acquisition and integration of GMO into KCPL's operations. In addition, I have participated in construction audits of KCPL's major construction projects in the period 2009 through 2014.

Q. How did the acquisition and integration of GMO likely affect KCPL's earnings?

A. In 2007 and 2008, KCPL's management narrowly focused on acquiring GMO and developing plans for integrating GMO into KCPL. In 2009 and 2010, KCPL's management focused greatly on the integration of GMO into KCPL. It is likely that the significantly high cost of acquiring and integrating GMO contributed to KCPL's achieved ROEs. During this time period, the acquisition and integration of GMO significantly distracted KCPL management from its normal focus on running KCPL's operations more efficiently and its normal focus on cost control and cost reductions.

Q. Did KCPL's major construction programs during the period 2009 through 2014 with its completion of the La Cygne environmental modifications likely have a significant impact on KCPL's earnings and cash flow during this period?

A. Yes. Mr. Ives makes this point at page 5, lines 7 through 13, and page 16 lines 12 through 21 of his direct testimony. In 2009 and 2010, KCPL completed the significant environmental modifications of its Iatan 1 coal unit and completed construction of the new multi-billion dollar Iatan 2 coal unit.

Q. Similar to the acquisition and integration of GMO in 2008 and 2009, was it also likely that the demands on KCPL's management associated with its major construction program in 2009 through 2014 caused a significant distraction from the normal focus on running KCPL's operations more efficiently and cost control?

A. Yes, clearly the acquisition and integration of GMO and the major Construction program was a significant KCPL management focus during this time. The more time that KCPL management focused on these issues, the less time it focused on running KCPL's operations more efficiently and concentrate on cost control measures.

Q. Please comment on the likely impact of the 2008 down turn in the economy on KCPL's operations.

A. The U.S. economy essentially crashed in 2008. While the consensus of the economists is that the economy has shown signs of improvement, most economists agree that the economy has not yet fully recovered.

The Commission recognized the worsening economic conditions in Missouri in its January 9, 2013, Report and Order in Case No. ER-2012-0174, KCPL's last rate case. The Commission, at page 14, included the following statements in its Findings of Fact:

> 1. Missouri's economy suffered more and is recovering more slowly than the rest of the nation's economy.
>
> 2. Adjusted for inflation ("read GDP"), in 2011, the nation grew by 1.5% and Missouri grew by 0.04%.
>
> 3. Between 2007 and 2011 KCPL's customers average weekly wages increased 11.45% while the dollar amount KCPL charges its customers for electric service increased 43.8%.

Q. Do these three factors that affected KCPL's achieved ROE in 2008 through 2014 still have the same impact on KCPL's earnings in 2015 and going forward?

A. No. All three factors discussed above that have potentially negatively impacted KCPL's achieved ROE have been eliminated or significantly improved.

GMO has no employees and, therefore, KCPL employees still run GMO's operations and KCPL's management still controls GMO's operations. However, KCPL completed its integration of GMO and GMO is in its seventh year of operating as a separate utility. While operating a separate utility with no employees may still distract KCPL's management from focusing on KCPL's operations and KCPL's cost of service, this distraction should be significantly less than it was during the 2007-2009 timeframe.

KCPL's major construction program ended in 2014 with the completion of the environmental modifications of KCPL's La Cygne Generation Station. Mr. Terry Bassham, Chairman of the Board, President and Chief Executive Officer, Great Plains Energy and KCPL also stated that

> *After several years of large complicated construction projects, our generation fleet is positioned to produce low-cost reliable power to our customers while meeting the demands of the EPA and other regulatory requirements. This positioning of the generation fleet and completion of our current rate cases also allow for increase cash flow available for ongoing investment and dividend growth.* (Great Plains Energy's February 26, 2015 "4Q / Year-End 2014 Earnings Call")

As a result of KCPL's completing its 2009-2014 Construction Programs, any regulatory lag associated with this program will be significantly reduced or eliminated when rates from this case are effective in 2015 and the cost of the La Cygne project is in KCPL's rate base.

While not at pre-2008 levels, KCPL recently realized improved economic conditions in its service territory. These improved economic conditions, including customer growth, should lessen the impact of KCPL's regulatory lag on a going-forward basis. The following improvements in the economic conditions and customer growth in KCPL's service territory was noted by Mr. Jim Shay in Great Plains Energy's February 26, 2015 "4Q / Year-End 2014 Earnings Call." Mr. Shay, Senior Vice President - Finance, and Chief Financial Officer, Great Plains Energy and KCPL, made the following points about the recent economic activity in KCPLs' service area in this Earnings Call:

> *Driven by our industrial segment, actual demand in 2014 was up 0.4%.
>
> *The industrial segment increased 2.3% in 2014
>
> *The residential segment was up 0.2% and the commercial segment was flat for the year.
>
> *During 2014 we experienced an increase in the number of customers in both residential and commercial segments. However, the use per customer declined, partially due to the impact of our energy efficiency programs for which we recover a throughput disincentive.
>
> *The housing recovery in the region remains strong with single and multi-family permits up approximately 17% compared to 2013 and are at their highest levels since 2006.
>
> *Through December the region's unemployment rate was 5% compared to the national rate of 5.4%.

Q. Do you agree that it is important for the Commission to seek a level of balance and fairness both to utility ratepayers and shareholders when it addresses the issues of regulatory lag in a utility rate case?

A. Yes. To achieve this level of balance and fairness, I believe it is important to approach the regulatory lag issues raised by utilities today from a historical perspective.

One of the characteristics of regulatory lag is that it tends to be sensitive to various economic factors facing utilities, including the overall health of the economy. During previous time periods when certain economic factors were in place, regulatory lag resulted in financial benefits to shareholders. In other periods, such as the current period with the current economy, regulatory lag has not worked to the benefit of utility shareholders.

As an illustration, after its Wolf Creek rate cases in the mid-1980s, KCPL's earnings were so good that, for a period of approximately 20 years, it did not file a rate increase case with the Commission. In fact, during this period, KCPL's earnings were so strong that it even agreed periodically to reduce its rates, although by a relatively small amount.

It is quite safe to say that due to the positive regulatory lag (positive to KCPL shareholders) from a declining rate base, customer growth, strong off-system sales and possibly other factors, KCPL earned at or above its authorized return on equity for this 20-year period. KCPL did not only have an "opportunity" to earn its authorized ROE during this period, the evidence indicates that it was almost a "guarantee" that, due primarily to the prevailing economic conditions, it would earn at or above its authorized ROE for this 20-year period.

RATE OF RETURN AND REGULATORY LAG

Q. Please describe how regulatory lag is supposed to work in rate of return regulation.

A. In an actual utility operating environment, revenues, expenses and rate base are constantly changing. In a rate case, a specific test year is selected to develop a utility's revenue requirement based on the most current investments in plant and other shareholder investments in the utility, and a normalized level of revenues and expenses.

Matching the rate base with normalized revenues and expenses creates a revenue requirement that produces a revenue level that allows for the recovery of all of the utility's prudently incurred expenses, and also provides it an opportunity to earn a reasonable rate of return on the investment in its regulated rate base. Once the Commission orders the revenue requirement and rates are set, a long list of variables come into play that affect a utility's ability to earn at the authorized level established by the Commission.

Q. What are examples of these variables?

A. One example is when a utility is not currently engaged in a large amount of construction or adding a large amount of new plant additions to its rate base. During this period, due to the rate recovery of its plant investment through depreciation expense and the resulting increases in depreciation reserve offset to rate base, shareholder investment in regulated rate base is constantly declining. However, while the utility's actual rate base is smaller, the overall rate of return is based on the large rate base that was fixed in rates in the previous rate case, resulting in a larger than required financial return to the utility.

This larger-than-required financial return paid by a utility's ratepayers is the result of regulatory lag. This regulatory lag, resulting from a declining rate base, results in the utility's investors recovering more of a financial return on the rate base in utility rates than was determined reasonable and set in rates in the previous rate case.

Q. May KCPL soon be in a position to enjoy the shareholder-positive regulatory lag benefits from a declining rate?

A. Yes. In 2010, KCPL completed its regulatory plan for the construction of major utility projects, including the Iatan 2 coal plant new construction. Supported by Staff and other parties, the Commission authorized KCPL to use of extraordinary ratemaking mechanisms and single-issue ratemaking trackers to help with the financial and cash flow implications of such a large construction program. While the project was not part of its regulatory plan, KCPL expects to complete environmental upgrade additions at the La Cygne Generation Station within the next month. After this project is completed, the amount of KCPL's construction expenditures is projected to decrease significantly.

Q. Has KCPL announced publicly that its major construction program will soon be complete and it will be in a positive cash flow positon in 2016?

A. Yes. KCPL's Chief Financial Officer made that statement in KCPL's Year-End and Fourth Quarter 2014 Earnings Presentation held on February 26, 2015.

Q. In addition to a declining rate base, what other factors may result in a positive regulatory lag for KCPL?

A. Increases in efficiency and advances in technology can result in significant cost reductions as well as positive regulatory lag that can offset negative regulatory lag associated with increases in fuel or other expenses.

Q. How does KCPL take advantage of efficiency gains?

A. KCPL describes this process in previous Form 10-Qs, Quarterly Reports and Form 10-Ks, Annual Report to the SEC:

> The Company continues to place increased emphasis on new technologies, improved methods and cost control. Processes are being changed to provide increased efficiencies and improved operations. Through the use of cellular technology, a majority of customer meters will be read automatically by the end of 1996. These types of changes have allowed the Company to assimilate work performed by those who elected to participate in the early retirement program.

> The electric utility industry is undergoing fundamental changes in response to increasing competition. To achieve its desired market position in this changing environment, the Company is continually modifying its business processes to operate more efficiently and cost effectively, and is developing energy related businesses through its subsidiary, KLT Inc.

SINGLE ISSUE RATEMAKING

Q. What is single issue ratemaking?

A. As with regulatory lag, there are various definitions. The best definition of "single issue ratemaking" defines it as a process that involves “singling out” certain expenses, or revenue requirement components, from a company's cost of service and allowing a utility to separately recover those costs from ratepayers. In Missouri, the primary ways for recovery of expenses under single issue ratemaking are customer surcharges, expense trackers and AAOs.

The Missouri Court of Appeals Western District described how single issue ratemaking is generally prohibited in Missouri due to its inherent potential for inequitable ratemaking actions by the Commission. In a 2013 opinion, the Missouri Court of Appeals Western District explained how single issue ratemaking is generally prohibited in Missouri due to its inherent potential for inequitable ratemaking actions by the Commission, and ratemaking should involve determinations based on all factors, especially considering that increased costs in one area can be balanced by realized savings in another. See attached Schedule CRH-R1.

Q. Does the utility industry consider trackers to be single-issue ratemaking?

A. I am aware that at least one of the largest electric utilities in the United States understands that trackers are single-issue ratemaking mechanisms. One of the largest electric utilities in the country, serving over five million customers in 11 states, American Electric Power (AEP) refers to trackers as single-issue ratemaking on its website. AEP also acknowledges that utilities and ratepayers can benefit from efficiencies, which is not encouraged with trackers, and that many commissions feel that single issue ratemaking diminishes their authority and limits transparency. AEP is a business partner of Great Plains Energy, KCPL's parent company.

Q. Does AEP describe its position on trackers on its website?

A. Yes. On its website AEP describes its position on trackers as follows, "AEP has been a supporter of trackers in situations where immediate cash flow is an issue. However, we also are cognizant of the issues associated with single-issue ratemaking tools."[1]

This recognition of the "issues", encompassing the negative, associated with trackers is refreshing coming from a regulated electric utility. I note that Mr. Ives presents no recognition of potential negative issues associated with the many trackers he requests the Commission adopt for KCPL.

Q. Does the language that AEP uses to describe its use of trackers seem reasonable to you?

A. Yes, it does. The use of trackers to address a short-term and immediate cash flow problem can be an appropriate use of trackers.

Q. What are concerns about single issue ratemaking mechanisms like trackers and surcharges?

A. Mr. Ralph C. Smith, a highly-experienced regulatory consultant and CPA with Larkin & Associates, PLC, presented an excellent summary of the current problems with trackers and other single-issue ratemaking mechanisms. Mr. Smith presented the "Increasing Use of Surcharges on Consumer Utility Bills" at The National Energy and Utility Affordability Coalition (NEUAC) 2012 Conference. This presentation is attached as Schedule CRH – R2 to this testimony. His presentation boils down to 8 main points.

> 1. In the past, surcharges were only permitted in limited circumstances for costs that were substantial, volatile and uncontrollable, and that could harm the utilities' financial health if not addressed outside of a general rate case base rate proceeding.

[1] https://www.aep.com/about/IssuesAndPositions/Financial/Regulatory/AlternativeRegulation/Trackers.aspx.

> 2. In recent years, however, requests for surcharges and tracking mechanisms by utilities have significantly increased, for many different types of costs, including capital investments, for specific operating and maintenance expenses and even for revenue losses.
>
> 3. The excessive use of special ratemaking mechanisms such as surcharges and other tracking mechanisms can proliferate to the point of becoming difficult and burdensome for regulators to monitor.
>
> 4. The use of surcharges can reduce utility incentives to control costs.
>
> 5. Whenever new or expanded utility surcharges are proposed, care must be taken to protect ratepayers.
>
> 6. Surcharges are a violation of the matching principle, a fundamental accounting and ratemaking principle
>
> 7. Review of surcharges is typically more limited
>
> 8. Utility may over-collect costs recovered through surcharges or over-earn during periods when surcharges are in effect.

Q. What is NEUAC and is KCPL a member?

A. NEUAC describes itself as a "broad-based coalition of diverse organizations dedicated to heightening awareness of the energy needs of low income energy consumers, fostering public-private partnerships and engaging in other activities to address these needs." KCPL is on NEUAC's Governing Board of Directors, represented by Lori Shaffer, senior manager of KCPL Customer and Community Affairs. KCPL was one of NEUAC's 2014 conference leaders contributing in the range of $10,000 to $25,000 dollars to this event.

JUST AND REASONABLE STANDARD

Q. Does the Commission have a "Just and Reasonable" standard as it relates to utility rates set in a rate proceeding?

A. Yes. The January 9, 2013, Report and Order in Case No. ER-2012-0174, the Commission, at page 11, described its standard for just and reasonable rates. The

Commission stated that "balancing the interests of the investor and consumer is not reducible to a single formula and making pragmatic adjustments is part of the Commission's duty." The Commission also stated that "the Commission is charged with approving rate schedules that are "just and reasonable" to consumers as they are to the utility."

Q. Given this standard that the Commission places on itself, in making decisions concerning the trackers proposed by Mr. Ives in this case, what specifically should the Commission consider?

A. It is important for the Commission to take a long-term and comprehensive view as opposed to a short-term and narrow view of regulatory lag and the measures proposed to eliminate only one side of regulatory lag. Among other considerations, the Commission should address the following question: Is it fair to consumers to impose single-issue ratemaking mechanisms designed to eliminate one type of regulatory lag during a time period of lower profits when neither the Commission nor any other party proposed the imposition of any ratemaking mechanisms to eliminate regulatory lag during periods of higher profits?

Q. Please summarize your testimony on regulatory lag.

A. In a 2009 rate case hearing in Case No. ER-2010-0036, Chief Staff Counsel Kevin Thompson informed the Commission: “regulatory lag is a normal and inevitable part of utility regulation. You know that regulatory lag cuts both ways, sometimes to the benefit of the customer and sometimes to the benefit of the utility.” (Tr. 214-215) While I agree with Mr. Thompson, I would go one step further and state that regulatory lag is not only inevitable, but necessary as it plays a vital role in making rate of return regulation work fairly and equitably, with inherent incentives for the utility to operate at reasonable levels of productivity and cost effectiveness.

The Staff has in the past and will likely continue to support some specific, targeted and short-term measures to mitigate the impact of regulatory lag, such as supporting the use of AAOs when necessary and the use of expense trackers in certain limited and special circumstances. But the Staff believes these measures deserve greater scrutiny today and in the future by both the Staff and the Commission. As noted by Mr. Ralph Smith in his presentation attached as Schedule CRH – R2 to this testimony, trackers, surcharges and other single-issue ratemaking mechanisms are increasing significantly. I understand, given the recent downturn in economic activity, the reasons for the current onslaught of requests for trackers and other single-issue ratemaking mechanisms, but that does not take away the need for regulatory Commission Staff, regulated utilities and regulatory Commissions to understand the importance of regulatory lag as the foundation to ratemaking and be extremely cautious when recommending, proposing and implementing single-issue ratemaking mechanisms that distort the ratemaking process and are detrimental to the captive regulated utility customers. When traditional companies operating in a competitive environment raise their prices as a direct result of an economic downturn or raising costs, customers have the option to change company or do without the good or service altogether. No such freedom of choice exists for electricity customers.

Q. What conclusion should the Commission reach?

A. The Commission should reach the conclusion about regulatory lag is that it only works when it is treated in a symmetrical and balanced manner. The Commission should also conclude that any attempt to manipulate regulatory lag, other than for a very short-term and in a narrowly-focused manner, has a high likelihood of being unfair and therefore unreasonable to the party that is negatively affected, whether it be the utility's customers or the utility's shareholders.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service))))	Case No. ER-2014-0370

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Charles R. Hyneman, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 29 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Ch R. Hyn

Charles R. Hyneman

Subscribed and sworn to before me this 7th day of May, 2015.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public