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-2012-0174

INITIAL POSTHEARING BRIEF OF

MIDWEST ENERGY CONSUMERS' GROUP

(KCPL ISSUES)

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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. Specifically, the Commission is asked to decide the following issues: (1) return on common equity; (2) capital structure; (3) cost of debt; (4) transmission tracker; and (5) resource planning – LaCygne and Montrose. In addition, while a non-unanimous stipulation was filed regarding class cost of service / rate design, because that stipulation was opposed, the Commission must also decide those issues.

While MECG is concerned with the issues of cost of debt and resource planning, as a result of time available for briefing and limited resources, MECG has chosen not to brief those issues and instead support the position advanced by Staff on cost of debt and OPC on resource planning. Therefore, this brief will address return on common equity, capital structure, transmission tracker and class cost of service / rate design.

I. INTRODUCTION

For the past six years, since the implementation of the KCPL Regulatory Plan, the Commission's primary focus has been on KCPL and providing KCPL the regulatory support necessary to build Iatan 2 and complete the remainder of its Comprehensive Energy Plan. Time and time again, the Commission demonstrated an unwavering support for KCPL's efforts. This support was reflected in: (1) the Commission's authorization of the highest return on equity in the nation; (2) the reduced expectations of KCPL's performance in the wholesale market and (3) the inclusion of over $180 million of regulatory amortizations in rates.

The support for KCPL extended beyond rate cases. Instead of requiring KCPL to maintain focus on the construction of Iatan 2 (which ultimately exceeded budget by over 25%), the Commission allowed KCPL to divert its attention and engage in a merger with Aquila. Through this merger, KCPL promised seemingly unlimited merger synergies that would lead to reduced retail rates. Nevertheless, given the level of KCPL's current rates, it is apparent that those merger synergies never actually came to fruition.

Long and short, the Commission made each of these concessions to KCPL over the customers' vehement opposition. The impact of these concessions has been a rapid increase in rates that have caused KCPL's rates to pass the point of being affordable. Now, Iatan 2 has been completed, but the rate cases have not slowed. Having become accustomed to the Commission's regulatory concessions, KCPL entered this case with a laundry list of new items to improve its bottom line financial performance. Each of these concessions was proposed by KCPL without any regard for the customers or the affordability of its rates.

Recently, however, the Commission appears to be taking notice of the problem with KCPL's rates. After 5 rate cases in 6 years and increasing customer hostility, the Commission sought to limit the number of rate cases. During the course of this case, the Commission issued an order asking the parties to address a proposed rate stabilization plan. Under the proposed plan, the Commission would grant an inflated return on equity "in exchange for the utility not filing any changes to rates for a period of years."[1] The Commission's plan, however, was not properly focused. Instead of focusing simply on the stabilization of rates, the Commission's concern should be on the stabilization of ***affordable*** rates. In this regard, the Commission's proposal is counter-intuitive in that it would, through the inflated return on equity, lead to rates that, while more stable, are also more unaffordable. While the Commission subsequently withdrew its order asking the parties to address its misguided rate stabilization plan, there is still an opportunity for the Commission to demonstrate a renewed focus on customers and ***affordable*** rates.

Evidence in this case not only demonstrates that KCPL's are unaffordable, it also pinpoints one of the primary reasons for the affordability of KCPL's rates – the continued inability of KCPL to control its administrative and general ("A&G") costs.

A. AFFORDABILITY

Since 2006 and the commencement of its Regulatory Plan, KCPL rates have skyrocketed. Specifically, since that date, the Commission has authorized the following rate increases.

ER-2006-0314 (effective January 1, 2007): 10.46% increase

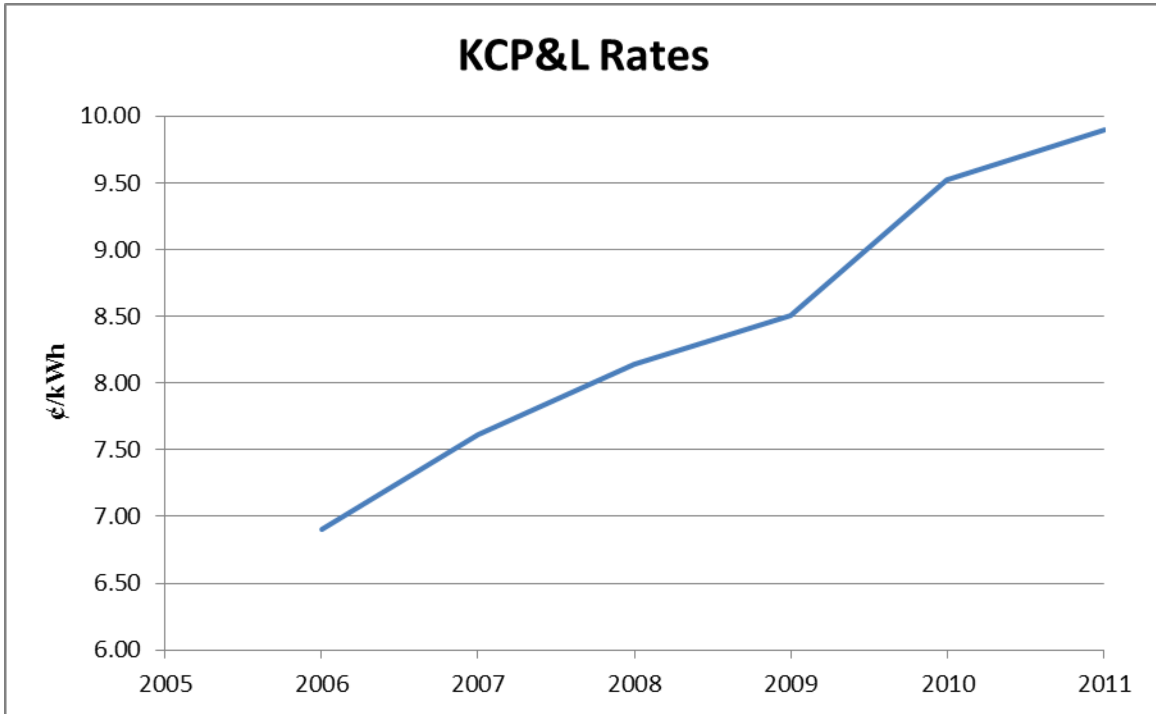
ER-2007-0291 (effective January 1, 2008): 6.50% increase

[1] *Order Directing Filing*, Case No. ER-2012-0174, issued August 24, 2012, at page 2.

ER-2009-0089 (effective September 1, 2009): 16.16% increase

ER-2010-0355 (effective May 4, 2011): 5.23% increase[2]

Recognizing that, through settlements, KCPL is guaranteed an increase of $53.5 million (7.6%) in this case,[3] KCPL rates will have increased by at least 54.7% in six years. Graphically, the increase in KCPL's rates can be easily seen:



KCPL tries to brush over the 54.7% increase in rates by noting that its rates are actually below the national average.[4] KCPL, however, fails to provide the Commission with the complete story. While the national average residential rate has increased by only 13.56% since 2006, KCPL's residential rates have increased almost three times as much (43.5%).[5] More importantly to the economic well-being of Missouri, while the national

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[2] See, Staff Exhibit 200, Cost of Service Report, at page 7.
[3] See, Second Non-Unanimous Stipulation and Agreement as to Certain issues, filed November 8, 2012, at page 2.
[4] See, KCPL Exhibit 2, Bassham Direct, at pages 5-6 and Tr. 102-103.
[5] Staff Exhibit 200, Staff Cost of Service Report, at page 17.

average commercial and industrials rates has increased by 9.3% and 10.7% since 2006, KCPL's commercial and industrial rates has increased by 38.8% and 38.5% respectively.[6]

The unaffordability of KCPL's rates is best seen while considering other economic data for the KCPL service area. Specifically, while KCPL rates will have increased a minimum of 54.7% in six years, the increase in average wages over that period has only been 11.45%.[7] While KCPL 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."[8] At the same time, counties served by KCPL are experiencing a higher mortgage delinquency rate and a higher unemployment rate than the rest of the state.[9] Clearly then, KCPL's rates have reached the point of being unaffordable.

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.[10]

	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%

[6] *Id.* at pages 18-19.
[7] *Id.* at page 6.
[8] *Id.* at page 7.
[9] *Id.* at pages 10-11.
[10] Staff Exhibit 200, Staff Cost of Service Report, at pages 250-251.

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.[11] 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.[12]

	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.

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 and (3) the implementation of a transmission tracker. Not surprisingly, by agreeing with KCPL's position on these issues, ratepayers will be confronted with higher rate increases both now and in the future. For this reason, MECG asks the Commission, in light of the evidence regarding the affordability of KCPL's rates and its excessive A&G costs, to make a renewed effort to focus on the customers in this case and reject KCPL's requests for an inflated return on equity, an equity rich capital structure, and the implementation of a transmission tracker.

[11] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 154.
[12] Staff Exhibit 200, Staff Cost of Service Report, at page 252.

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 KCPL'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%). In 2011, the Commission found that KCPL / GMO should be awarded a return on equity that is 20 basis points below Ameren. There is no basis to discontinue this ROE reduction. 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 KCPL'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 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 KCPL'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, KCPL 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.

- Class Cost of Service / Rate Design: As detailed in Section VII of this brief, MECG recommends that the Commission make findings of fact consistent with the interclass shifts set forth in the October 29, 2012 Non-Unanimous Stipulation and Agreement. Specifically, MECG asks that the Commission continue to adopt the use of the Average and Excess methodology for allocation of production plant. Furthermore, the Commission should reaffirm its previous decisions to allocate off-system sales on the basis of class energy usage. Given these findings, the Commission can then find that the interclass shift set forth in the October 29, 2012 Non-Unanimous Stipulation is just and reasonable.

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.[13]

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.[14]

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.[15]

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[13] *Order Setting Blocks of Exhibit Numbers*, Case No. ER-2010-0355, page 2 (issued January 12, 2011).
[14] *Highfill v. Brown*, 320 S.W.2d 493 (Mo. 1959).
[15] *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."[16]

[16] *Id.*

<u>IV. RETURN ON EQUITY</u>

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

<u>Regulatory Policy and Economic Considerations</u>: (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.[17] 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,"[18] 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."[19]

In this case, KCPL / GMO request an inflated profit (the return on equity) of 10.30%.[20] 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%.

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[17] Phillips, Charles F. Jr., *The Economics of Regulation*, Rev. ed. (1969) at page 124.
[18] *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692-693 (1923).
[19] *Id.*
[20] KCPL Exhibit 20, Hadaway Rebuttal, page 2.

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 KCPL 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, KCPL'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 KCPL in April of 2011. In this brief, MECG urges the Commission to award KCPL a return on equity that is at the lower end of Mr. Gorman's range (9.10%). This recommendation reflects concerns with the affordability of KCPL's rates for utility service and KCPL'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.[21] The ultimate result of each of these models leads to a recommended range of 9.10% - 9.50%.[22]

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[21] Mr. Gorman also conducted a Capital Asset Pricing Model ("CAPM") analysis that resulted in a recommended return of 8.40%. (OPC Exhibit 300, Gorman Direct, pages 34-39. In an effort to be

MODEL		RESULT
DCF	Constant Growth	9.46% (OPC Exhibit 300, Gorman Direct, page 19)
	Sustainable Long-Term Growth	9.15% (OPC Exhibit 300, Gorman Direct, page 21)
	Multi-Stage Growth	9.30% (OPC Exhibit 300, Gorman Direct, page 28)
Risk Premium		9.10% (OPC Exhibit 300, Gorman Direct, page 33)
Recommendation		**9.10% - 9.50%** (OPC Exhibit 300, 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.

Party Witness	ROE Recommendation[23]
Staff Witness Murray	9.0%
OPC Witness Gorman	9.1% - 9.5%
FEA Witness Kahal	9.5%
KCPL Witness Hadaway	10.3%[24]

Clearly, Dr. Hadaway's recommendation on behalf of KCPL is the outlier.[25]

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.*

[22] OPC Exhibit 300, Gorman Direct, page 39.

[23] KCPL Exhibit 20, Hadaway Rebuttal, page 2.

[24] KCPL Exhibit 20, Hadaway Rebuttal, page 31.

[25] 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%).[26]

	MODEL	HADAWAY RESULT[27]	ADJUSTED HADAWAY RESULT[28]
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.[29] 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 KCPL and provides financial support for KCPL'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

[26] OPC Exhibit 300, Gorman Direct, page 45.
[27] KCPL Exhibit 20, Hadaway Rebuttal, Schedule SCH-12 and 13.
[28] OPC Exhibit 301, Gorman Surrebuttal, Schedule MPG-SR-1.
[29] 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."[30]

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."[31] As the Commission recognized, Gorman took these "deficiencies into account and based [his] recommendation on additional sustainable growth DCF and multi-stage DCF models."[32]

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."[33] 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

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[30] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 117.
[31] *Report and Order*, Case No. ER-2010-0036, issued May 28, 2010 ("AmerenUE") at page 21.
[32] *Id.* at page 22.
[33] *Id.*

10 percent area along with Gorman and Lawton."[34] 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 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%.[35]

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.[36] 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.[37] As Mr. Gorman's analysis reveals, his recommended return on equity will allow both KCPL and GMO to meet the investment

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[34] *Id.*
[35] OPC Exhibit 300, Gorman Direct, page 39.
[36] OPC Exhibit 300, Gorman Direct, pages 39-43 and MPG-17 and 18.
[37] *Id.* page 41.

grade credit metrics for each of these financial ratios. As Mr. Gorman concludes, therefore, "KCPL'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.[38]

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'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.[39] 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.

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[38] *Id.* at pages 42 - 43.
[39] Ex. 19, 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.[40] Ultimately, his risk premium approach results in a return on equity of 9.87%.[41] 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%.[42] While Dr. Hadaway claims that his rejection of the risk premium approach was due to "current market conditions,"[43] it appears that this is simply a continuation of an ongoing habit of disregarding those analyses that are lower than his predisposed position.[44]

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.[45] As Mr. Gorman notes, however, Dr. Hadaway never considered making a similar adjustment to eliminate those companies that had a

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[40] See, KCPL Exhibit 19, Hadaway Direct, page 27 ("The basic risk premium models 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, KCPL Exhibit 19, Hadaway Direct, page 32 ("The risk premium approach is generally useful because it is founded on current market interest rates, which are directly observable.").

[41] KCPL Exhibit 20, Hadaway Rebuttal, page 31.

[42] 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 300, Gorman Direct, page 39.

[43] KCPL Exhibit 19, Hadaway Direct, page 33.

[44] 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.

[45] KCPL Exhibit 20, Hadaway Direct, 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 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.[46]

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).[47] Ultimately, because of their short-term focus, these analysts' growth projections are not sustainable.[48] 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

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[46] OPC Exhibit 301, Gorman Surrebuttal, page 7.
[47] OPC Exhibit 300, Gorman Direct, page 19
[48] 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.[49]

The same problems previously noted by the Commission in the constant growth DCF model are found within Dr. Hadaway's analysis.[50] 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.[51] 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

[49] *Report and Order*, Case No. ER-2010-0036, pages 21-22.
[50] Ex. 1204, Gorman Rebuttal, page 7 ("These growth rates are not sustainable in the long run.").
[51] KCPL Exhibit 19, 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.***[52]

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.***[53]

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

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[52] *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)
[53] *AmerenUE* at page 20, paragraph 18 (emphasis added).

5.8%.[54] In contrast, the "consensus economists' projections" of GDP growth is 4.80%.[55] 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%.[56]

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.[57]

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

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[54] OPC Exhibit 300, Gorman Direct, page 47.
[55] *Id.*
[56] *Id.* at page 48.
[57] *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%.[58]

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. KCPL'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.[59] Similarly, KCPL sought, but was denied, a 25 basis point increase in the last case to account for its alleged customer service excellence.[60]

[58] OPC Exhibit 300, Gorman Direct, page 49.
[59] *Report and Order*, Case No. ER-2006-0314, issued December 21, 2006, at page 30.
[60] *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 KCPL's service as well as (2) the inflated nature of KCPL'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 KCPL's fifth rate increase in the last 6 years. Specifically, KCPL has been granted these recent rate increases:

ER-2006-0314 (effective January 1, 2007):	10.46% increase
ER-2007-0291 (effective January 1, 2008):	6.50% increase
ER-2009-0089 (effective September 1, 2009):	16.16% increase
ER-2010-0355 (effective May 4, 2011):	5.23% increase[61]

Recognizing that, through settlements, KCPL is guaranteed an increase of $53.5 million (7.6%),[62] KCPL revenues will have increased by a minimum of 54.7% in just six short years. In contrast, while KCPL revenues have grown by 54.7%, the national average rate for electricity has only increased by 13.6%.[63] Therefore, KCPL's revenues have ***increased at four times the rate*** of the national average.

While KCPL 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

[61] See, Staff Exhibit 200, Cost of Service Report, at page 7.
[62] See, Second Non-Unanimous Stipulation and Agreement as to Certain issues, filed November 8, 2012, at page 2.
[63] *Id.* at page 17 (national average rate increases for residential customers).

challenging economic times since 2007 due to the recession and a slow recovery."[64] Specifically, while KCPL rates will have increased by at least 54.7%, average weekly wages for KCPL customers have only increased by 11.45%.[65] Interestingly, during this troubling period, only KCPL has sought to take advantage of its customers as the remainder of the Consumer Price Index has only risen by 11.58%.[66] 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."[67]

2. KCPL'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.[68]

	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

[64] *Id.* at page 6.
[65] *Id.*
[66] *Id.*
[67] *Id.* at page 7.
[68] *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 million[69]

-on a per Mwh basis: savings = $44.42 million[70]

-on a % of revenue basis: savings = $40.83 million[71]

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 KCPL'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%.[72] At approximately the same time, the Commission granted KCPL a return on equity of 10.0%.[73] 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.

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[69] 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.
[70] 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.
[71] 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.
[72] *Report and Order*, Case No. ER-2011-0028, issued July 13, 2011, at page 74.
[73] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011, at page 124

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."[74] 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."[75]

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,

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[74] *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-693 (1923).
[75] *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 April 12, 2011, the Commission issued its decision on the most recently completed KCPL / GMO rate cases.[76] In that decision, the Commission authorized a return of 10.0% for KCPL. That decision was based upon a true-up period ending December 31, 2010.[77] In contrast, the updated test year used in this proceeding ended on August 31, 2012.[78] 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 KCPL.

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 KCPL. "[C]apital market costs today are much lower than they were in 2011 when KCPL's rates were approved."[79] Empirical evidence that the cost of capital has declined significantly is reflected in utility bond yields. Specifically, KCPL'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.[80] Similarly, KCPL'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.[81]

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[76] *Report and Order*, Case No. ER-2010-0355, issued April 12, 2011
[77] *Order Approving Nonunanimous Stipulation and Agreement, Setting Procedural Schedule, and Clarifying Order Regarding Construction and Prudence Audit*, Case No. ER-2010-0355, issued August 18, 2010, at page 2.
[78] *Order Determining Relevant Periods and Other Matters*, Case No. ER-2012-0174, issued April 19, 2012, at page 1.
[79] OPC Exhibit 300, Gorman Direct, page 3.
[80] OPC Exhibit 300, Gorman Direct, page 4.
[81] *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 KCPL'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.[82]

The decline in the cost of capital is also reflected in the fact that KCPL's recommended return on equity, while still inflated, declined by 45 basis points from 10.75%[83] to 10.30%.[84] Furthermore, the average authorized return on equity for vertically-integrated electric utilities (like KCPL) dropped by 31 basis points between the 2nd quarter of 2011 and the 2nd quarter of 2012 (the last reported quarter).[85]

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 KCPL 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 Commission rejected the utility's

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[82] 110 basis point reduction in bond yield – 25 basis point increase in risk premium = 85 basis point decrease in return on equity.
[83] *Id.*
[84] KCPL Exhibit 20, Hadaway Rebuttal, page 6.
[85] *Id.* at page 5.

request for a 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.[86]

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% increase[87] as well as the South Dakota Commission granting Northern States Power Company a 9.25% return on equity.[88]

G. CONCLUSION

MECG asks that the Commission set a return on equity for KCPL at ***<u>9.10%</u>***. 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 its most recent KCPL 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."[89]

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[86] *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).
[87] *Proceding 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).
[8888] *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).
[89] *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 KCPL's recommendation. First, Mr. Gorman performs and considers the results of the DCF and risk premium analyses. In contrast, KCPL'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 KCPL'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. MECG's 9.10% recommendation is consistent with the Commission's most recent KCPL 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 KCPL 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 KCPL's rates. Specifically, while the national average rate for electricity has increased by 25.7% over the last 6 years, KCPL rates will have increased by over twice as much. This rapid increase in KCPL rates is largely a result of the uncontrolled nature of KCPL's A&G costs. Evidence presented by Staff indicates that KCPL's rates are approximately $43 million too high because of these uncontrolled A&G costs. If KCPL simply reduced its costs to the level of the next worst electric utility, this rate increase would be largely unnecessary.

6. In its last KCPL decision, the Commission recognized a twenty point differential between the return on equity for KCPL 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 KCPL a return on equity that is 20 points below that authorized to Ameren.

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

7. As indicated at pages 43-46, the implementation of a transmission tracker results in a significant shift of risk from KCPL to its ratepayers. If the Commission implements KCPL'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 KCPL'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.[90]

As the Commission has recognized, given this cost difference, "there is an optimum structure that will produce the minimum cost."[91] 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

[90] *Report and Order*, ER-93-41 and EC-93-252, issued June 25, 1993, at page 252.
[91] *Id.* at page 252.

> 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.***[92]

As of March 31, 2012, KCPL's capital structure included only 45.51% common equity.[93] This capital structure is reflective of that utilized by KCPL throughout 2011 and most of 2012.[94] Suddenly, and without any financial justification, KCPL's capital structure through the August 30, 2012 true-up increased to 52.56% common equity.[95] As will be seen, there is no justification for this sudden increase in common equity ratio other than to inflate KCPL's revenue requirement.

As with its analysis that it undertook in the *St. Joseph Light and Power* case, the KCPL actual capital structure contains much more equity that 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.[96] The common equity ratio for the comparable company group is 49.6% as reported by Value Line.[97] As compared to the comparable company group then, KCPL's true-up capital structure of 52.56% is

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[92] *Id.* at page 252.
[93] OPC Exhibit 300, Gorman Direct, page 13.
[94] *Id.* at page 10.
[95] Staff True-Up Accounting Schedules, Accounting Schedule 12.
[96] OPC Exhibit 300, Gorman Direct, page 15 ("I relied on the same utility proxy group used by KCPL witness Dr. Hadaway to estimate KCPL'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.").
[97] OPC Exhibit 300, 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 KCPL's capital structure. As such, the appropriate comparison is to the 49.6% common equity ratio reported by Value Line.

clearly equity rich.[98] In fact, KCPL's proposed capital structure contains more common equity than 17 of the 21 entities included in the comparable company group.[99]

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.[100] This credit rating and outlook are based upon a higher ratio of debt in the capital structure.[101] Even with the higher equity ratio, the S&P credit rating and outlook remain the same.[102] 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."[103]

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.[104] Such a capital structure is generous in that it includes more equity (50.0%) than that of the comparable company group (49.6%).[105] Furthermore, recognizing that the 50.0% hypothetical equity ratio is greater than that utilized by KCPL over the past two years,[106] it appears even more generous.

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[98] Staff True-Up Accounting Schedules, Accounting Schedule 12.
[99] OPC Exhibit 300, Gorman Direct, Schedule MPG-2.
[100] OPC Exhibit 301, Gorman Surrebuttal, page 4.
[101] *Id.*
[102] *Id.* at page 5.
[103] *Id.*
[104] *Id.*
[105] OPC Exhibit 300, Gorman Direct, Schedule MPG-2.
[106] *Id.* at page 10.

Moreover, KCPL'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. KCPL witness Bryant testified, in response to Mr. Gorman, that it used short-term debt to refinance maturing long-term debt during the true up period[107] 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.[108] This refinancing will be conducted after Great Plains accumulates short-term debt of at least $300 million.[109] 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.[110] 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, KCPL's proposal to artificially increase the equity ratio in its capital structure is contrary to other statements that KCPL made in this case. Specifically, KCPL claims to have taken steps to minimize its revenue deficiency in response to the "difficult economic times" currently being experienced in its service area.[111] It appears, however, that KCPL's claims are simple rhetoric. When given an opportunity to inflate its revenue deficiency, KCPL 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 KCPL's credit standing to be "Stable," with adequate utility cash flows. KCPL's current

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[107] KCPL Exhibit 10, Bryant Rebuttal, pages 6-11.
[108] *Id.*
[109] Tr. 360-363.
[110] *Id.*
[111] KCPL Exhibit 2, 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 KCPL's cost of service and income.[112]

Given the fact that KCPL'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 KCPL 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.

[112] OPC Exhibit 300, Gorman Direct, page 11.

VI. TRANSMISSION TRACKER (ISSUE II.11)

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"?

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?

A. INTRODUCTION

In its testimony, KCPL 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 KCPL 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."[113]

As this brief demonstrates, KCPL's proposed tracker is problematic for several reasons. ***First***, KCPL'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, KCPL 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 the doctrine against retroactive ratemaking. ***Third***, the tracker mechanism disturbs the

[113] KCPL Exhibit 29, Ives Direct, page 14 (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 13) (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***, KCPL 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 KCPL has to minimize such costs.

For all of the reasons set forth in this brief, the Commission must ultimately agree that KCPL's proposed tracker represents poor policy and will result in unlawful ratemaking. As such, KCPL's proposed transmission tracker must be rejected. It is important to realize, however, that by denying KCPL'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 KCPL. The rejection of the transmission tracker only prevents KCPL 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.[114] 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.

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

Through its tracker proposal, KCPL seeks to turn this entire notion of ratemaking on its ear. Rather than an "opportunity" to recover this cost, KCPL, 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. KCPL'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, KCPL's proposal has been opposed by every consumer group as well as the Commission's Staff. KCPL'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*,[115] 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

[115] 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.**[116]
>
> **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.[117]

In the case at hand, KCPL proposes a tracker mechanism that would use future rates to recover for past losses. Specifically, KCPL envisions that a specific amount of transmission costs would be established in this rate proceeding.[118] KCPL 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, KCPL would treat the excess amount as a regulatory asset.[119] KCPL asserts that the regulatory asset would be amortized in the next rate proceeding and recovered in future rates.[120]

As such, KCPL's proposed transmission tracker would violate the doctrine against retroactive ratemaking due to the fact that KCPL 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 expenses," KCPL proposes the any loss associated with transmission costs would be recovered in future rates. For this reason, KCPL's transmission tracker is fatally flawed.

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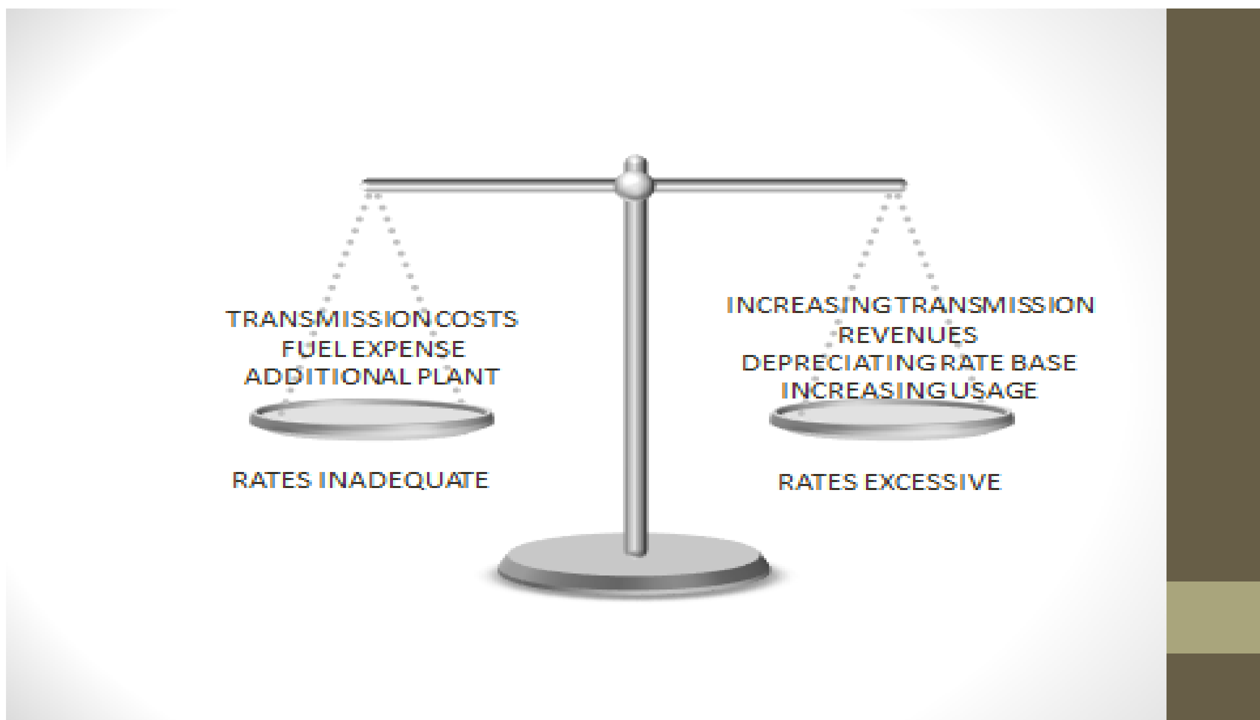
[116] *Id.* at page 59. (emphasis added).
[117] *Id.* (emphasis added)
[118] KCPL Exhibit 29, Ives Direct, page 15, lines 12-13.
[119] *Id.* at lines 13-15.
[120] *Id*. at page 16, lines 10-12.

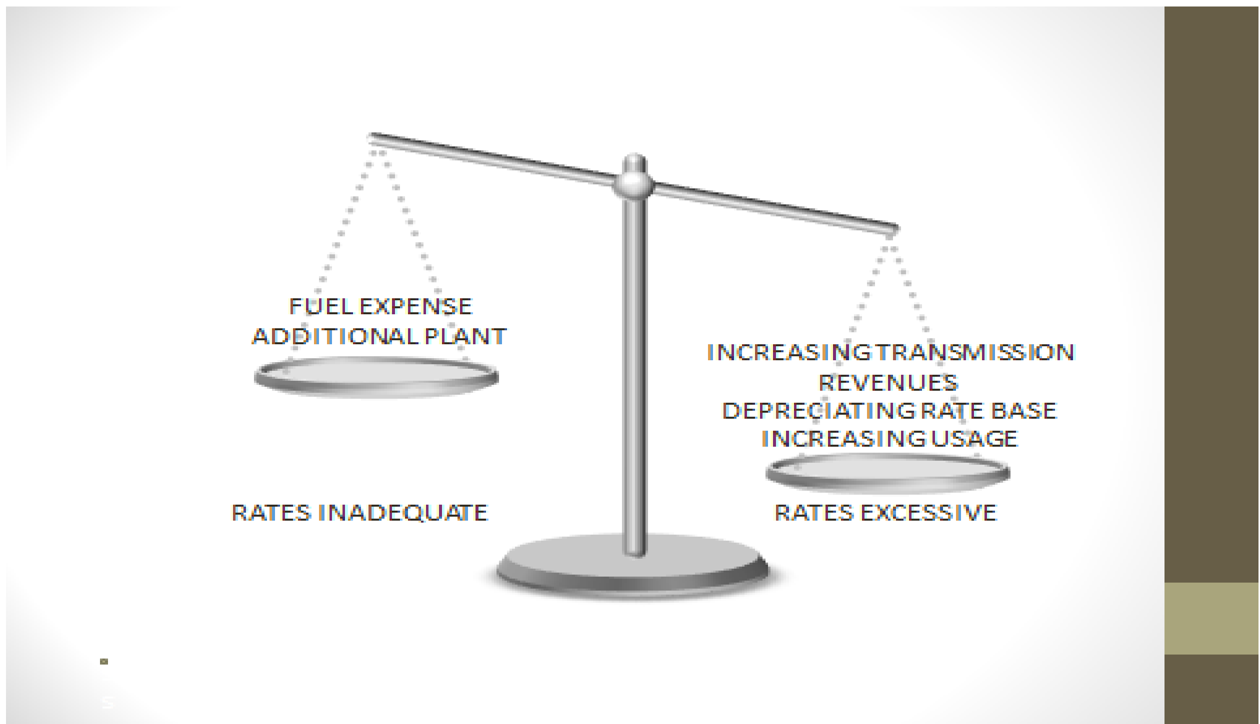
D. TRACKER MECHANISMS DISTURB THE BALANCING OF RISK AND INCREASE THE PROBABILITY THAT RATES WILL BE EXCESSIVE.

Besides violating the doctrine against retroactive ratemaking, KCPL'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."[121] 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.



[121] *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, KCPL 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, KCPL has shifted the careful balancing of risk envisioned by the Supreme Court.



As MECG witness Dauphinais points out, the KCPL 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."[122]

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 KCPL'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."[123]

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 KCPL's transmission tracker proposal. That said, if the Commission did implement this proposal, it is incumbent that the Commission reflect this decreased risk in its return on equity for KCPL. As Mr. Gorman points out, "[i]f the Commission modified KCPL's existing regulatory mechanisms to reduce KCPL's investment risk, then any related risk reduction should be considered in determining a fair risk-adjusted return on equity for KCPL."[124] 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 basis points.[125]

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[122] MECG Exhibit 404, Dauphinais Direct, page 7.
[123] *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 18.
[124] OPC Exhibit 300, Gorman Direct, page 3.
[125] *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).

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

E. KCPL'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.[126]

The evidence in this case demonstrates that KCPL 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.[127] Similarly, KCPL fuel and

[126] *Id.* at pages 20-21.
[127] *Id.* at page 21.

purchased power expense of $264,312,622[128] represents 44.7% of KCPL's total O&M costs.[129]

KCPL'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 $20 million.[130] Current costs are expected to increase by $25 million.[131] Therefore, the incremental increase in transmission costs that KCPL seeks to track is only 4.2% of KCPL'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 KCPL's request. As will be seen, KCPL 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 KCPL's management. For instance, the vast majority of costs in

[128] Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 2).
[129] Total O&M cost = $590,839,365 Staff True-Up Accounting Schedules, Schedule 9, page 1 (column H, line 12).
[130] MECG Exhibit 404, Dauphinais Direct, page 8.
[131] *Id.*

question concern SPP administration and transmission costs. Given its ability to participate in SPP and FERC, KCPL 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."[132]

Moreover, even to the extent that the transmission costs do change, given the forewarning provided through SPP projections, KCPL 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."[133] Therefore, these costs can certainly be influenced by KCPL, 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 KCPL has to minimize these costs.[134]

<u>Volatile</u>: 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.[135]

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[132] MECG Exhibit 404, Dauphinais Direct, page 8.
[133] *Id.*
[134] *Id.*
[135] *Report and Order*, Case No. ER-2007-0002, issued May 22, 2007, at page 23.

KCPL'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."[136] In fact, in its 18 pages of direct testimony supporting the implementation of a tracker mechanism, KCPL itself never characterizes transmission costs as "volatile."[137]

Rather, like other aspects of KCPL'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.[138]

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 KCPL. Unlike fuel expenses that have previously been addressed by the Commission, KCPL's transmission costs are relatively small and are not large enough to have a material impact on KCPL's financial performance. Also, unlike costs for items purchased in a commodity market, KCPL's transmission costs can certainly be influenced and managed by KCPL. 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

[136] MECG Exhibit 404, Dauphinais Direct, page 8.
[137] See, KCPL Exhibit 29, Ives Direct, pages 13-17; KCPL Exhibit 12, Carlson Direct, pages 1-11 and Schedule JRC-1.
[138] MECG Exhibit 404, Dauphinais Direct, page 8. See also the stair step projected increases in KCPL Exhibit 12, Carlson Direct, Schedule JRC-1.

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

F. CONCLUSION

As this brief demonstrates, KCPL 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 KCPL's proposed tracker mechanism. In addition, KCPL's proposal represents a significant shift in the balancing of risk envisioned by the Supreme Court. Finally, KCPL has failed to show that its proposal meets the criteria set forth by the Commission for the implementation of such an extraordinary mechanism. For all these reasons, the Commission should reject KCPL's proposal. Again, by rejecting the transmission tracker, the Commission is not disallowing any portion of these transmission costs. Rather, a normalized level of transmission costs has already been included in KCPL's revenue requirement. By rejecting the tracker, the Commission is only disallowing KCPL's ability to tracker differences against this normalized amount and recover these differences in future rates. In the event that the Commission does implement the KCPL transmission tracker, it should make an explicit 10 basis point reduction in KCPL's return on equity to account for the significant shift in risk caused by the implementation of the tracker mechanism.

VII. RATE DESIGN / CLASS COST OF SERVICE (ISSUE I.6)

6. Rate Design/Class Cost Of Service Study:

a. How should the class cost of service studies be relied on for determining shifts in customer class revenue responsibilities that are revenue neutral on an overall company basis?
   i. What methodology should be used to allocate demand-related (fixed) production costs in KCPL's class cost-of-service study?
   ii. What methodology should be used in the CCOS to allocate OSS margins?

b. How should any rate increase be allocated among the various customer classes?

c. How should rates be designed?

e. Should the Commission adopt Mr. Brubaker's LGS / LP rate design.

A. INTRODUCTION

Any rate increase is necessarily divided into two distinct parts. First, how much of a revenue increase should the utility receive (revenue requirement)? Second, how should the revenue increase be allocated among the various customer classes (class cost of service)? This portion of the brief addresses the second inquiry – how KCPL's revenue requirement should be allocated among the KCPL customer classes.

On October 29, 2012, a non-unanimous Stipulation and Agreement was executed and filed by Kansas City Power & Light Company, the Staff of the Public Service Commission, Midwest Energy Consumer's Group and the Missouri Industrial Energy Consumers. As provided by that settlement, the Signatories agree that the Commission should increase residential true-up revenues by 1.00% in addition to any other increase implemented by the Commission with a corresponding equal-percentage revenue neutral decrease in the true-up revenues for all other non-lighting rate classes. As reflected in

more detail later, the settlement exactly matches the revenue allocation recommended by the Staff.

On November 2, 2012, opposition to the Stipulation was filed by OPC and the Consumers Council.[139] Given the opposed nature of the Stipulation, the Commission cannot simply approve the Stipulation. Rather, as Commission Rule 4 CSR 240-2.115(2)(D) provides, the opposed non-unanimous stipulation "shall be considered to be merely a position of the signatory parties to the stipulated position." Consistent with *State ex rel. Fischer v. Public Service Commission*,[140] all of the opposed issues "shall remain for determination after hearing."

In this brief, MECG will address several specific points. ***First***, MECG will discuss KCPL's recent rate cases and the extent to which the rates for the various customer classes have increased relative to the national average. ***Second***, MECG will provide the results of the various class cost of service studies presented in this case. ***Third***, MECG will demonstrate that the OPC and CCM opposition to the Stipulation is premised entirely upon the Commission's adoption of the KCPL class cost of service study and the rejection of all of the other class cost of service studies. As such, MECG will demonstrate, with references to recent Commission decisions, the flaws inherent in the KCPL study and therefore the flaws underlying the OPC and CCM stipulation opposition. ***Fourth***, MECG will discuss the need for the LGS / LP rate design proposal contained in the MECG testimony. This proposal has not been opposed by any party and

[139] Counsel for Consumers Council of Missouri also represents AARP. The exact same opposition was filed on behalf of CCM and AARP. For purposes of this brief, both CCM and AARP are simply denominated as CCM.
[140] 645 S.W.2d 39 (Mo.App. 1983).

should be treated as a unanimous stipulation. As such, MECG asks the Commission to expressly note its acceptance of this rate design proposal.

B. RECENT CHANGES IN KCPL CLASS AVERAGE RATES

On March 28, 2005, KCPL as well as several parties executed a stipulation designed to provide the regulatory support necessary for it to implement its Comprehensive Energy Plan including construction of the Iatan 2 generation station. On July 28, 2005, the Commission approved that stipulation. As envisioned by that stipulation, KCPL had four separate rate increases starting in 2006 and ending in May of 2011. This is the first rate increase since the completion of Iatan 2 and much of the Comprehensive Energy Plan.

While all customer classes made financial sacrifices in order to help KCPL with the completion of the Comprehensive Energy Plan, the evidence indicates that KCPL's commercial and industrial customers have suffered more than others. As reflected in Staff's testimony, KCPL's commercial and industrial rates have grown, relative to the national average, much faster than residential rates.[141]

It is well known that the Commission is an agency within the Missouri Department of Economic Development.[142] As described in various statutes, the mission of the Department of Economic Development is to attract and promote economic opportunities in Missouri and assist in the development of jobs.[143] In this regards, the fact that KCPL's commercial and industrial rates have grown much quicker than the national average rate is not conducive to the Commission and the Department's fundament mission.

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[141] Staff Exhibit 258, Staff Cost of Service Report, pages 17-19.
[142] Section 620.010.2 RSMo.
[143] See, for example, Section 620.020.

In addition, the evidence indicates that, during the pendency of the KCPL Regulatory Plan, very little progress has been made to address the ongoing subsidy implicit in the commercial and industrial rates. Specifically, since the 2006 KCPL case, very little progress has been made.[144]

Therefore, while commercial and industrial rates have been rapidly outpacing their national average counterparts, very little has been done to address the subsidies inherent in those rates. Specifically, industrial rates have not been addressed since 2006 and commercial rates have not been addressed since 2007. Recognizing this, MECG, presumably as well as the other Stipulation signatories, believe that the Commission needs to take this opportunity to review those rates and make necessary revenue shifts.

C. RESULTS OF CLASS COST OF SERVICE STUDIES

In this case, the Commission has been presented with several class cost of service studies designed to assess each classes' cost of service and whether that class is currently paying rates consistent with its cost of service. Specifically, class cost of service studies were prepared and filed by: (1) KCPL; (2) Staff; (3) Department of Energy; and (4) the Industrials. In fact, in the testimony of Maurice Brubaker, the various industrial groups presented three separate class cost of service studies. Noticeably, each of the parties that sponsored a class cost of service study supported the Non-Unanimous Stipulation as a reasonable resolution to this issue. In contrast, the two parties that opposed the Stipulation did not provide a class cost of service study. Instead, while refusing to

[144] *Report and Order*, Case No. ER-2007-0291, issued December 6, 2007, at page 62; *Order Approving Non-Unanimous Stipulations and Agreements and Authorizing Tariff Filings*, Case No. ER-2009-0089; *Non-Unanimous Stipulation and Agreement as to Class Cost of Service / Rate Design*, Case No. ER-2010-0355, filed February 4, 2011, at page 1. Approved by *Report and Order,* Case No. ER-2010-0355, issued April 12, 2011, page 9.

endorse any of the allocators used by KCPL, OPC and CCM simply ask the Commission to adopt the results of KCPL's study.[145]

The results of the various class cost of service studies are as follows:[146]

INDEX OF RETURN

	Staff	**DOE**	**Industrials (A&E 4NCP)**	**Industrials (A&E 2NCP)**	**Industrials (4CP)**	**KCPL**
Residential	0.53	0.49	0.42	0.42	0.49	**0.98**
Small General	2.13	1.84	2.02	1.99	1.84	**1.98**
Medium General	1.55	1.31	1.42	1.41	1.31	**1.28**
Large General	1.29	1.34	1.42	1.45	1.34	**1.05**
Large Power	1.16	1.28	1.33	1.33	1.28	**0.54**

As Staff indicates:

> An Index of Return above 1.0 indicates revenue from the customer class exceeds KCPL's cost of providing service to that class; therefore, to equalize revenues and cost of service, rate revenues should be reduced, i.e., the class has overpaid. An Index of Return below 1.0 indicates revenue from the class is less than KCPL's cost of providing service to that class; therefore, to equalize revenues, and cost of service, rate revenues should be increased, i.e., the class has underpaid.[147]

Given this understanding, there are two conclusions that are immediately apparent from the results of the class cost of service studies. First, six of seven studies (filed by Staff, DOE and Industrials) agree that the residential class rates are significantly below

[145] See, *Public Counsel's Statement of Positions*, filed October 12, 2012, at page 3 ("Because of workload and resource issues, Public Counsel accepted the results of KCPL's CCOS for use in this case, but does not endorse any of KCPL's allocators."). See also, *Position Statement of AARP* and *Position Statement of Consumers Council of Missouri*, filed October 15, 2012, at page 2 ("Consumers Council [AARP] supports the Public Counsel's position.).
[146] Staff Exhibit 233, Scheperle Rebuttal, page 3 (referring to KCPL Study contained in Normand Direct; Staff Study contained in Staff Class Cost of Service Report; DOE Study contained in Goins Direct; and Industrials Study contained in Brubaker Direct).
[147] *Id.* at page 4.

their actual cost of service. Only the faulty KCPL study, as detailed more significantly in the next section, believes that residential rates are in line with cost of service. Second, six of seven studies indicate that the Large General / Large Power classes are currently paying rates that exceed their cost of service. Again, only the faulty KCPL study fails to reach this same conclusion.

Given the virtual unanimity in the conclusions reached between the various class cost of service studies, Staff made a recommendation that would allocate more of the rate increase to residential and less to the non-residential classes.

> Staff recommends adjustments to class revenue responsibilities be made first on a company-wide revenue neutral basis to all classes of customers except the lighting class. The KCPL residential class should receive a positive 1% adjustment, the lighting class should receive the system average increase, and the remaining classes of customers (Small General Service group, Medium General Service group, Large General Service group, and the Large Power Service group) should all receive a negative adjustment of approximately 0.6%.[148]

MECG believes that, given the recent slow movement to address interclass subsidization, the revenue shifts should be greater than those recommended by Staff and more in line with those recommended by Mr. Brubaker.[149] Nevertheless, for purposes of settlement, MECG has agreed to Staff's recommendations and encourages the Commission to adopt that recommendation.

D. THE KCPL STUDY IS FAULTY AND THE OPC / CCM RELIANCE ON THAT STUDY IS MISPLACED.

As indicated, neither OPC nor CCM, the opponents to the non-unanimous stipulation, provided a class cost of service study. Instead, while expressly disavowing the method and allocations by which KCPL conducted its study, OPC and CCM embrace

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[148] Staff Exhibit 212, Scheperle Direct, at page 2.
[149] See, MECG Exhibit 406, Brubaker Direct, at page 28 and Schedule MEB-COS-6.

the results of the KCPL study.[150] Unfortunately for their positions, there are three fatal flaws underlying OPC and CCM's reliance on the KCPL study.

First, KCPL has expressly indicated that its study is simply a snapshot and should not be relied upon for determining interclass revenue shifts. Several years ago, in preparing for a rate case, KCPL made a decision to switch to the Base, Intermediate, Peak ("BIP") methodology. As KCPL acknowledges, the BIP methodology was not utilized because it was a superior methodology, but because it was perceived to allow consideration of seasonal class cost of service.[151] In subsequent meetings, KCPL indicated that the BIP method should not be used to as a basis for revenue allocation.[152] Certainly, if KCPL believes that the BIP class cost of service study is unsuitable for purposes of allocating a revenue increase, OPC and CCM's reliance on such a study is misplaced.

Second, recognizing the limitations of its study, KCPL has itself agreed to the non-unanimous stipulation encompassing Staff's recommendation. As was demonstrated in the Table on page 55, the KCPL BIP study provides results that are vastly different from those resulting from any of the other 6 class cost of service studies. Undoubtedly, based in part on the outlier nature of its results and its unsuitability for purposes of revenue allocation, KCPL agreed to Staff's recommended revenue allocation as reflected in the Non-Unanimous Stipulation. It is telling that the sponsoring party has agreed to the Stipulation. Nevertheless, OPC and CCM, without agreeing with the methodology or

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[150] See, *Public Counsel's Statement of Positions*, filed October 12, 2012, at page 3 ("Because of workload and resource issues, Public Counsel accepted the results of KCPL's CCOS for use in this case, but does not endorse any of KCPL's allocators."). See also, *Position Statement of AARP* and *Position Statement of Consumers Council of Missouri*, filed October 15, 2012, at page 2 ("Consumers Council [AARP] supports the Public Counsel's position.).
[151] KCPL Exhibit 42, Rush Rebuttal, page 4.
[152] MEUA Exhibit 675, Johnstone Rebuttal, page 4.

the specific allocators in the study, ask that the Commission adopt the BIP results. One must necessarily wonder, since OPC and CCM will not specifically advocate for the methods used and KCPL has effectively cautioned against its applicability, how can the Commission rely on the study as suggested by OPC and CCM?

Third, and most important, the KCPL study is contrary to several recent Commission pronouncements regarding the proper methodology for conducting a class cost of service study. As Mr. Brubaker relates, the BIP methodology first surfaced in 1980. In the 30 years since its development, the "BIP method never caught on and is only infrequently seen in regulatory proceedings."[153] KCPL made little effort to rebut this fact.

> What [KCPL] has not rebutted, and indeed cannot rebut, is that BIP is an obscure and arcane method that has not found support in the industry. . . In response to the request to identify rate proceedings he was aware of where the BIP method was adopted, all that Mr. Normand was able to provide was a reference to the November 2010 decision by the Kansas Corporation Commission in the KCPL Iatan 2 rate case. ***I would certainly think that if Mr. Normand had succeeded in selling the BIP method during the last 30 or so years that he has been promoting it, that he would be able to find at least one instance where it was adopted by a Commission prior to 2010***.[154]

The reason that KCPL's BIP methodology has not seen acceptance in Missouri is that it is explicitly contrary to previous Commission decisions. Specifically, contrary to prior decisions, the BIP methodology over-emphasizes the importance of energy in its allocation of production plant. In this way, the BIP methodology minimizes the importance of class peak demand. In a recent Ameren decision, the Commission expressly criticized production plant allocators that rely heavily on class energy usage and recognized the logic of the Average & Excess methodology.

[153] MECG Exhibit 407, Brubaker Rebuttal, pages 3-4.
[154] MECG Exhibit 408, Brubaker Surrebuttal, page 3.

> Some customer classes, such as large industrials may run factories at a constant rate, 24 hours a day, 7 days a week. Therefore, their usage of electricity does not vary significantly by hour or by season. Thus, while they use a lot of electricity, that usage does not cause demand on the system to hit peaks for which the utility must build or acquire additional capacity. Another customer class, for example, the residential class, will contribute to the average amount of electricity used on the system, but it will also contribute a great deal to the peaks on system usage, as residential usage will tend to vary a great deal from season to season, day to day, hour to hour. To recognize that pattern of usage, the Average and Excess method separately allocates energy cost based on the average usage of the system by the various customer classes. It then allocates the excess of the system peaks to the various customer classes by a measure of that class' contribution to the peak. In other words, the average and excess costs are each allocated to the customer classes once.[155]

As such, the Commission found that production plant allocators need to rely heavily on the customer classes' relative peak demand.[156]

In this case, the reliance on the class energy usage is even more predominant than it was when the Commission cautioned against its use. In the Ameren case, approximately 55% of production plant was allocated on the basis of class energy usage.[157] In contrast, the KCPL BIP methodology, now relied upon by OPC and CCM, allocates approximately 80% of production plant based upon class energy.[158] Certainly, the BIP methodology and its over-reliance on energy usage is faulty and should again be rejected.

Finally, in addition to its faulty allocation of production plant, the BIP study is also contrary to the Commission's stated method for allocating off-system sales between the classes. In both a recent KCPL and Ameren case, the Commission stated that off-

[155] *Report and Order*, Case No. ER-2010-0036, issued May 28, 2010, at pages 84-85.
[156] *Id.* at page 85.
[157] MECG Exhibit 407, Brubaker Rebuttal, page 6.
[158] *Id.*

system sales should be allocated based upon energy usage. As the Commission stated in that KCPL decision:

> The only costs assigned to non-firm off-system sales is the fuel and purchased power costs – the variable costs – hence the appropriateness of using the energy allocator. This is consistent with the way KCPL itself allocates the costs relating to the energy portion of firm capacity contracts – using the energy allocator. The reason is simple – the energy allocator is used to allocate variable costs of fuel and purchased power costs relating to retail sales. ***Using the same rationale, the energy allocator is equally appropriate to use as the allocation factor for both energy of firm and non-firm off-system sales.***[159]

Despite the clarity of the Commission order in that KCPL case, KCPL has again neglected to allocate off-system sales on the basis of class energy usage.[160] As such, the KCPL BIP methodology is inherently unreliable and should be rejected by the Commission.

E. CONCLUSION

As this brief has demonstrated, the KCPL BIP methodology is unreliable. While in existence for over 30 years, the methodology has been repeatedly rejected by various state utility commissions. In fact, the BIP methodology has been characterized as "an obscure and arcane method that has not found support in the industry."[161] Furthermore, the methodology is contrary to recent decisions by the Commission regarding the allocation of production plant as well as off-system sales margins. For these reasons, the results of the BIP methodology, as shown in the Table on page 55, are drastically different than the results of the six other studies provided by Staff, DOE and the Industrials. Given all these problems, the Commission should reject the KCPL BIP study and the OPC / CCM reliance on its results.

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[159] *Report and Order*, Case No. ER-2006-0314, issued December 21, 2006, at page 39.
[160] MECG Exhibit 407, Brubaker Rebuttal, page 6.
[161] MECG Exhibit 408, Brubaker Surrebuttal, page 3.

In its place, the Signatories ask that the Commission adopt the results of the Staff class cost of service study. The results of that study, reflected in the October 29 Non-Unanimous Stipulation provide an adequate basis for the allocation of revenues among the various parties. While MECG suggests that a greater allocation of costs from the commercial and industrial class is appropriate, it has agreed with Staff's recommendation and requests that the Commission adopt the Staff position.

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 Mr. 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 KCPL rates and KCPL's continued failure to control its escalating A&G costs. In the event that the Commission implements KCPL'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.

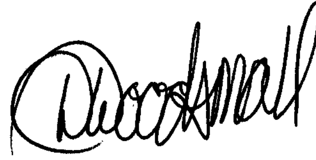
2. As set forth in Section V, MECG urges the Commission to reject KCPL's equity heavy capital structure that existed as of the end of the true-up period. That equity rich capital structure provides no benefit to ratepayers and is solely designed to inflate KCPL's revenue requirement. As the Commission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

3. Reject KCPL'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 if the balancing of risk envisioned by the Missouri Supreme Court. Finally, KCPL 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 KCPL's authorized return on equity to account for this shift in risk from shareholders to ratepayers.

4. Adopt the interclass shifts reflected in the October 29, 2012 Non-Unanimous Stipulation and Agreement. As set forth in Section VII, MECG urges the Commission to reaffirm: (1) its previous adoption of the Average and Excess methodology for allocation of production plant and (2) the previous finding that off-system sales margins should be allocated on the basis of class energy usage. After the affirmation of these previous Commission decisions, the Commission should find that the interclass shift contained in the Non-Unanimous Stipulation represents a reasonable movement towards each class' true class cost of service. Finally, as an unopposed portion of the October 29, 2012 Non-Unanimous Stipulation, MECG urges the Commission to expressly adopt the LGS / LP rate design set forth in that stipulation

Respectfully submitted,



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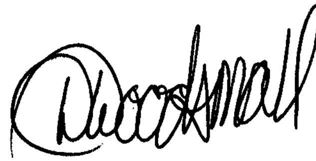
CERTIFICATE OF SERVICE

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.



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David L. Woodsmall

Dated: November 28, 2012