

MEMORANDUM

TO: Missouri Public Service Commission
Official Case File, Case No. EU-2010-0194,
Kansas City Power & Light Company Tariff Tracking No. JE-2010-0430 and
KCP&L Greater Missouri Operations Company, Tracking No. JE-2010-0431

FROM: Charles R. Hyneman, Auditor V, USD - Auditing Department

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SUBJECT: Staff Recommendation

DATE: February 24, 2010

On December 29, 2009, Kansas City Power & Light Company (KCPL) and KCP&L Greater Missouri Operations Company (GMO) filed with the Public Service Commission (Commission) their APPLICATION for an accounting authority order (AAO) for the booking of incremental costs associated with compliance with the Renewable Energy Standard enacted in 2008 and thereby designated as Case No. EU-2010-0194.

With their Application, KCPL and GMO each filed three (3) tariff sheets bearing an issue date of December 29, 2009, and an effective date of January 28, 2010. Tracking No. JE-2010-0430 is for the three (3) tariff sheets KCPL filed and Tracking No. JE-2010-0431 is for the three (3) tariff sheets GMO filed. Staff filed its recommendations on those tariff sheets in this case on February 8, 2010 recommending the Commission to issue an order approving Applicants Tariff Sheets.

On January 6, 2010, the Commission issued its ORDER SUSPENDING TARIFFS AND DIRECTING FILINGS, AND NOTICE OF CONTESTED CASE, suspending all six (6) of the filed tariff sheets for a period of 30 days, from January 28, 2010 to February 27, 2010, and directed KCPL, GMO and the Commission's Staff (Staff) to advise the Commission as to whether the Commission should decide the Application and tariffs on an expedited basis.

On January 8, 2010, Staff, GMO and KCPL advised the Commission that there was no need for the Commission to decide either the application or whether to approve tariff sheets on an expedited basis. Staff, GMO, and KCPL also advised the Commission that the Commission may address the tariff sheets independently from the Application.

As part of its February 3, 2010 "Order Directing Filings" the Commission ordered Staff to file by no later than February 24, 2010, the Staff's recommendation as to whether the Commission should issue the requested AAO.

This Staff recommendation addresses only the Application for an Accounting Authority Order (AAO). The Staff has reviewed the Application, met with representatives of KCPL and GMO, reviewed responses to data requests, reviewed the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA), and reviewed prior Commission orders in AAO cases. For the reasons outlined below, Staff recommends the Commission not grant the request for an AAO in this case.

In its Application KCPL and GMO seek authorization to defer the incremental costs associated with the compliance of Section 393.1030, RSMo, which has been referred to as Proposition C. Proposition C requires electric utilities to generate or purchase electricity generated from renewable energy resources. This requirement is referred to as the "Renewable Energy Standard" or "RES". The RES as set out in Section 393.1030, RSMo, was passed into law on November 4, 2008. The RES requires electric utilities to provide rebates to retail customers who install solar electric systems and establishes a portfolio requirement for electricity generated from renewable energy sources beginning in 2011.

KCPL and GMO propose to defer the incremental costs they incur to comply with the RES to Account 182 as a regulatory asset, add to these costs capitalized interest expense and profit at their respective allowance for funds used during construction (AFUDC) rates and amortize the asset over a 10-year period. KCPL and GMO request that the respective amortization periods not begin until some unknown future date to coincide with the effective date of rates in their respective next general electric rate cases. While Proposition C is silent on how a utility should treat costs between rate cases, Applicant's are the only utilities seeking an AAO.

Normal Accounting Rules

As electric companies, subject to the Commission's jurisdiction, KCPL and GMO are required by regulation to keep all of their accounts in conformity with the USOA prescribed by the FERC. The USOA, specifically 18 CFR part 201, General Instruction 7 states that normal accounting requires that net income of a period shall include all items of profit and loss during the period in which such profit and loss occurs. Items of profit or loss include revenues, expenses and gains and losses. The USOA only allows a deviation from normal accounting rules under extraordinary circumstances, which will be described below.

An AAO is simply an accounting mechanism available to the Commission to authorize a utility to deviate from the normal accounting rules under extraordinary circumstances, as specified in the USOA. The complete definition of Extraordinary Items in General Instruction 7 is shown below:

7. Extraordinary items. It is the intent that net income shall reflect all items of profit and loss during the period with the exception of prior period adjustments as described in paragraph 7.1 and long-term debt as described in paragraph 17 below.

Those items related to the effects of events and transactions which have occurred during the current period and which are of unusual nature and infrequent occurrence shall be considered extraordinary items.

Accordingly, they will be events and transactions of significant effect which are abnormal and significantly different from the ordinary and typical activities of the company, and which would not reasonably be expected to recur in the foreseeable future. (In determining significance, items should be considered individually and not in the aggregate. However, the effects of a series of related transactions arising from a single specific and identifiable event or plan of action should be considered in the aggregate.)

To be considered as extraordinary under the above guidelines, an item should be more than approximately 5 percent of income, computed before extraordinary items. Commission approval must be obtained to treat an item of less than 5 percent, as extraordinary. (See accounts 434 and 435.)

Accounting Authority Orders

An AAO should be used only in situations when it can be justified, based on the specific facts and circumstances on a case-by-case basis where the use of normal accounting rules would not be appropriate. An AAO is designed to mitigate (not eliminate) the effects of extraordinary events that either would have a detrimental impact on earnings (where an AAO would benefit utility shareholders) or result in extraordinary revenues that should be deferred with the potential to benefit utility ratepayers. Note the language in General Instruction 7 above, there is no reference to extraordinary expenses or costs, but to all items of profit or loss, which include revenues and gains equally as well as expenses and losses.

The actual use of AAOs, however, has been that utility companies in Missouri only seek extraordinary accounting treatment for the impact of events expected to result in expenses or losses, not revenues or gains. While the Commission has issued dozens of AAOs over the years for extraordinary costs, to the Staff's knowledge, no utility has requested the use of an AAO to defer extraordinary revenues. Because of this inherently biased application of AAOs by Missouri utilities, the Commission should give great scrutiny to AAO requests and apply strict tests that must be met prior to issuing an AAO.

An AAO is **strictly** an accounting mechanism which allows for the deferral of an extraordinary item. It is not designed to be, nor should it be understood to be a ratemaking mechanism under any circumstances.

AAOs are appropriately used to mitigate the financial impact of extraordinary events on the utility's financial results of the period. Under the appropriate circumstances The Commission has determined that a utility should be allowed to lessen the impact of extraordinary revenues, expenses, gains and losses on its earnings in a period so that the earnings of a particular period are not distorted by a single extraordinary event.

KCPL and GMO correctly recognize this appropriate use of AAOs in paragraph 10 of the Application where they state, "An AAO simply ensures that, by amortizing these costs over an extended period, Applicants will avoid distorting their financial results." However, at paragraph 8 of the Application KCPL and GMO propose to amortize the costs deferred under this AAO over 10 years starting with the effective date of rates in their respective next general rate cases. It is still unknown when either KCPL or GMO will file their next rate cases. Linking the start of the amortization period to rates in a next general rate case is treating an AAO as a ratemaking mechanism and not an accounting mechanism. This is not the intent of an AAO. If the purpose of an AAO is to avoid distorting financial results in one period, as KCPL and GMO profess, tying the amortization period to some future date for specific rate recovery of the total amount of the deferral is seeking specific ratemaking treatment, not avoidance of distorted earnings.

In instances when an extraordinary expense is authorized to be deferred on a utility's balance sheet as a deferred cost, the appropriate application of an AAO (that an AAO is simply an accounting mechanism used to mitigate the potential distortion of net income of a period under extraordinary circumstances) would require the amortization of this deferred expense to begin immediately and not be tied to future utility rates specifically designed to recover this expense amortization.

Some Missouri utilities, however, including KCPL and GMO in this Application, do not treat an AAO as an accounting mechanism but, instead, treat it as a ratemaking mechanism through the effort of tying the start date of an expense amortization period to the effective date of rates in its next general rate case. This treatment is not consistent with the purpose of AAOs in Missouri. At page 8 of its Application in this case, KCPL proposes to amortize the costs deferred under this AAO over 10 years starting with the effective date of rates in its next general rate case. This proposal is nothing more than a way to shield itself from the "shareholder risk" inherent in normal regulatory lag and increase the "ratepayer risk" also inherent in regulatory lag.

In the past, however, KCPL has sought and been granted AAOs for such extraordinary events as ice storms and did appropriately begin the amortization in the month following the deferral of the costs. This method of accounting for an extraordinary event is the appropriate method as it does not attempt to tie the deferral of the cost and the amortization of the deferred cost to any ratemaking proceeding.

The Standard for Granting an AAO

The Commission has consistently used the standards established in the FERC USOA General Instruction 7 definition of Extraordinary Items as basic standards for granting an AAO to Missouri utilities. The four basic tests of whether or not a revenue, expense, gain or loss is determined to be extraordinary are as follows:

1. The financial effects of the event must have occurred during the current period. In other words, the revenues, expenses, gains and losses must be reflected in the current period's reported net income absent specific authority to defer the financial effects and remove them from current period earnings.
2. The event must be unusual in nature which is defined as abnormal and significantly different from the ordinary and typical activities of the company.
3. The event must be infrequent in occurrence which is defined as an event that would not reasonably be expected to recur in the foreseeable future.
4. The revenue, expense, gain or loss of the event must be of significant effect, which is defined as more than approximately 5 percent of income, computed before extraordinary items.

The Commission has also established a test to determine when an AAO should be granted. In a 1991 decision In the Matter of the Application of Missouri Public Service for the Issuance of an Accounting Order Relating to its Electrical Operations. In the Matter of the Application of Missouri Public Service for the Issuance of an Accounting Order Relating to its Purchase Power Commitments. 1 MPSC 3d 200 (1991) (known as the "Sibley case"). The Commission in Sibley, stated that it would consider the appropriateness of granting an AAO on a case-by-case basis. In doing so, it would approve an AAO for events that it found to be "extraordinary, unusual and unique, and not recurring."

In addition to reviewing KCPL's and GMO's Application, the Staff attended a meeting with representatives of KCPL and GMO and obtained data from KCPL through informal data requests. To form a basis for its recommendation to the Commission as to whether or not it should grant an

AAO under this Application, the Staff applied the four tests outlined above to the information included in the Application and the data obtained from KCPL.

The first test was whether or not the financial effects of KCPL's compliance with Proposition C have been reflected in its current period's reported net income. KCPL and GMO have not yet released their 2009 net income levels. However, in informal data requests that Staff has learned that at most, actual incremental costs of Proposition C compliance reflected in 2009 earnings is \$ ** _____ ** combined for both utilities. For 2010 KCPL has budgeted \$ ** _____ ** for Proposition C compliance costs and GMO has budgeted \$ ** _____ **. KCPL and GMO do not expect to incur any significant Proposition C compliance costs until 2011 and those costs relate to the renewable energy generation portfolio requirement.

The second test is whether or not the event (Applicant's compliance with Proposition C) is unusual in that it is abnormal and significantly different from Applicant's ordinary and typical activities. Anyone familiar with the electric utility industry today knows that compliance with governmental environmental standards, such as the RES, is not an unusual activity, but a primary activity of a regulated electric utility. In its Application KCPL and GMO made no attempt to show that compliance with Proposition C is an abnormal activity for Applicants or that compliance with this particular environmental standard is significantly different from its compliance with the myriad of other environmental standards in effect today in which it must comply.

The third test is that compliance with Proposition C must be infrequent in occurrence which is defined as an event that would not reasonably be expected to recur in the foreseeable future. As a primary activity of a regulated electric utility, compliance with current and future environmental standards is likely to be a frequent occurrence and recur regularly in the foreseeable future. KCPL and GMO have provided the Staff with budgets for Proposition C compliance costs from 2010 through 2014 clearly showing that these costs are expected to be annual and recurring costs. In its Application, KCPL and GMO fail to show how compliance with Proposition C was an event that is not expected to recur in the foreseeable future.

The fourth test is whether or not the financial impact of compliance with Proposition C is of significant effect, which is defined as more than approximately 5 percent of income. Data obtained from KCPL shows that as of February 11, 2010, actual incremental cost of Proposition C has been about \$ ** _____ **. As noted above, budgeted incremental costs for KCPL and GMO in 2010 are \$ ** _____ ** and \$ ** _____ ** respectively. Clearly these incremental costs are not of significant effect and are immaterial to the operations of these utilities.

In a relatively recent AAO Report and Order in Case No. GU-2007-0480, issued on December 17, 2008, the Commission noted that the utility's projected costs are only 8% of its net income and the actual incurred costs considered within this case are only 2% of its net income. The Commission concluded that the purported extraordinary event in that case was not of "such significant size and substantial cost to be considered extraordinary or unusual."

Staff Recommendation

KCPL and GMO will not incur any significant costs to comply with Proposition C at least until 2011. In 2011 both KCPL and GMO anticipate to incur millions of dollars in incremental costs to comply with Proposition C's renewable energy portfolio requirement which is discussed at paragraph 6 of the Application. It is not an appropriate use of an AAO to defer estimated costs that are not

expected to occur for another year. In addition, since KCPL and GMO will soon be filing general rate cases that may well extend into 2011, the rate case is the appropriate forum to address these costs, not an AAO proceeding.

Applicants are well aware of the Commission's standards for deferral for an AAO. Applicants even referenced the Commission's 1991 Sibley Order, which outlined its AAO standards of deferral, at paragraph 9 of its Application. However, nowhere in its Application did Applicants attempt to show that it met any of the Commission's standards of deferral. In the Staff's opinion, this Application is deficient in that it does not provide any support the Applicants' assertion that its compliance with Proposition C is an extraordinary event. Therefore this Application should be rejected. The Commission should order the Applicants, that if it is so desired, it should file a subsequent Application for an AAO and address the specific standards established by the Commission for granting AAOs.