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Case No.: ER-2010-0355
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2010-0355

REBUTTAL TESTIMONY

OF

CURTIS D. BLANC

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

**Kansas City, Missouri
December 2010**

REBUTTAL TESTIMONY

OF

CURTIS D. BLANC

Case No. ER-2010-0355

1 **Q: Please state your name and business address.**

2 A: My name is Curtis D. Blanc. My business address is 1200 Main Street, Kansas City,
3 Missouri 64105.

4 **Q: Are you the same Curtis D. Blanc who prefiled Direct Testimony in this matter?**

5 A: Yes, I am.

6 **Q: What is the purpose of your testimony?**

7 A: The purpose of my testimony is to provide an overview of the Company's response to
8 Staff's November 3, 2010 Construction Audit and Prudence Review for the Iatan
9 Construction Project ("Iatan Report"), and in particular, the Company's response to
10 Staff's recommended prudence disallowance for the Iatan projects. I also explain the
11 unreasonableness of Staff's recommended return on equity ("ROE"), as provided in
12 Staff's November 10, 2010 Revenue Requirement Cost of Service Report ("COS
13 Report"). In addition, I respond to certain other recommended cost of service
14 adjustments, such as (i) Staff's proposal to dramatically reduce KCP&L's annual
15 depreciation expense, including Staff's proposal to depreciate Iatan 2 over 60 years;
16 (ii) the Industrial's recommendation to change the manner in which KCP&L gives off-
17 system sales margins to its customers; (iii) Staff's proposed treatment of certain
18 settlements related to the Hawthorn Generating Station; and (iv) Staff's adjustment to
19 certain advertising expenses related to KCP&L's Connections campaign. .

1 **STAFF’S IATAN REPORT**

2 **Q: How would you describe Staff’s Iatan Report?**

3 A: Staff’s Iatan Report, particularly with respect to Iatan 2, contains two very different and
4 distinct approaches to reviewing prudence. At one end of the spectrum, Staff conducts a
5 construction audit and prudence review, arriving at a recommended prudence
6 disallowance of \$37 million. Although KCP&L strenuously disagrees with Staff’s
7 recommended disallowance, Staff appears to have attempted to follow the requisite two-
8 step process for a prudence review—first, to identify an imprudent act or decision, and
9 second, to quantify any impact that act or decision had on the cost of the project. In
10 Schedule 1-1 to Staff’s Iatan Report, Staff identifies seventeen acts or decisions by
11 KCP&L concerning Iatan 2 that Staff believes were imprudent. Staff then attempts to
12 quantify the impact of those acts or decisions on the cost of Iatan 2.

13 At the other end of the spectrum, Staff recommends a wholly unsupported
14 prudence disallowance for Iatan 2 of more than \$93 million based upon nothing more
15 than the observation that it is in excess of the December 2006 control budget estimate
16 (“CBE”) of \$1.685 billion. The sum of the proposed \$37 million and \$93 million
17 disallowances is how Staff arrives at its overall recommended prudence disallowance of
18 \$130 million for Iatan 2.

19 **Q: What is KCP&L’s response to Staff’s recommended prudence disallowance of**
20 **\$37 million for Iatan 2?**

21 A: KCP&L strongly disagrees with Staff’s allegation that the seventeen acts or decisions by
22 KCP&L listed in Schedule 1-1 were imprudent or resulted in \$37 million in unnecessary
23 costs to Iatan 2, as described in the Rebuttal Testimony of the following Company
24 witnesses:

- 1 • William Downey, who speaks to KCP&L’s management of the Iatan projects,
2 executive oversight, and settlements reached with certain vendors, which Staff alleges
3 were imprudent;
- 4 • Chris Giles, who speaks to the regulatory history of the projects, including the
5 unprecedented transparency into the projects that resulted from the Regulatory Plan;
- 6 • Brent Davis, who speaks to KCP&L’s day-to-day management of the Iatan projects;
- 7 • Forrest Archibald, who speaks to the project’s cost control system;
- 8 • Bob Bell, who speaks to KCP&L’s management of the Iatan projects, both in the
9 context of his significant power plant construction experience, as well as what was
10 occurring in the industry while Iatan 2 was being built;
- 11 • Steve Jones, who speaks to procurement;
- 12 • Ken Roberts, who speaks to Staff’s incorrect application of the prudence standard, as
13 well as KCP&L’s management of the Iatan projects, including the Alstom settlement
14 payments, which Staff seeks to disallow;
- 15 • Daniel Meyer, who provides extensive testimony supporting KCP&L’s prudent
16 management of the project; and
- 17 • Kris Nielsen, an independent prudence expert, who reviewed the prudence of
18 KCP&L’s management of the project.

19 Although I testify later in this testimony to certain of the seventeen allegedly
20 imprudent decisions or acts, that is not the primary point of my testimony. The primary
21 point of my testimony with respect to Staff’s Iatan Report is to point out the inadequacy
22 of Staff’s recommended \$93 million “plug” disallowance for Iatan 2.

1 **Q: Why do you describe Staff’s proposed prudence disallowance of \$93 million as a**
2 **“plug”?**

3 A: I call it a “plug” because it is not based on any alleged imprudent acts or decisions by
4 KCP&L, but rather is simply a mathematical computation.

5 **Q: Please explain.**

6 A: Staff’s Iatan Report looks at actual costs incurred as of June 30, 2010 for Iatan 2, which
7 was approximately \$1.815 billion on a total project basis (“June 30, 2010 Actuals”).
8 Staff then subtracts from that figure the CBE of \$1.685 billion to arrive at a
9 recommended prudence disallowance of \$130 million. Then, to avoid double counting
10 the impact of the seventeen allegedly imprudent acts or decisions referenced above, Staff
11 subtracts the \$37 million from the \$130 million to arrive at what I describe as the \$93
12 million “plug” disallowance.

13 **Q: How does Staff describe the \$93 million “plug” disallowance?**

14 A: In Schedule 1-1 to the Iatan Report, Staff describes its \$93 million recommended
15 prudence disallowance as a “Net Unidentified / Unexplained Cost Overrun adjustment.”

16 **Q: Does Staff explain how it arrives at its “Net Unidentified/Unexplained Cost Overrun**
17 **adjustment”?**

18 A: Yes. In Note A to Schedule 1-1, Staff explains that it does the computation I describe
19 above. Staff begins with the \$130 million difference between the June 30, 2010 Actuals
20 and the December 2006 CBE, which Staff describes as the “Gross Unidentified /
21 Unexplained Cost Overrun adjustment,” then subtracts its proposed disallowance of
22 \$37 million, which it describes as the “Staff disallowance adjustments” to arrive at the
23 \$93 million “Net Unidentified / Unexplained Cost Overrun adjustment.”

1 **Q: Does KCP&L take issue with how Staff arrives at the \$93 million “Net Unidentified**
2 **/ Unexplained Cost Overrun adjustment”?**

3 A: Yes, we do. That figure is unsupported. It is not tied to any alleged imprudent acts or
4 decisions by KCP&L. It is inconsistent with the Commission’s prior handling of
5 construction audits and prudence reviews. It does not satisfy Staff’s initial burden of
6 proof to raise “serious doubt” concerning prudence. It also incorrectly presumes that any
7 money spent over a budgeted amount is imprudent.

8 If it was Staff’s intent simply to recommend to disallow every dollar spent above
9 the December 2006 CBE, it could have saved itself, KCP&L, and the Commission a lot
10 of time, trouble, and expense by saying so at some point prior to its November 3, 2010
11 Iatan Report. To my knowledge prior to its Iatan Report, Staff never explained to
12 KCP&L, or more importantly the Commission, its intent to adopt such a simplistic
13 approach. Had Staff done so, KCP&L would have disputed Staff’s approach as
14 inadequate at that time, and the Commission could have given Staff guidance as to
15 whether its approach was consistent with how the Commission intended Staff to conduct
16 its construction audit and prudence review of Iatan 2. Instead, the dispute has arisen
17 now—

- 18 • 5 ½ years after the Commission approved the Regulatory Plan, which contemplated
19 (i) the construction of Iatan 2, (ii) KCP&L’s development of a cost control system,
20 and (iii) the timing of this rate case;
- 21 • more than 4 years after construction began on Iatan 2;
- 22 • more than 4 years after KCP&L first presented its cost control system to the Staff;
- 23 • about 4 years after the CBE was established;

- 1 • about 4 years after KCP&L began reporting to Staff on a quarterly basis detailed
2 status updates for Iatan 2, including a cost report that compared current spending on
3 Iatan 2 to the CBE, which KCP&L subsequently began providing to Staff on a
4 monthly basis; and
- 5 • Only about 5 months before the Commission will issue an order determining what
6 amount of Iatan 2 KCP&L gets to include in its Missouri rates.

7 Staff’s simplistic approach places the Commission in the untenable position of
8 having to make a decision concerning \$93 million in capital costs with little to no insight
9 from its Staff. As the Commission noted on page 5 of its order dated April 15, 2009 in
10 Case No. ER-2009-0089, “the Commission does not have the option to delay evaluating a
11 relevant issue or factor in a case setting rates.”

12 Staff’s simplistic approach also irresponsibly jeopardizes KCP&L’s financial
13 integrity. Under accounting rules KCP&L would have to immediately write off its books
14 any portion of Iatan 2 costs that this Commission concludes cannot be included in the
15 Company’s Missouri rates. To so cavalierly put a utility in the position of having to write
16 off such significant sums is irresponsible, particularly when that recommendation comes
17 from the Staff, who is supposed to balance the interests of KCP&L and its customers.

18 **Q: Do you have a similar concern with respect to Staff’s audit of the Iatan 1 projects?**

19 A: Yes. With respect to the Iatan 1 project, Staff’s recommended disallowance of \$69.7
20 million is similarly comprised of two audit methods. Staff recommends that \$51.3
21 million be disallowed based on eighteen allegedly imprudent acts or decisions by
22 KCP&L. Staff then adds to that a recommended “plug” disallowance of \$18.4 million.

1 Staff's "plug" disallowance for the Iatan 1 project suffers from the same flaws as Staff's
2 "plug" disallowance for Iatan 2, and should similarly be rejected.

3 **Q: Do you have any concerns about Staff's approach as the case progresses?**

4 A: Yes, I do. Since the \$93 million "plug" disallowance for Iatan 2 is based on the
5 difference between the June 30, 2010 Actuals and the December 2006 CBE, I am
6 concerned that when Staff updates its case for actual expenditures as of October 31, 2010,
7 it will simply subtract the December 2006 CBE from those actuals to arrive at a larger,
8 unsupported "plug." I do not believe that is what the Commission had in mind when it
9 established a deadline for its Staff to complete "all audit activity, of any type, involved
10 with the Iatan II generating facility, including any common plant shared between Iatan I
11 and II [by] January 30, 2011." Order Regarding Construction and Prudence Audits, File
12 Nos. ER-2010-0355 and ER-2010-0356 ("July 7, 2010 Order"), Ordering ¶ 9. If Staff
13 remains consistent in the true-up phase of this case and Iatan 2 ultimately costs what it is
14 presently projected to cost, the unsubstantiated "plug" component of Staff's proposed
15 disallowance could go from \$93 million to as much as \$226 million, which would
16 significantly exacerbate the issues I have described being concerned about.

17 **Q: Why do you believe the unsubstantiated "plug" component of Staff's proposed**
18 **disallowance could go from \$93 million to as much as \$226 million?**

19 A: The current cost estimate for Iatan 2 is \$1.948 billion. While that is a \$40 million
20 reduction from the most recent cost estimate of \$1.988 billion, it is \$263 million, or
21 \$15.6% more than the December 2006 CBE. If Staff sticks to its simplistic approach, and
22 if Iatan 2 ultimately costs \$1.948 billion, then I am concerned that Staff will simply
23 subtract the \$1.685 billion CBE from \$1.948 billion to arrive at a total recommended

1 disallowance of \$263 million. Then, to avoid double counting as it did in the Iatan
2 Report, Staff would subtract its proposed disallowance of \$37 million to arrive at a new
3 increased “plug” disallowance of \$226 million. Such a proposal would be absurd, but
4 unless Staff changes its methodology, I am concerned that is what Staff will ultimately
5 recommend.

6 **Q: Is Staff’s approach to the construction audit and prudence review of Iatan 2**
7 **consistent with what the Commission directed Staff to do?**

8 A: The methodology Staff used to arrive at its \$37 million recommended prudence
9 disallowance appears to be consistent with the Commission’s directive for Staff to
10 conduct a construction audit and prudence review of Iatan 2. However, I do not see how
11 Staff’s proposed \$93 million “plug” disallowance could be consistent with the
12 Commission’s directive. Simply subtracting the December 2006 CBE from the actual
13 dollars spent on the project at any given time could be done without doing any audit work
14 at all. That is not how I read the Commission’s orders, and I would not think that is what
15 the Commission had in mind.

16 **Q: How does Staff justify using the simplistic approach of subtracting the December**
17 **2006 CBE from the June 30, 2010 Actuals to arrive at its recommended**
18 **disallowance?**

19 A: Staff has two separate but related explanations as to why it believes it was appropriate to
20 take such a simplistic approach. First, Staff alleges that KCP&L “disregarded [its]
21 responsibility” under the Regulatory Plan to “develop and have a cost control system in
22 place that identifies and explains any cost overruns above the definitive estimate.” Iatan
23 Report, pp. 33-34. Second, Staff explains that it “considers KCP&L responses to be

1 nonresponsive to certain Staff Data Requests.” Iatan Report, p. 35. Instead, Staff claims
2 KCP&L “merely advises Staff how it can track budget variances.” Id.

3 **Q: Let’s take Staff’s explanations in turn. Do you agree that KCP&L “disregarded**
4 **[its] responsibility” under the Regulatory Plan to “develop and have a cost control**
5 **system in place that identifies and explains any cost overruns above the definitive**
6 **estimate?”**

7 A: No. As explained in the Rebuttal Testimony of KCP&L witness Forrest Archibald,
8 KCP&L satisfied its obligation under the Regulatory Plan by developing and having in
9 place a cost control system that identifies and explains cost overruns above the December
10 2006 CBE. Staff’s Iatan Report reads as though it expected the cost control system to be
11 a piece of paper that lists and explains every dollar spent over the December 2006 CBE.
12 That is an overly simplistic notion and does not accurately represent the purpose of a cost
13 control system, which is to manage the cost of a project, which KCP&L’s system
14 effectively did.

15 KCP&L’s cost control system is a complex and sophisticated system designed not
16 only to manage the review and payment of tens of thousands of invoices from hundreds
17 of vendors, but also to track cost and schedule trends to identify potential concerns on the
18 horizon before they have a chance to impact the project. That is what is necessary to
19 manage a multi-year, nearly \$2 billion construction project.

20 To my knowledge, no previous utility construction project in Missouri has had
21 such an elaborate, sophisticated, transparent cost control system in place as the one
22 KCP&L has used for the Iatan projects. If KCP&L’s cost control system is not adequate
23 for Staff to perform its audit of Iatan 2, it is not clear to me how Staff was able to audit

1 projects built prior to Iatan 2. In addition, it is my understanding that Staff has reached
2 out to other utilities in the state requesting that they implement cost control systems
3 similar to the one KCP&L used for the Iatan projects. That seems inconsistent with
4 Staff's argument here that KCP&L's system prevents it from doing its audit work.

5 My understanding from the discovery and hearings in Case No. EO-2010-0259 is
6 that Staff significantly changed its approach to construction audits and prudence reviews
7 part way through the construction of Iatan 2 by making the Services Division responsible
8 for conducting the audit, as opposed to the Operations Division, which had historically
9 been responsible for construction audits. Prior to the Iatan projects, Staff's construction
10 audits and prudence reviews were premised on an engineering review from the
11 Operations Division. Here, the engineers' review of the Iatan projects has been largely
12 cast aside as a "non dollar adjustment." Iatan Report, p. 28.

13 Staff's audit of the Iatan projects seems to be the exact opposite of what has
14 historically occurred. Before, the Operations Division, that is the engineers, audited the
15 project with support from the Services Division. For Iatan, the Services Division ran the
16 audit with limited coordination with or input from the engineers in the Operations
17 Division.

18 **Q: Did the Operations Division, *i.e.*, the engineers, audit Iatan 2?**

19 **A:** Yes. According to Staff's Iatan Report, the Operations Division reviewed "construction
20 project change orders associated with the project for the following:

- 21 • To understand the reason for the change at the point in time when the change order
22 was issued;

- 1 • To determine whether the change corrected an engineering-related problem, resulted
2 in a better design, or improved the operation or construction of the plant; and
- 3 • To determine whether the change resulted in a safety concern, caused unnecessary
4 construction, or caused unnecessary duplication of facilities or work.”

5 Iatan Report, at p. 28. After reviewing 647 change orders, the Operations Division
6 ultimately concluded that it “found no engineering concerns with any of the Iatan 2 or
7 Iatan common plant change orders reviewed.” Iatan Report, at p. 29. Since many of the
8 expenditures in excess of the CBE relate to design changes or design maturation, as
9 explained in the Rebuttal Testimony of Forrest Archibald, the findings of the Operations
10 Division are contrary to Staff’s recommendation to disallow every expenditure in excess
11 of the CBE.

12 **Q: Does KCP&L’s cost control system fulfill its obligations in the Regulatory Plan?**

13 A: Absolutely. The Regulatory Plan obligated KCP&L to develop a “system” to identify
14 and explain costs incurred in excess of the December 2006 CBE. As Mr. Archibald
15 explains in his Rebuttal Testimony, KCP&L’s cost control system does just that. It might
16 not be on a single piece of paper, as Staff intimates it should be, but KCP&L’s cost
17 control system contains all the data one needs to identify and explain costs incurred in
18 excess of the CBE.

19 **Q: Are you surprised by the timing of Staff’s allegation that KCP&L “disregarded [its]**
20 **responsibility” under the Regulatory Plan to “develop and have a cost control**
21 **system in place that identifies and explains any cost overruns above the definitive**
22 **estimate”?**

1 A: Yes. Although Staff has requested and received on several occasions an explanation as to
2 how the cost control system works and how costs can be tracked through the system, to
3 my knowledge the November 3, 2010 Iatan Report is the first time Staff has told
4 KCP&L, or more importantly the Commission, that it believes KCP&L “disregarded,” or
5 somehow failed to satisfy its obligation in the Regulatory Plan to implement an adequate
6 cost control system. Staff briefly discussed KCP&L’s cost control system in its August
7 6, 2010 report for Iatan 1, but Staff did not claim that KCP&L had disregarded or
8 otherwise violated its commitments under the Regulatory Plan.

9 **Q: When did KCP&L first present its cost control system to Staff?**

10 A: KCP&L first presented its cost control system to Staff in July of 2006. KCP&L’s cost
11 control system has been the basis for the cost section of each quarterly CEP update report
12 provided to Staff since the fourth quarter of 2006. KCP&L has worked diligently to
13 answer Staff’s questions about how the cost control system works. I have personally
14 observed Mr. Archibald explain the system to members of the Staff on several occasions.
15 I do not understand why Staff would wait until now to say that KCP&L has not fulfilled
16 its obligations under the Regulatory Plan concerning the cost control system, especially
17 since Staff appears to believe it cannot complete its audit because the cost control system
18 is inadequate. Such a significant allegation should have been raised long before now, for
19 the Commission’s sake as well as the Company’s.

20 **Q: Turning to Staff’s second explanation, do you agree that KCP&L’s responses to**
21 **Staff data requests were nonresponsive because they “merely advise Staff how it can**
22 **track budget variances”?**

1 A: No. Consistent with what KCP&L has been explaining to Staff since it began its audit
2 work on Iatan 2, understanding how to “track budget variances” in the cost control
3 system is how Staff can use the system to identify and explain costs in excess of the CBE,
4 precisely what Staff claims to be unable to do. That is the point of the system from an
5 audit perspective. Staff’s request for “**a list** that shows the amount of each cost overrun
6 and an explanation of each cost overrun” supports my concern that Staff has an overly
7 simplistic understanding of what a cost control system is or does. Iatan Report, at p. 34
8 (emphasis added). Staff appears to want a single document, a “list” that “shows the
9 amount of each cost overrun and an explanation of each cost overrun” over the December
10 2006 CBE. No such list exists, nor could KCP&L easily create one for the Staff. More
11 importantly, that is not what a cost control system is or should be, and it does not reflect
12 KCP&L’s obligation under the Regulatory Plan. Furthermore, if such a list existed, there
13 would be little audit work for Staff to do. The Commission could read the list for itself
14 and make a determination as to whether the explanations provided by KCP&L justified
15 the costs comprising the list.

16 As recognized by Staff in the Iatan Report, KCP&L has consistently maintained
17 that although no such “list” exists, the cost control system contains all the necessary data
18 to identify and explain those expenditures. Iatan Report, at p. 34 (“KCP&L indicated that
19 its cost overruns are reported in its Cost Portfolio and the supporting documents of the
20 overruns were provided in previous responses to Staff Data Requests.”). Specifically, as
21 accurately quoted by Staff in its Iatan Report, KCP&L stated in response to Data Request
22 970 in Case No. EO-2010-0259:

23 all variances from the [CBE] are captured in, and reported from, the Cost
24 Control System. The System provides the detailed tracking process in the

1 Cost Portfolio, which includes the [CBE] as well as each budget change,
2 the Committed Costs, the Uncommitted Costs, the Current Forecast Total
3 Cost At Completion and the Actuals Including Accruals. These details are
4 maintained by Budget Line Item and the supporting documentation is
5 voluminous. There is not a single set of output documents resulting from
6 the process.

7 Utilizing the April 2010, Iatan 2 K(a) Cost Report, the Control Budget
8 Estimate (Column A) is \$1,685.0 billion. As of April 2010, the Actuals
9 Including Accruals (Column M) total \$1,782.4 billion. The justification
10 for the additional \$97.4 million is located within the documentation
11 previously provided to staff in multiple data requests. As discussed above,
12 the variance is explained within the documentation previously provided in
13 data requests such Contingency Logs, PO logs, Change Order logs,
14 Reforecast Presentations and supporting documentation, Budget Transfer
15 Logs, etcetera.

16 (a) The K Cost Reports are routinely provided in hard copy in the
17 Strategic Infrastructure Investment Status Reports on a quarterly basis and
18 has been provided in Microsoft Excel format in data requests question
19 series number 0622.

20 A drawing illustrating how to track variances is attached, "Example for
21 DR 0970 Rev 1.xls." Mr. Forrest Archibald has walked through the
22 portfolio in previous meetings and would be able to provide the assistance
23 again if requested.

24 Iatan Report, at p. 36.

25 **Q: When did KCP&L receive Data Request 970 and provide the response to quoted**
26 **above?**

27 A: KCP&L received Date Request 970 from Staff on July 13, 2010 and responded on July
28 30, 2010.

29 **Q: Does anything strike you about the timing of Staff's Data Request?**

30 A: Yes. July 13, 2010 strikes me as extremely late in the process to be asking such a
31 fundamental question, especially in light of the fact that Staff contends it was unable to
32 conduct its construction audit and prudence review based upon KCP&L's alleged

1 “nonresponsiveness” to this data request. I would think that the majority of Staff’s audit
2 work would have been completed by then.

3 **Q: Does KCP&L take issue with Staff’s explanation that KCP&L’s alleged**
4 **nonresponsiveness to a data request justifies Staff using such a simplistic approach?**

5 A: Yes, we do. Staff claims that because KCP&L did not provide a “list” of each dollar
6 spent over the CBE with an explanation for each expenditure, (i) KCP&L “disregarded”
7 its commitments in the Regulatory Plan and (ii) Staff is justified in simply proposing to
8 disallow all expenditures in excess of the December 2006 CBE. Staff’s position is
9 concerning and unreasonable for several reasons.

- 10 • First, the Regulatory Plan did not require KCP&L to create the “list” Staff now insists
11 it needs to complete its review of the Iatan projects.
- 12 • Second, prior to the November 3, 2010 Iatan Report, Staff did not inform KCP&L, or
13 more importantly the Commission, that KCP&L creating such a “list” was critical to
14 Staff’s audit work. Staff did not even ask for it until July of 2010.
- 15 • Third, the Commission went so far as to establish monthly status hearings to discuss
16 discovery issues to avoid problems like this from arising, making it even more
17 concerning that Staff would wait until its Iatan Report to allege that KCP&L’s failure
18 to provide the list in response to a data request prevented Staff from doing what the
19 Commission directed it to do.

20 With respect to this third point, in its July 7, 2010 Order, the Commission ordered
21 that “Any discovery disputes shall be taken up immediately at these [status] hearings.
22 Any discovery dispute not timely raised at the status hearings shall be deemed waived.”
23 Ordering ¶ 5. Staff never raised at a status hearing that KCP&L was nonresponsive to a

1 Staff data request by failing to provide the list Staff now says it needs. It would appear
2 that Staff has waived the right to make that argument now.

3 **Q: Did KCP&L make available to Staff the type of information Staff was apparently**
4 **attempting to obtain on the “list” it requested?**

5 A: Yes. All of the information Staff needed to audit the construction project was available
6 in the cost control system. Staff’s dispute really seems to be with the format in which the
7 information was available. That is not a valid reason to reject the information. And it
8 does not justify the simplistic approach Staff seeks to adopt here.

9 **Q: Did the Kansas Staff require such a list to complete its review of the Iatan projects?**

10 A: No, the consultant hired by the KCC completed his review of the Iatan projects without
11 such a list. He was able to conduct his audit with the same information made available to
12 the Missouri Staff. I should also add that the Operations Division did its audit work
13 without such a list, as did Kris Nielsen and Daniel Meyer, who discuss their audit work in
14 their testimony in this case.

15 **Q: Is Staff’s rationale for its proposed Iatan 2 prudence disallowance consistent with**
16 **the Commission’s prior handling of construction audits and prudence reviews?**

17 A: No. As far as I am aware, Staff has never suggested and the Commission has certainly
18 never adopted an approach that would disallow every expenditure in excess of a project’s
19 control budget estimate. In Wolf Creek, for example, the control budget estimate for the
20 project was approximately \$1 billion. The plant ultimately cost nearly \$3 billion. To do
21 what Staff has done here, the Commission would have been asked to disallow nearly
22 \$2 billion in cost overruns. That would have been unreasonable, and it is not what
23 occurred.

1 In Wolf Creek, the Staff did a comprehensive construction audit and prudence
 2 review involving numerous witnesses covering numerous disciplines to arrive at a
 3 recommended prudence disallowance of approximately \$200 million—about 7% of total
 4 project costs and only about 11% of the excess costs above the control budget estimate.
 5 The primary basis for that recommendation was an engineering review.

6 It is worth taking a moment to compare the Wolf Creek project to Iatan 2. Wolf
 7 Creek was more than two years behind schedule and cost almost 200% more than its
 8 definitive estimate. By comparison, Iatan 2 satisfied its in-service criteria on August 26,
 9 2010, less than three months after the June 1, 2010 target date provided in the Regulatory
 10 Plan. In addition, Iatan 2 is forecasted to cost only about 15.6% more than the December
 11 2006 CBE. Despite these differences, Staff proposes to disallow a similar amount, as a
 12 percentage of total project costs, and a more severe disallowance as a percentage of the
 13 cost above the definitive estimate. The following table compares the cost, schedule, and
 14 ultimate ratemaking treatment of Wolf Creek to Staff’s proposal for Iatan 2:

| | Wolf Creek | Iatan 2 |
|---|-------------------|--|
| Definitive Estimate | \$1.033 billion | \$1.685 billion (December 2006 CBE) |
| Cost to Complete | \$2.9 billion | \$1.948 billion (current estimate) |
| Costs Above the Definitive Estimate | 181% | 15.6% |
| Schedule | > 2 years late | < 3 months after June 1, 2010 Regulatory Plan Target Date |
| Prudence Disallowance (in Dollars) | \$200 million | \$130 million (potentially \$263 million) |
| Disallowance (% of Cost to Complete) | 7% | 7% (potentially 14%) |
| Disallowance (% of Costs Above the Definitive Estimate) | 11% | 100% |

15 I include assumptions of what Staff’s proposed disallowance could be if it continues to
 16 seek to disallow every expenditure above the December 2006 CBE to illustrate that the

1 larger Staff's unsupported "plug" disallowance becomes, the more unreasonable Staff's
2 recommendation also becomes when compared to what the Commission did in Wolf
3 Creek.

4 Staff is proposing to treat the Iatan 2 project significantly worse than the
5 Commission treated the Wolf Creek project when Iatan 2 was essentially completed on
6 time and on budget compared to Wolf Creek's cost and schedule. Staff's approach here
7 is not only fundamentally different from the Commission's approach in Wolf Creek, but
8 it results in an outcome that on its face is unreasonable when compared to the
9 Commission's findings concerning Wolf Creek.

10 **Q: How should the Commission address the \$37 million and \$93 million prudence**
11 **disallowances recommended by Staff?**

12 A: Staff conducted a construction audit and prudence review of Iatan 2. The result of which
13 is a recommended prudence disallowance of \$37 million. The Commission should weigh
14 Staff's evidence concerning the seventeen items that comprise that proposed
15 disallowance against the Company's evidence concerning those items and make a
16 determination. The remainder of Staff's proposed \$130 million disallowance, that is, the
17 unsupported \$93 million "plug," is not the result of a construction audit and prudence
18 review and should be disregarded. Any attempts by Staff to subsequently increase its
19 "plug" disallowance should similarly be disregarded.

20 **Q: Did the KCC express an opinion about Iatan 2 costing more than the December**
21 **2006 CBE.**

22 A: Yes, in its recent order in KCP&L's companion Kansas rate case to this one, the KCC
23 found that "Given the magnitude of the project, the timeline under which the project was

1 constructed, and the range permitted for a definitive type of cost estimate, the
2 Commission finds that this factor does not indicate imprudence on the part of KCP&L.”
3 KCC Docket No. 10-KCPE-415-RTS, at p. 22 (Nov. 22, 2010) (citing AACE
4 International Recommended Practice No. 18R-97, p.6 (noting the range of accuracy for a
5 definitive estimate to be -5 to +15%)). It is also noteworthy that the KCC was looking at
6 a larger amount of excess above the CBE when it made that statement. At the time of the
7 Kansas hearings, the estimate to complete Iatan 2 was \$1.988 billion. That figure has
8 now been reduced to \$1.948 billion.

9 **Q: Did the KCC made any findings concerning the prudence of KCP&L’s management**
10 **of Iatan 2?**

11 A: Yes. In its November 22, 2010 order, the KCC found that KCP&L “built a strong and
12 credible case in defense that its actions were not imprudent.” The KCC had hired an
13 outside prudence consultant, Walter Drabinski of Vantage Consulting, a witness in this
14 case to conduct a construction audit and prudence review of the Iatan projects. In its
15 order, the KCC rejected its own expert’s analysis in part because it “hinges on a hindsight
16 analysis, which is clearly prohibited,” Kansas Order, at p. 15, and instead disallowed
17 \$20.4 million on a total project basis (\$5.1 million on a Kansas jurisdictional basis).

18 **SPECIFIC PROPOSED IATAN DISALLOWANCES**

19 **Q: You noted that you would speak to several of the allegedly imprudent acts or**
20 **decisions that comprise Staff’s proposed prudence disallowance of \$37 million.**
21 **Which of those will you speak to?**

22 A: Four of Staff’s seventeen allegedly imprudent acts or decisions concerning Iatan 2 relate
23 to Schiff Hardin. One relates to Cushman and Associates (“Cushman”). Staff also has a

1 proposed disallowance from the cost of the Iatan 1 project related to employee mileage
2 reimbursement, as well as companion proposed disallowances for Iatan 1 and Iatan 2
3 based upon an arbitrary sum for each unit to address the potential for what Staff describes
4 as “inappropriate” charges. In this portion of my testimony, I speak to those proposed
5 disallowances.

6 **Schiff Hardin’s Fees And Expenses Were Prudently Incurred**

7 **Q: Why does Staff seek to disallow Schiff Hardin fees and expenses?**

8 A: Although Staff dedicates 24 pages of the Iatan Report to Schiff Hardin (pages 65-89),
9 Staff’s criticisms boil down to the following:

- 10 (i) Schiff Hardin’s rates in Staff’s opinion are too high, and relatedly that Schiff
11 Hardin was not hired primarily to perform legal services in support of the Iatan
12 projects;
- 13 (ii) KCP&L should have solicited bids and undertaken a formal Request for Proposal
14 (“RFP”) process to select a provider of legal services for the Iatan projects;
- 15 (iii) KCP&L should have sent written approval to Schiff Hardin of changes in the
16 hourly rates of its lawyers; and
- 17 (iv) KCP&L should have required Schiff Hardin to submit with its invoices for legal
18 services a copy of every receipt for travel-related expenses.

19 Although I will respond to each of these criticisms specifically, my general observation is
20 that Staff’s criticisms are based on the incorrect notion that KCP&L should procure legal
21 services in the same manner it procures office supplies or some other fungible
22 commodity. I disagree. KCP&L treats the procurement of legal and other professional

1 services differently. That is not only appropriate but it is in the best interest of KCP&L
2 and its customers.

3 **Q: If the Commission would find in favor of the Staff that a portion of Schiff Hardin’s**
4 **fees and expenses should be disallowed, do you agree with the calculations made by**
5 **Staff to compute those disallowances?**

6 A: No, I do not. As I discuss below, the calculation of Staff’s proposed disallowances
7 suffers from significant flaws.

8 *The fees KCP&L paid Schiff Hardin for its work in support of the Iatan projects are*
9 *reasonable.*

10 **Q: Please respond to Staff’s allegation that Schiff Hardin’s rates were too high.**

11 A: Staff’s proposal to disallow a portion of Schiff Hardin’s fees on the basis that the hourly
12 rates charged by its lawyers and contractors are too high is flawed in several respects.
13 First, the comparisons Staff does, specifically the Laffey Matrix and the hourly rates of
14 Kansas City law firms, are not a reasonable benchmark against which to measure Schiff
15 Hardin’s fees. Second, Staff’s claim that only 20% of the work Schiff Hardin did in
16 support of the Iatan projects constituted legal services, is arbitrary, unsupported, and
17 incorrect. Third, Staff’s claim that “the selection of Schiff was primarily influenced by
18 KCPL management’s desire to be prepared to defend and protect itself from any charges
19 of unreasonable, inappropriate or imprudent decisions and not about conducting the day-
20 to-day project management work required to complete a significant construction project
21 on time and on budget” is similarly unsupported and incorrect. Iatan Report, at p. 73.
22 Schiff Hardin’s role was to support KCP&L in its efforts to complete the Iatan projects
23 on time and on budget. Schiff Hardin fulfilled that role very well. Fourth, Staff’s claim

1 that KCP&L could have demanded and Schiff Hardin would have accepted a discounted
2 fee arrangement is similarly arbitrary and unsupported.

3 **Q: What has KCP&L paid Schiff Hardin for its services in support of the Iatan**
4 **projects?**

5 A: KCP&L has paid Schiff Hardin approximately \$20 million for its work in support of the
6 Iatan projects.

7 **Q: Why were Schiff Hardin's fees and expenses prudently incurred in the context of**
8 **the Iatan projects?**

9 A: \$20 million is a significant amount of money. However, one must view it in context, that
10 is, the scope of the work performed, the value of that work, and what was at stake. As a
11 preliminary point, it is important to note that the fees paid to Schiff Hardin amount to less
12 than 1% of the cost of the Iatan projects. For the level and quality of the support Schiff
13 Hardin provided for the Iatan projects, 1% is a reasonable amount, as testified to by Bob
14 Bell and Daniel Meyer in their Rebuttal Testimony. In addition, as explained in the
15 testimony of William Downey, Schiff Hardin's support for the Iatan projects was
16 extensive, including legal services related to developing RFPs, contract negotiation,
17 contract administration, project controls, review and management of change orders and
18 claims, dispute avoidance, and dispute resolution, among other things—all over a several-
19 year period.

20 Moreover, one would be hard pressed to find a team as experienced and
21 knowledgeable as Schiff Hardin when it comes to large-scale construction projects such
22 as the Iatan projects. One also must consider what was at stake. Without highly
23 competent legal representation, the Iatan projects could have gotten bogged down in

1 vendor disputes, potentially including litigation. Although no one can prove what would
2 have happened had Schiff Hardin not been involved in the Iatan projects, it is clear that
3 the costs and delays associated with vendor disputes and litigation could easily have
4 surpassed the fees paid to Schiff Hardin. Staff fails to take any of these considerations
5 into account.

6 **Q: Why does Staff's rate comparison analysis fail to support its claim that Schiff**
7 **Hardin's rates were so high as to be imprudently incurred?**

8 A: Staff fails to acknowledge that an hour of one lawyer's time might legitimately be more
9 valuable than an hour of another lawyer's time based upon their respective knowledge
10 and experience. Schiff Hardin brought a tremendous amount of knowledge and
11 experience to the Iatan projects. Staff's hourly rate analysis fails to take that into
12 account.

13 The real question is not how Schiff Hardin's hourly rates compare to the Laffey
14 Matrix, which is not applicable here, or how Schiff Hardin's hourly rates compare to the
15 rates of other law firms that might or might not have been capable of doing the work
16 Schiff Hardin did in support of the Iatan projects. The real question is whether the
17 services KCP&L received from Schiff Hardin are worth the fees KCP&L paid, or put
18 another way, whether those fees were prudently incurred. The answer to that question is
19 an emphatic yes.

20 **Q: Do you agree with Staff's use of the Laffey Matrix or the rates of Kansas City area**
21 **law firms to measure the reasonableness of Schiff Hardin's hourly rates?**

22 A: No, I do not. The Laffey Matrix does not apply in cases such as this, and the rates
23 charged by Kansas City area law firms are not relevant. Neither is a proper baseline for

1 evaluating the reasonableness of Schiff Hardin’s hourly rates for legal services relative to
2 the Iatan projects. Both approaches fail to take into consideration the unique nature of
3 the project and the significant experience and industry-specific knowledge that the Schiff
4 Hardin team possesses, all of which legitimately impact the hourly rate for legal services.

5 **Q: What is the Laffey Matrix?**

6 A: The Laffey Matrix represents the prevailing market rates for legal fees charged by federal
7 court litigators in the Washington, D.C. area on an hourly basis. It is based on the
8 number of years a lawyer has been able to practice as of a given year. Thus, for example,
9 the matrix provides an hourly rate for all lawyers that graduated from law school four
10 years ago as of 2008.

11 **Q: In what types of cases is the Laffey Matrix intended to be used?**

12 A: As indicated on the USAO website, the Laffey Matrix is intended to be used in cases
13 involving fee-shifting statutes, those limited instances in which the law allows the
14 prevailing party to shift the burden of its attorneys’ fees to the losing party. The USAO
15 website identifies a few examples of such statutes, including the Civil Rights Act, the
16 Freedom of Information Act, and the Equal Access to Justice Act. It is my understanding
17 that the Laffey Matrix has been applied most frequently in civil rights cases. There is no
18 indication that the Laffey Matrix was intended to represent the prevailing market rates in
19 every State, without regard to the subject matter of the legal services at issue.

20 **Q: Has this Commission or any Missouri court applied the Laffey Matrix as Staff
21 proposes here?**

22 A: No. I am only aware of one Missouri case that even mentions the Laffey Matrix—*White*
23 *v. McKinley*, 2009 WL 813372 (W.D.Mo. 2009). The court did not endorse or approve

1 the Laffey Matrix but simply noted that it was one of the bases upon which the plaintiff
2 based its claim for attorneys fees. Notably, *White* is a civil rights case.

3 **Q: Has the Laffey Matrix been applied by other courts in the Eighth Circuit?**

4 A: Only in certain limited circumstances. I am only aware of a few references to it. District
5 courts in Minnesota, for example, have considered the Laffey Matrix and expressly
6 rejected it as “unpersuasive and of little value in determining a reasonable hourly rate.”
7 *Olson v. Kramer*, 2008 WL 1699605 (D. Minn. 2008). The *Olson* court criticized the
8 Laffey Matrix specifically for not distinguishing between the rates charged by lawyers
9 who specialize in one field of law versus another, which is one of the key matters at issue
10 here concerning the reasonableness of Schiff Hardin’s rates.

11 **Q: Why do you believe that the Laffey Matrix fails to take into consideration the nature
12 of an attorney’s experience?**

13 A: The USAO clarifies on its website that the years of experience reflected in the matrix
14 represents the number of years since a lawyer graduated from law school. In other
15 words, the hourly rate specified by the Laffey Matrix does not take into consideration the
16 actual experience that a lawyer may have acquired, but rather uses the lawyer’s law
17 school graduation data as a proxy for experience. So, for example, the Laffey Matrix
18 would recommend the same hourly rate an attorney who graduated from law school in
19 1975, regardless of whether the attorney had thirty-five years of experience in civil rights
20 litigation or whether the attorney had practiced for 5 years, left the practice of law for 25
21 years, and then decided to practice law again. The Laffey Matrix would recommend the
22 same hourly rate for any lawyer who graduated from law school in 1975, regardless of
23 whether the lawyer had successfully tried dozens of civil rights cases, had lost dozens of

1 cases, or had no trial experience at all. How qualified or effective the lawyer is simply
2 not a factor.

3 **Q: Is it appropriate for the Commission to consider an attorney's degree of knowledge
4 and experience when evaluating the reasonableness of his or her hourly rate?**

5 A: Not only is it appropriate, it is critical. The simple fact is that not all lawyers are created
6 equal. An hour of one lawyer's time is legitimately worth more than an hour of another
7 lawyer's time based upon his or her knowledge and experience. That is particularly true
8 in specialized areas of the law such as large-scale construction. As explained above, the
9 Laffey Matrix as applied here by Staff would suggest that any lawyer that graduated in
10 1975 should charge the same rate for his or her services. That does not make sense and
11 does not reflect reality. Different lawyers charge different hourly rates, even if they
12 happened to graduate law school the same year. Supply and demand and how the market
13 values a particular lawyer's services based on his or her knowledge and experience has
14 significantly more to do with a given lawyer's rates than does the year he or she
15 graduated from law school.

16 **Q: Should the Commission determine the reasonableness of Schiff's hourly rates based
17 on the hourly rates charged by Kansas City law firms?**

18 A: No. In fact, the Missouri courts in the *White* case I previously mentioned, as well as in
19 *Hendrickson v. Branstad*, 934 F.2d 158 (8th Cir. 1991), found that when attorneys have
20 specialized skills, it is appropriate to compare the rates to those of non-local attorneys in
21 other states or nationwide, as the case may be. In *Hendrickson*, for example, the Eighth
22 Circuit held that the attorney's fees should be compared to other nationally prominent
23 federal civil rights counsel rather than local Iowa counsel. Even more applicable to the

1 present situation, the Missouri district court in *White* found that Chicago rates, rather than
2 Kansas City rates, were the proper baseline for determining reasonable attorney's fees
3 because that case involved unique circumstances (*e.g.*, unsympathetic clients, difficult
4 facts, and allegations of conspiracy surrounding the alleged civil rights violations). In
5 light of those unique circumstances, the Court found that it was appropriate for the party
6 to seek legal services from attorneys in Chicago that specialize in difficult civil rights
7 cases and awarded attorneys fees based on Chicago rates.

8 **Q: Do you believe that there are unique circumstances on this project that would**
9 **justify legal fees higher than those charged by local law firms?**

10 A: Yes. The Iatan projects are among the largest and most complex construction projects
11 the region has seen for many years. Recognizing that fact, it would not have been
12 prudent for KCP&L to hire the least cost construction counsel or favor local counsel
13 without regard to their knowledge or experience. Simply put, there are not many firms in
14 the United States that have significant experience with projects as large and complex as
15 the Iatan projects.

16 KCP&L needed to seek out construction lawyers that possess the requisite skill,
17 knowledge and experience to handle the legal issues that arise during the construction of
18 a large coal-fired power generation facility, regardless of where they are based. KCP&L
19 recognized that it would need guidance from construction lawyers who know the issues,
20 know how to avoid them, know how to handle them when they arise, and know how to
21 maximize the returns and minimize the losses. Lawyers who know the industry and the
22 select number of qualified vendors on these projects can provide better guidance to a
23 project owner than lawyers who do not. Lawyers who are familiar with the obligations

1 and limitations imposed on regulated utilities can provide better counsel to a regulated
2 utility than those who do not. KCP&L recognized that and hired Schiff Hardin.

3 Schiff Hardin's team for the Iatan projects possesses the requisite skill,
4 knowledge and experience to handle a project as large and complex as the Iatan projects.
5 Few firms in the United States have significant experience with these types of projects.
6 Schiff Hardin also has specific experience and knowledge with respect to the vendors on
7 the Iatan projects. Under these circumstances, as the *White* court recognized, it is
8 appropriate for KCP&L to seek out lawyers who specialize in this type of work even if
9 their hourly rates are higher than other lawyers.

10 **Q: Staff's rationale for its Schiff Hardin disallowance aside, do you have any concerns**
11 **about how Staff attempted to quantify its disallowance?**

12 A: Yes, I do. Staff came up with what it believes to be reasonable hourly rates for legal and
13 non-legal services. Staff then concluded that only 20% of Schiff Hardin's work in
14 support of the Iatan projects was legal and that the rest—80% was non-legal. Finally,
15 Staff applied what it determined to be reasonable hourly rates to the ratios it developed
16 for Schiff Hardin's legal and non-legal work. As I discuss above, KCP&L disagrees with
17 Staff's attempt to develop proxy hourly rates. Here, I discuss the flaws in the ratios Staff
18 developed for Schiff Hardin's legal and non-legal work.

19 **Q: What rationale did Staff use to reduce the amounts billed for services provided that**
20 **they considered "non-legal"?**

21 A: Staff contended that 80% of the services provided by Schiff Hardin was for work that
22 could be considered "project control" and that such services could have been provided at
23 a lower cost by other qualified professional firms.

1 **Q: What rationale did Staff use to reduce the amounts billed for services provided that**
2 **they considered “legal”?**

3 A: Staff contended that only 20% of the services provided by Schiff Hardin were for work
4 that was legal in nature and that KCP&L did not consider the use of other qualified legal
5 firms, which might have charged lower hourly rates.

6 **Q: What issues do you have with Staff’s positions?**

7 A: Staff’s estimate of the breakdown of Schiff Hardin services between legal and non-legal
8 services is significantly misstated, with a disproportionate portion being assigned to the
9 non-legal category, which significantly overstates Staff’s recommended disallowance. In
10 addition, Staff calculates the reduction in hourly rates using assumptions that are not
11 supported by an analysis of the actual invoiced costs.

12 **Q: Why do you believe that Staff’s estimate of the breakdown of Schiff Hardin services**
13 **between legal and non-legal services is significantly misstated, with a**
14 **disproportionate portion being assigned to the non-legal category?**

15 A: KCP&L completed an analysis of invoices paid to Schiff Hardin from July 2007 through
16 April 2010, the period used by Staff in its August 6, 2010 Report. Although Staff’s
17 August 2010 Report focused solely on charges to the Iatan 1 AQCS project, KCP&L’s
18 analysis covered all charges to both the Iatan 1 and Iatan 2 projects. The results of this
19 analysis are shown in Schedule CDB2010-2.

20 **Q: What did this analysis show?**

21 A: For the period reviewed, labor costs for services provided totaled \$9.9 million for slightly
22 more than 36,000 hours. These amounts include services provided by Schiff Harden’s
23 subcontractors, the primary of which was J. Wilson & Associates, Inc. Based on the

1 information identified on the individual invoices, the hours incurred pertained to Iatan
2 Oversight (23%), Iatan Project Control (35%), Contracts (7%), Contract Administration
3 (33%) and other (1%). Of the hours identified as “project control”, 79% were incurred
4 by J. Wilson & Associates.

5 **Q: How does this breakdown compare with Staff’s breakdown?**

6 A: As discussed beginning on page 80 of its Report, Staff contended that only 20% of the
7 total costs incurred by Schiff Hardin, after excluding all out-of pocket costs, related to
8 legal services while 80% applied to non-legal services such as project controls.

9 KCP&L’s analysis indicates that only 35% of the hours billed relate to project controls,
10 and that those hours were substantially incurred, *i.e.*, 79%, by J. Wilson and Associates.

11 **Q: Why is it significant that the majority of project control services were provided by**
12 **J. Wilson & Associates?**

13 A: As shown on the analysis, the average billing rate by J. Wilson & Associates over the
14 period reviewed was \$174 per hour. In Staff’s disallowance workpapers, they assign the
15 project control work (estimated at 80%) to four specific Schiff Hardin employees,
16 computing a weighted billing rate of \$322 per hour. The weighted rate was calculated
17 using assumptions regarding the percent of time incurred by each individual multiplied
18 by that individual’s 2009 billing rate. Staff compared the \$322/hour weighted billing rate
19 with the \$185/hour weighted billing rate of LogOn Consulting, an excess of \$137/hour,
20 and computing an adjusted rate of 58% ($\$185/\322). Staff applied this 58% adjusted rate
21 to 80% of the incurred costs, after eliminating the out-of pocket costs. This resulted in a
22 proposed disallowance of 42% or \$5,353,124 for both Iatan 1 AQCS and Iatan 2 In
23 actuality, if the \$174/hour weighted billing rate of J. Wilson & Associates was compared

1 with the \$185/hour weighted billing rate of LogOn Consulting, there would be no
2 recommended disallowance.

3 **Q: How would the total hours have been distributed if only the hours incurred by**
4 **Schiff Hardin personnel had been considered?**

5 A: If only hours incurred by Schiff Hardin personnel were considered, then the statistics
6 would reflect Iatan Oversight (32%), Iatan Project Control (10%), Contracts (10%),
7 Contract Administration (46%) and other (2%).

8 **Q: Why is this significant?**

9 A: Staff contended that only 20% of the costs incurred by Schiff Hardin for Iatan projects
10 were legal in nature. KCP&L believes that it derived substantial benefit from having a
11 single construction law firm deliver the wide-range of required construction-related
12 services. Regardless, KCP&L believes that a substantially higher proportion of services
13 were legal in nature and could not have been completed equally well by non-lawyers. As
14 shown above, only 10% of services provided by Schiff Hardin related to project control.

15 **Q: How did Staff calculate the value of its proposed disallowance?**

16 A: As explained beginning on page 87 of the Iatan Report, Staff computed an estimated
17 weighted billing rate for four specific Schiff Hardin personnel, using assumptions
18 regarding the percent of time incurred by each individual multiplied by that individual's
19 2009 billing rate. This resulted in an assumed weighted billing rate of \$434 per hour.
20 Next, they computed comparable weighted billing rates for each person using the Laffey
21 Matrix, a listing of hourly rates for attorneys and paralegals of varying experience levels.
22 These comparable rates were reduced by 10% to apply an assumed volume discount that
23 Staff believed should have been negotiated for a project of this size. These two previous

1 steps resulted in a weighted billing rate of \$305 per hour. The \$305/hour represented
2 70% of the estimated Schiff Hardin weighted rate of \$434. The 70% was applied to the
3 20% of costs previously determined to be legal in nature to arrive at adjusted costs and a
4 30% proposed disallowance totaling \$936,179.

5 **Q: Do you agree with the method used to calculate this proposed disallowance?**

6 A: No. KCP&L believes that the rates paid to Schiff Hardin for services provided were
7 reasonable and appropriate. That being said, Staff used assumptions that were
8 inappropriate. The calculation of the weighted billing rate for Schiff Hardin was based
9 on only four lawyers and one paralegal. Additionally, the proportion of time for each of
10 these four individuals was estimated without supporting analysis. As indicated above, the
11 majority of the project control work was performed by J. Wilson & Associates. Only
12 2,700 of the 26,000 hours charged by Schiff Hardin personnel were for project control.
13 The remainder of the hours charged by the more than 17 people who charged time to the
14 project was for project oversight, contracts and contract administration. The actual
15 weighted hourly rate for the complete group of individuals was \$297/hour as opposed to
16 the \$434/hour weighted rate computed by Staff for the small subset of four people.

17 In addition, it would appear that Staff fundamentally misunderstands Schiff
18 Hardin's role. Staff's claim that "the selection of Schiff was primarily influenced by
19 KCPL management's desire to be prepared to defend and protect itself from any charges
20 of unreasonable, inappropriate or imprudence decisions and not about conducting the
21 day-to-day project management work required to complete a significant construction
22 project on time and on budget" is similarly unsupported and incorrect. Iatan Report, at p.
23 73. In fact, the exact opposite is true. Schiff Hardin's role was to support KCP&L in its

1 efforts to complete the Iatan projects on time and on budget. Schiff Hardin fulfilled that
2 role very well. It is not clear to me on what Staff bases its assertion.

3 **Q: How does this actual weighted rate/hour based on KCP&L's analysis of the actual**
4 **billed costs compare with the Staff's weighted rate/hour based on the Laffey**
5 **Matrix?**

6 A: The actual \$297/hour weighted rate for Schiff Hardin personnel is slightly less than the
7 \$305/hour rate calculated by Staff, even after applying a presumed volume discount to
8 the Laffey Matrix values. Consequently, such a comparison if done correctly would
9 result in no disallowance.

10 **Q: Do you have any other issues with how Staff calculated its proposed disallowance of**
11 **Schiff Hardin Costs?**

12 A: Yes. Staff disallowed \$2.8 million because they had not yet been provided copies of the
13 underlying invoices.

14 **Q: Do you agree with this proposed disallowance?**

15 A: No. The Company routinely accrues costs prior to the payment of the underlying
16 invoices. The amounts disallowed by Staff were accrued in June 2010, the Staff's cutoff
17 date, based on estimates received from Schiff Hardin of amounts not yet invoiced.
18 Subsequent to that time, all invoices disallowed by Staff have been received from and
19 paid to Schiff Hardin and have been provided to Staff.

1 *It was unnecessary and consistent with KCP&L policies not to solicit bids for the services*
2 *Schiff Hardin provided in support of the Iatan projects.*

3 **Q: Please respond to Staff’s allegation that KCP&L should have solicited bids and**
4 **undertaken a formal RFP process to select a provider of legal services for the Iatan**
5 **projects.**

6 A: As a preliminary point, Staff’s claim that KCP&L’s decision not to solicit bids for this
7 work is a “violation of [KCP&L’s] own procurement policies” is not correct. Iatan
8 Report, at p. 78. KCP&L’s procurement policies authorize the Company to procure
9 professional or highly technical services without undertaking a formal RFP process. As I
10 discuss above, KCP&L recognized that the construction of the Iatan projects would be
11 challenging and complex. KCP&L recognized that it needed highly competent legal
12 counsel with knowledge and experience specific to projects similar to Iatan projects. One
13 would be hard pressed to find a team with as much expertise and experience in power
14 plant construction issues as Schiff Hardin.

15 The real question is whether Schiff Hardin’s fees were reasonable in the context
16 of the facts and circumstances of their work in support of the Iatan projects. As I discuss
17 above, it was not only reasonable but prudent to hire Schiff Hardin even if other lawyers
18 could have been hired at a lower hourly rate. KCP&L was not required to solicit bids for
19 legal support for the Iatan projects and Staff’s analysis fails to raise serious doubts that
20 imprudent costs were incurred as a result of KCP&L’s decision to hire Schiff Hardin
21 without undertaking a formal RFP process.

1 *It was unnecessary and consistent with KCP&L's contract with Schiff Hardin not to*
2 *provide written approval of changes to Schiff Hardin's hourly rates.*

3 **Q: Please respond to Staff's allegation that KCP&L should have sent written approval**
4 **to Schiff Hardin of changes in its rates.**

5 A: As a preliminary point, Staff's claim that "KCPL intentionally decided not to enforce the
6 terms and conditions of its contract with Schiff that require rate increases to be approved
7 in advance" is not correct. Iatan Report, at p. 76. Staff's criticism is that KCP&L did not
8 provide written approval to Schiff Hardin in response to notifications of its changes in
9 rates. KCP&L's contract with Schiff Hardin did not require written approval of such
10 changes. In addition, my experience both at two large law firms and as in-house counsel
11 is that many lawyers change their hourly rates on an annual basis, and that while that is
12 always communicated to the client, I am not aware of it being a common practice for the
13 client to provide a written response to the lawyer "approving" the new rate. The more
14 common practice is to discuss the change with the client, and the client formally accepts
15 the change by paying the bill on which the new rates appear.

16 More to the point, the real question, which Staff's criticism does not really speak
17 to, is whether Schiff Hardin's fees were reasonable in the context of the facts and
18 circumstances of their work in support of the Iatan projects. As I discuss above, Schiff
19 Hardin's rates were reasonable and their fees were prudently incurred. The mechanism
20 by which KCP&L approved changes in hourly rates seems to have very little to do with
21 that.

1 *It was unnecessary and consistent with KCP&L's contract with Schiff Hardin not to*
2 *require Schiff Hardin to provide with its invoices a copy of the receipt for each expense.*

3 **Q: Please respond to Staff's allegation that KCP&L should have required Schiff**
4 **Hardin to submit with its invoices for legal services a copy of every receipt for**
5 **expenses.**

6 A: As a preliminary point, Staff's claim that KCPL failed to enforce the terms and
7 conditions of its contract with Schiff Hardin or violated its own procurement practices by
8 not requiring Schiff Hardin to provide copies of receipts with its invoices is not correct.
9 On this basis, Staff proposes to disallow 100% of Schiff Hardin's expenses. Staff's
10 recommendation is unreasonable and extreme. Staff is in essence saying that not a single
11 penny of Schiff Hardin's expenses should be recovered, not because they were imprudent
12 or excessive, but because Staff did not have receipts to look at. Again, the real question,
13 which Staff's allegations do not speak to, is whether Schiff Hardin's fees, including
14 expenses, were reasonable in the context of the facts and circumstances of their work in
15 support of the Iatan projects. As I discuss above, Schiff Hardin's fees, including
16 expenses, were reasonable and those costs were prudently incurred.

17 **Q: Did KCP&L apply reasonableness checks before reimbursing Schiff Hardin for**
18 **these expenditures?**

19 A: Yes. Each invoice submitted by Schiff Hardin included a section itemizing expenses,
20 including the date incurred, description of the expenditure, person incurring the
21 expenditure, city in which incurred, and the amount. Descriptions included local travel,
22 telephone tolls, duplicating and binding, meals, and other travel expenses for
23 air/lodging/car rental/parking/taxi. A summary of expenses by type was also provided.
24 KCP&L reviewed both the itemized and summarized listings to verify the reasonableness

1 of the charges. KCP&L also requested and received from Schiff Hardin two months of
2 expense receipts, which KCP&L also provided to Staff. KCP&L audited those expense
3 receipts and found no irregularities or other causes of concern.

4 **Q: Is that consistent with your experience working at law firms?**

5 A: Yes. Consistent with what Schiff Hardin has done here, the bills of the law firms I have
6 worked for included a list or summary of expenses, but not the actual receipts for those
7 expenses. Like here, expenses usually account for a very small portion of the bill.

8 **Q: What portion of the fees KCP&L paid to Schiff Hardin is for the expenses Staff
9 seeks to disallow?**

10 A: About 6% of the fees paid to Schiff Hardin have been to reimburse the firm for expenses
11 it has paid out in support of its work on the Iatan projects.

12 **Cushman & Associates' Fees Were Prudently Incurred**

13 **Q: Does Staff recommend to adjust the per hour rate of any vendor other than Schiff
14 Hardin?**

15 A: Yes, Staff also proposes an adjustment based upon the allegation that the hourly rates of
16 Cushman & Associates ("Cushman") were too high. Cushman is a consulting firm hired
17 to assist KCP&L in the development of the Iatan Project Execution Plan. Staff again
18 attempts to benchmark one professional service provider's hourly rate against another
19 without taking into account that there could be legitimate reasons for differences in their
20 rates. Staff simply comes up with what it believes Cushman's rate should have been and
21 proposes to disallow anything paid in excess of that rate.

22 **Q: Do you agree with Staff's proposed disallowances?**

1 A: No. KCP&L determined that Cushman was the best qualified firm to perform the
2 services required because of its previous consulting assistance to KCP&L on the
3 Hawthorn 5 boiler rebuild project.

4 **Q: If the Commission were to find in favor of Staff's position that the rate paid to**
5 **Cushman was not reasonable, do you agree with Staff's calculation of the amount of**
6 **the proposed disallowance?**

7 A: No. I believe Staff's calculation is overstated for two reasons. First, Staff computed a
8 weighted hourly rate for Cushman estimating that higher priced services provided by Mr.
9 Cushman were 70% of the total engagement while the lower priced services provided by
10 Mr. Cushman's associate represented 30% of the total costs. An analysis of the actual
11 invoiced amounts for services provided indicates that costs were incurred with a 57% to
12 43% ratio. Second, because Mr. Cushman and his associate were billed on a fixed cost
13 per day rate, Staff had to translate the daily rate to an hourly rate for comparison with the
14 hourly rate of LogOn Consulting. They did this assuming an 8-hour work day. I believe
15 that it would be more realistic to assume that these consultants worked a minimum 10-
16 hour day. Both of these factors lead to the conclusion that Staff's calculation of its
17 proposed disallowance is overstated, assuming the Commission endorses the underlying
18 rationale for the disallowance.

19 **It Was Appropriate for KCP&L to Provide Mileage Reimbursement For Employees**
20 **Commuting To The Iatan Project Site**

21 **Q: Do you agree with Staff's recommendation to disallow \$59,136 from the Iatan 1**
22 **project for mileage reimbursement paid by KCP&L to workers traveling to the**
23 **Iatan project site?**

1 A: No, I do not. Staff's adjustment is comprised of two parts, both of which are problematic
2 for different reasons. First, Staff proposes to disallow \$51,113 of mileage
3 reimbursements because the Iatan project site was designated as the recipient employees'
4 primary work location. As KCP&L has explained to Staff, even though the Iatan project
5 site was designated as the employees' primary work location, the employees were
6 assigned to Iatan on a temporary basis during the construction and start up of the project.
7 It is appropriate to reimburse mileage costs for these temporary assignments because it is
8 more cost effective than relocating the employees for a five-year period. To require
9 employees to work at the Iatan project site on a temporary, five-year project without
10 compensation for mileage costs would not have been equitable and likely would have
11 been viewed as a deterrent to working on the Iatan projects.

12 The remainder of Staff's proposed disallowance (\$8,023) is derived by arbitrarily
13 disallowing 10% of all other employees' mileage reimbursements, i.e., those employees
14 who did not have the Iatan project site designated as their primary work location. Staff's
15 rationale for disallowing 10% is the potential for errors or miscoding of mileage
16 reimbursements. KCP&L has a process in place to review mileage reimbursements.
17 KCP&L supervisors review employee mileage reimbursements for reasonableness.
18 KCP&L recognizes that some errors may not be detected in such a review. However, it
19 would not be cost effective to audit each reimbursement of every individual employee's
20 mileage records to the degree Staff suggests is necessary.

1 **The Commission Should Reject As Arbitrary And Unsupported Staff's Proposed**
2 **Disallowance To Address "Inappropriate" Charges That Potentially Might Exist**

3 **Q: Do you agree with Staff's recommendation to disallow \$25,000 and \$75,000 for Iatan**
4 **1 and Iatan 2, respectively, for what Staff describes as "inappropriate" charges?**

5 A: No, I do not. This adjustment is similar to the arbitrary proposed disallowance of
6 mileage reimbursements. Obviously any project of this size and scope will have some
7 errors in coding of charges. However, other than the specific ones Staff has brought to
8 the Company's attention and KCP&L has corrected there is no basis for this adjustment.
9 Staff arbitrarily chose \$25,000 and \$75,000 for Iatan 1 and Iatan 2, respectively, because
10 that amount "should be adequate in the Staff's opinion" That is not the sound basis
11 for a disallowance and disregards the requirement for Staff to identify an imprudent act or
12 decision, then quantify its impact on the cost of the Iatan projects. It is not apparent that
13 any more "inappropriate" charges exist than those Staff has identified and the Company
14 has corrected. Staff's proposal to disallow potential "inappropriate" charges that might
15 exist is arbitrary, unsupported and should be rejected.

16 **STAFF'S RECOMMENDED ROE IS UNREASONABLE, UNSUPPORTED,**
17 **AND WOULD ULTIMATELY BE HARMFUL TO KCP&L AND ITS CUSTOMERS.**

18 **Q: Why is Staff's recommended ROE unreasonable?**

19 A: Staff recommends an ROE range for KCP&L of 8.5% - 9.5%. The flaws in Staff's
20 analysis to arrive at that range is discussed in the Rebuttal Testimony of Dr. Hadaway. I
21 speak to the general reasonableness of Staff's recommendation.

22 **Q: Please explain.**

23 A: Staff's recommended ROE does not balance the interest of KCP&L and its customers.
24 Staff's recommendation is also inconsistent with the ROEs this Commission has recently
25 awarded. It is also inconsistent with the ROEs currently being awarded elsewhere in the

1 country. Although unreasonably low ROEs are often described as a shareholder problem,
2 that is a shortsighted and oversimplified view. If common stock and fixed-income
3 investors have concerns about whether a utility will receive fair and reasonable
4 ratemaking treatment, a likely implication is a higher cost of capital, which, in turn,
5 would ultimately be borne by the utility's customers.

6 **Q: How does the data indicate that Staff does not balance the interests of KCP&L and**
7 **its customers?**

8 A: Staff's entire range is below the customer recommended ROE of 9.65% sponsored by
9 Mr. Gorman. If Staff is balancing the interests of KCP&L and its customers, its ROE
10 recommendation should not be the lowest. It should be in the middle—between what the
11 Company and its customers believe is appropriate.

12 **Q: Is it unusual for Staff to recommend an ROE lower than that recommended by**
13 **consumer advocates?**

14 A: No. In each of the three prior rate cases under KCP&L's Regulatory Plan, Staff proposed
15 an ROE lower than the ROE recommended by the Office of Public Counsel ("OPC"). In
16 the first rate case, Case No. ER-2006-0314, Staff recommended an ROE range of 9.32%-
17 9.42%. Staff's entire range was below OPC's recommended ROE of 9.9%. In the
18 second rate case, Case No. ER-2007-0291, Staff recommended an ROE range of 9.14%-
19 10.3%. While OPC's recommended ROE of 10.1% was within Staff's range in that case,
20 OPC's recommendation was 38 basis points above the 9.72% midpoint of Staff's range.
21 In the third rate case, Case No. ER-2009-0089, Staff recommended an ROE of 9.25%-
22 10.25%. Staff's entire range was below OPC's recommended ROE of 10.3%. In each
23 rate case under the Regulatory Plan, Staff's recommended ROE has been lower than

1 OPC's. If Staff is balancing the interests of KCP&L and its customers, that should not
2 occur.

3 **Q: How do Staff's ROE recommendations in other utilities' rate cases compare to the**
4 **ROE recommendations of consumer advocates in those cases?**

5 A: Similar to what KCP&L has seen in its cases, in other utilities' rate cases Staff
6 consistently recommends a lower ROE than the ROE recommendations of OPC or other
7 consumer advocates in the cases. In Schedule CDB2010-3, I summarize the ROE
8 recommendations in electric utility rate cases for the last five years. Staff's ROE
9 recommendation is consistently the lowest.

10 **Q: How does Staff's recommended ROE compare to the ROEs being awarded by other**
11 **public utility commissions elsewhere in the country?**

12 A: Staff's recommended ROE range of 8.5%-9.5% is significantly lower than the ROEs
13 other public utility commissions are awarding elsewhere in the country. As noted in
14 Staff's COS Report, the average authorized ROE for electric utility companies for the
15 first three quarters of 2010 was 10.36%, 86 basis points more than the top of Staff's
16 range, and 186 basis points more than the bottom of their range.

17 **Q: How does the 10.36% national average for an awarded ROE for the first three**
18 **quarters of 2010 compare to ROEs awarded in recent years?**

19 A: According to SNL Financial, the average ROE awarded in 2009 for electric utilities was
20 10.52%. In 2008, the average was 10.37%. In 2007, it was 10.31%. In 2006, it was
21 10.35%, all as summarized in Schedule CDB2010-3.

22 **Q: Are you aware of the national average ever dropping below 10%?**

1 A: I reviewed SNL data going back to 1989. In no year did the national average awarded
2 ROE for an electric utility drop below 10%.

3 **Q: Did your review of other ROEs recently awarded elsewhere in the country turn up**
4 **any examples that would be of interest to this Commission?**

5 A: Yes. On August 25, 2010, the Indiana Utility Regulatory Commission (“IURC”) issued a
6 rate case order in a Northern Indiana Public Service Company (“NIPSCO”) rate case that
7 is rather informative, especially with respect to the reasonableness of Staff’s
8 recommended ROE range in this case. The portion of the IURC’s order addressing
9 NIPSCO’s authorized ROE is attached as Schedule CDB2010-4. In the NIPSCO case,
10 the IURC authorized an ROE of 9.9%--one of the lowest in the country. However, it is
11 clear from the order that the IURC viewed an authorized ROE of 9.9% as both punitive
12 and temporary. The IURC noted that “NIPSCO was in the bottom quartile of the J.D.
13 Power studies in 2007 and 2008, and one of the worst-rated utilities in 2009.” *NIPSCO*
14 *Order*, at p. 32. The IURC noted that it

15 has a unique role in regulating its jurisdictional utilities, which at times
16 requires us to send a clear and direct message to utility management
17 concerning the need for improvement in the provision of its utility service.
18 Our determination of the authorized cost of common equity capital can be
19 a very direct means to incent improved service. We anticipate that
20 NIPSCO will respond accordingly and therefore anticipate that such
21 authorized cost of common equity capital will apply for a limited duration
22 as identified below.

23 *NIPSCO Order*, at p. 32. The IURC then directed NIPSCO to file a rate case no later
24 than September 30, 2010, recognizing that “a higher return may be appropriate if
25 NIPSCO is able to demonstrate improved company performance in its next base rate
26 proceeding.”

27 **Q: How is the NIPSCO Order relevant here?**

1 A: This Commission is clearly not bound by the rationale or conclusions reached by another
2 commission. However, for perspective, it is important to note that Staff's entire
3 recommended ROE range of 8.5%-9.5% is below an ROE that another Commission
4 found to be both punitive and temporary. In the NIPSCO Order, the IURC authorized an
5 ROE as low as 9.9% "to send a clear and direct message to utility management
6 concerning the need for improvement in the provision of its utility service." It is also
7 important to note that KCP&L's J.D. Power results are very good, in stark contrast to the
8 issues the IURC was trying to address in the NIPSCO case. The IURC's rationale in the
9 NIPSCO Order also supports KCP&L's request for a 25 basis point adder in this case. If
10 it was appropriate for the IURC to reduce NIPSCO's authorized ROE due to poor
11 customer satisfaction results, it would also be appropriate for this Commission to
12 recognize KCP&L's strong customer satisfaction results.

13 **STAFF'S PROPOSAL TO REDUCE KCP&L'S DEPRECIATION EXPENSE**

14 **Q: What is your response to Staff's proposal to depreciate Iatan 2 over 60 years, as**
15 **opposed to the Company's recommendation of 50 years?**

16 A: Iatan 2 was the cornerstone of the Regulatory Plan. There was a collective recognition
17 that the region needed additional, base load, coal-fired generation capacity and that
18 KCP&L was in the best position to build it. KCP&L took on the risk of building the
19 plant. Now, five years later, when the plant is complete and providing power to the
20 region, Staff proposes to prolong KCP&L's recovery of the costs it incurred to build the
21 plant. Over the next 50 years, the Commission will have countless opportunities to adjust
22 the depreciation rate for Iatan 2 if it appears the unit will run for more than 50 years,
23 which is significant given the potential for carbon legislation at some point that could

1 impact the lives of coal-fired power plants. To presume a 60-year life now penalizes
2 KCP&L from a cash flow perspective and sends the wrong signal to utilities and the
3 investment community about how large-scale utility construction projects are treated in
4 the State of Missouri.

5 **Q: Is Staff's proposal to reduce KCP&L's depreciation expense by about \$15 million**
6 **reasonable?**

7 A: No. John Spanos provides a detailed, technical response to Staff's proposed depreciation
8 treatment. In addition to those technical deficiencies, it is important to note the practical
9 impact of Staff's depreciation recommendation on the Company. Without increasing
10 rates, a utility's annual depreciation expense largely reflects the amount a utility can
11 spend on replacement capital projects. Replacement capital spending is intended to
12 maintain or replace existing infrastructure. Additional capital is needed to build new
13 infrastructure, such as to satisfy new demands on the system or to satisfy new mandates.
14 Practically speaking, if an adequate depreciation expense is not allowed in a utility's
15 rates, capital that might otherwise be spent on new infrastructure will need to be allocated
16 to maintain existing infrastructure. With renewable mandates in both Missouri and
17 Kansas, required environmental investments on the horizon, as well as continued
18 investments to maintain the reliability of our transmission and distribution system,
19 KCP&L will need to make significant capital investments over the next several years.

20 Inadequate depreciation expense would also reduce cash flow and hurt KCP&L's
21 credit metrics, as it would decrease the Company's funds from operations and increase its
22 debt requirements. The ratio of funds from operations to debt and the ratio of total debt
23 to total capitalization are two of the key metrics credit rating agencies consider when

1 assessing a company's creditworthiness. Although reducing a utility's depreciation
2 expense might appear to be an attractive way to mitigate a rate increase request, the
3 resulting cash flow impacts would ultimately be negative for the utility and its
4 customers.

5 **INDUSTRIALS' PROPOSAL TO CHANGE HOW KCP&L GIVES**
6 **OFF-SYSTEM SALES MARGINS TO CUSTOMERS**

7 **Q: Does KCP&L currently give all of its off-system sales margins to its retail**
8 **customers?**

9 A: Yes, and then some. Although KCP&L believes there are good reasons why a utility's
10 shareholders and customers should share off-system sales margins, KCP&L has not
11 requested such a sharing mechanism as part of this case. In actuality, KCP&L currently
12 returns more than all of its off-system sales margins to its customers. Because Missouri
13 and Kansas adopt different allocation methodologies to derive what portion of the
14 margins KCP&L's Kansas and Missouri customers should receive, KCP&L presently
15 gives to its customers about 105% of its off-system sales margins. That is punitive and
16 should stop, but requires this Commission and the KCC to adopt the same allocation
17 methodology, which to date they have chosen not to do. This allocation issue is
18 addressed in the Rebuttal Testimony of Larry Loos.

19 **Q: How does KCP&L give off-system sales margins to its Missouri customers?**

20 A: Because KCP&L does not have a fuel adjustment clause through which to give its
21 Missouri customers its off-system sales margins, KCP&L gives those margins to
22 customers in two steps. First, a certain amount of forecasted off-system sales margins are
23 credited against KCP&L's revenue requirement. That is, KCP&L's retail rates presume
24 KCP&L realizes at least that level of margins as an offset to the costs KCP&L incurs to

1 serve its retail customers in Missouri. KCP&L is entirely at risk for realizing those
2 funds. There is no way for KCP&L to be made whole if that presumed level of margins
3 is not ultimately realized. Any level of margins above that established threshold is given
4 to customers in subsequent rate cases.

5 **Q: How do MEUA, MIEC, and Praxair propose to modify how KCP&L gives off-**
6 **system sales margins to customers?**

7 A: Through the testimony of Mr. Meyer, those industrial customers want to significantly
8 increase the portion of KCP&L's off-system margins that are presumed to be realized in
9 KCP&L's Missouri retail rates. That level is set using a probabilistic analysis of the
10 likelihood of KCP&L realizing a particular level of margins, as explained in the Direct
11 Testimony of Michael Schnitzer. Currently, the level of margins KCP&L is presumed to
12 earn is set at the 25th percentile in recognition of the fact that KCP&L is entirely at risk
13 for realizing that amount, and there is no way for KCP&L to be made whole if that level
14 of margins is not ultimately realized. The Commission has used the 25th percentile in
15 KCP&L's prior three rate cases. In this case, MEUA, MIEC, and Praxair propose to
16 increase the level of margins for which KCP&L is entirely at risk to the 40th percentile.

17 **Q: What is your response to Mr. Meyer's proposal?**

18 A: Mr. Meyer does not present a sound basis for changing the policy the Commission has
19 adopted in KCP&L's last three rate cases. Moreover, adopting Mr. Meyer's proposal
20 would put KCP&L at significant risk of not recovering the revenue requirement this
21 Commission deems to be just and reasonable for KCP&L. Due to factors beyond its
22 control, KCP&L has not always realized the 25th percentile level of margins since the
23 first case when the 25th percentile was established. Prices in the wholesale power market

1 have fallen dramatically due to lower natural gas prices, and the recession has reduced
2 demand for electricity in the wholesale markets. These factors are entirely beyond
3 KCP&L's control and it would be inappropriate to subject KCP&L to that risk.

4 KCP&L will give all (potentially more than all) of its off-system sales margins to
5 its customers under both its approach and Mr. Meyer's. The issue is how much of
6 KCP&L's authorized revenue requirement should be placed at risk. The 25th percentile
7 strikes a better balance than the 40th percentile. The Commission should deny Mr.
8 Meyer's request to alter the policy the Commission has adopted in KCP&L's prior three
9 rate cases.

10 **HAWTHORN 5 SCR IMPAIRMENT SETTLEMENT**

11 **Q: What is the issue regarding Hawthorn 5 ("H5") SCR settlement?**

12 A: Commission Staff witness Karen Lyons proposes that KCP&L reflect the \$2,800,000
13 settlement proceeds recorded by the Company in 2007 related to the performance
14 standards of an H5 SCR placed in service in 2001 as an increase to the depreciation
15 reserve and a decrease in depreciation expense, as if the plant cost had been adjusted for
16 the total settlement proceeds received.

17 **Q: What reasoning did Ms. Lyons give to support her position?**

18 A: Ms. Lyons, in Staff's COS Report, page 109, states

19 KCPL's customers should receive the benefit of the settlement with B&W
20 since they paid the costs KCPL incurred because of the substandard
21 performance of the plant. All the increased costs to KCPL were and are
22 currently being paid by KCPL customers in utility rates. These costs
23 include the salaries and benefits, office space, and all employee-related
24 costs of KCPL's attorneys and employees who worked on this dispute
25 between KCPL and B&W.

26 **Q: Do you agree with Ms. Lyons?**

1 A: No, I do not. Some background is appropriate to establish the context of these proceeds.
2 KCP&L received these proceeds in 2007, two years prior to the test year in this case.
3 The proceeds were related to damages awarded to the Company primarily for
4 reimbursement of incremental purchased power costs, as well as to reimburse KCP&L
5 for increased ammonia consumption, increased catalyst cleaning and increased frequency
6 of catalyst replacements.

7 **Q: Why do you believe these proceeds should not be given to customers?**

8 A: There are several reasons why the proceeds should not be flowed back:

9 (1) The proceeds of this litigation have nothing to do with the test year in this case.

10 (2) The cost of replacement power and additional ammonia expenses that resulted from
11 the H5 catalyst outage (representing about 90% of the settlement proceeds) was never
12 paid by customers.

13 (3) To the extent KCP&L personnel were included in the process there would not have
14 been any incremental costs to the Company or in turn its customers.

15 (4) This issue represents retroactive ratemaking, which is not appropriate, whether for the
16 Company's benefit or detriment. I do not think Ms. Lyons would support the
17 Company if it were to propose to reach back to 2007 and charge customers now for
18 the cost of replacement power and additional ammonia expense during this period.

19 **Q: Why were customers not charged for costs of replacement power and additional**
20 **ammonia expenses related to the H5 catalyst outage during 2007, the test year in the**
21 **Company's last rate case?**

22 A: During the period of the H5 catalyst outage, KCP&L did not have a fuel adjustment
23 clause that would have recovered replacement power costs and additional ammonia

1 expenses. KCP&L normalizes fuel and purchase power expenses in its rate cases.
2 KCP&L did not request a rate increase at any time during the outage or subsequent to the
3 outage that resulted in recovery of the replacement power costs and the additional
4 ammonia expenses. Thus, customers have never paid these costs.

5 **Q: What is the purpose of using a normalized test year to set rates?**

6 A: Rates are set for a future period. In this case, rates will become effective in May 2011
7 based on a normalized test year of 2009 trued up for certain items through December 31,
8 2010. Unusual non-recurring events are excluded from test year data because they do not
9 reflect the ongoing operating characteristics or cost of service of the Company. The only
10 means to truly deal with this issue had customers been charged for it in the first place
11 would be to refund the proceeds directly to customers through a fuel adjustment or a one
12 time credit.

13 **Q: Why would a refund be appropriate when customers have never paid for the**
14 **replacement power in the first place?**

15 A: It wouldn't. I simply raise this point to illustrate that one would not refund money that
16 had never been collected in the first place.

17 **Q: Has the Commission dealt with a similar issue in a recent KCP&L rate case?**

18 A: Yes, it has. In the ER-2007-0291 case, the company removed from its case the impact of
19 receiving \$16.9M in subrogation proceeds that were recorded by KCP&L in 2006 related
20 to the H5 boiler explosion that occurred in 1999. The Commission found the issue in
21 favor of KCP&L for precisely the same reasons I raise here. The proceeds received were
22 an unusual non-recurring event that should be excluded from the test period, and more

1 importantly, KCP&L's customers never paid the costs being reimbursed through the
2 settlement.

3 **HAWTHORN 5 TRANSFORMER SETTLEMENT**

4 **Q: What is the issue regarding H5 SCR Impairment settlement?**

5 A: This issue is essentially the same as the H5 SCR settlement issue I just discussed, as well
6 as the H5 subrogation claim from the ER-2007-0291 case. Staff's position here, like the
7 H5 SCR settlement and the subrogation proceeds, is a violation of the "matching"
8 principle and represents retroactive ratemaking. These proceeds were received as a result
9 of activities that happened in a prior period. The corresponding costs are not in this test
10 year. KCP&L's customers never paid the costs being reimbursed by this settlement.
11 KCP&L did not have a fuel adjustment clause that would have recovered replacement
12 power costs. It is no more appropriate to reach back beyond the test year as Staff
13 proposes, than it is for the Company to reach back for rate increases foregone between
14 rate cases.

15 Staff witness Karen Lyons proposes that KCP&L reflect the \$6,689,344
16 settlement proceeds recorded by the Company in 2008 related to the failure of the H5
17 step-up transformer in 2005 as an increase to the depreciation reserve and a decrease in
18 depreciation expense, as if the plant cost had been adjusted for the total settlement
19 proceeds received. That is not appropriate.

20 **Q: What reasoning did Ms. Lyons give to support her position?**

21 A: Ms. Lyons, in Staff's COS Report, page 111, states

22 KCP&L's customers should receive the benefit of the settlement since
23 they are the ones who paid higher costs for the substandard plant
24 performance. All the increased costs to KCP&L of the operation of
25 Hawthorne 5 resulting from the step-up transformer failure were paid by

1 KCP&L customers in its utility rates. These costs include the salaries and
2 benefits, office space, and all employee-related costs of KCP&L's
3 attorneys and employees who worked on KCP&L's dispute with the
4 contractors and subcontractors, increased maintenance, fuel and purchased
5 power expense, and increased expenses that were capitalized to the new
6 plant.

7 **Q: Do you agree with Ms. Lyons?**

8 A: No, I do not. Again, some background is appropriate to establish the context of these
9 proceeds. KCP&L received these proceeds in 2008, one year prior to the test period in
10 this case. The proceeds were related to damages awarded to the Company primarily for
11 reimbursement of incremental purchased power costs.

12 **Q: Why do you believe these proceeds should not be given to customers?**

13 A: For the same reasons noted above for the H5 SCR proceeds. Simply put, KCP&L's
14 customers never paid the costs the settlement reimburses. As such, giving the settlement
15 proceeds to customers would be a windfall to them and a detriment to KCP&L.

16 **Q: Why were customers not charged for costs of replacement power related to the H5
17 step-up transformer failure during 2005?**

18 A: During the period of the H5 step-up transformer failure, KCP&L did not have a fuel
19 adjustment clause that would have recovered replacement power costs. KCP&L
20 normalizes fuel and purchase power expenses in its rate cases. KCP&L did not request a
21 rate increase at any time during the outage or subsequent to the outage that resulted in
22 recovery of the replacement power costs. Thus, customers have never paid these costs.
23 The cost of replacement power that resulted from the H5 step-up transformer failure
24 (representing about 97% of the settlement proceeds) was never passed on to customers
25 during the outage or at any time subsequent to the outage.

1 **STAFF'S PROPOSAL TO REDUCE KCP&L'S ADVERTISING EXPENSE,**
2 **INCLUDING THE COST OF ITS CONNENCTIONS PROGRAM**

3 **Q: What is Staff proposing?**

4 A: Staff proposes two reductions to the amount of advertising costs included in KCP&L's
5 cost of service 1) a \$86,406 (total company) reduction of general advertising costs
6 pertaining to energy efficiency programs and 2) elimination of \$347,000 (total company)
7 representing 50% of the Company's cost of its Connections Program. For both of these
8 items, they propose transfer of the Missouri jurisdictional portions to the deferred DSM
9 regulatory asset for recovery over a ten-year amortization period.

10 **Q: Do you agree with Staff's proposal?**

11 A: No. These costs were incurred to benefit our customers currently as well as in the
12 immediate future. We expect costs of a similar nature to be incurred on an ongoing basis.
13 Consequently it is not appropriate to delay recovery of them over a ten-year period and
14 they should be allowed in current cost of service.

15 **Q: Please describe the Staff's \$86,406 reduction.**

16 A: Staff's \$86,406 reduction was comprised primarily of two items: 1) \$23,043 for energy
17 efficiency kiosks and 2) \$56,872 for development of an energy efficiency website.

18 **Q: Please describe the Company's Connections Program.**

19 A: The Connections Program helps customers access a variety of resources that can make
20 their life easier in the current tough economic environment. The program includes
21 products and services to help customers save energy and money, information about a
22 range of payment options available to them and ways for them to connect to assistance
23 programs in the community.

1 **Q: Does Staff have any substantive concerns with the Connections Program?**

2 A: No. In fact, Staff states that it desires KCP&L to “Continue to conduct as many as
3 feasible Connections campaign Energy Resource Fairs on an annual basis.” COS Report,
4 at p. 139. It does not make sense to encourage the Company to continue the Connections
5 campaign while at the same time requiring it to defer the recovery of certain costs related
6 to the campaign for many years.

7 **Q: If the Commission would agree that these costs should be included in current cost of
8 service, how would this affect Staff’s case?**

9 A: If the Commission agrees that it is proper to include these costs in current cost of service,
10 the Staff must remove them from its DSM regulatory asset as discussed by Company
11 witness John P. Weisensee.

12 **Q: Does that conclude your testimony?**

13 A: Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Application of Kansas City)
Power & Light Company to Modify Its Tariffs to) Docket No. ER-2010-0355
Continue the Implementation of Its Regulatory Plan)

AFFIDAVIT OF CURTIS D. BLANC


STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

Curtis D. Blanc, being first duly sworn on his oath, states:

1. My name is Curtis D. Blanc. I work in Kansas City, Missouri, and I am employed by Kansas City Power & Light Company as Senior Director – Regulatory Affairs.

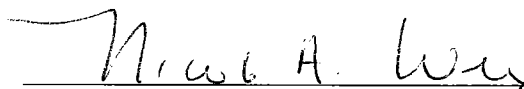
2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Kansas City Power & Light Company consisting of fifty-four (54) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.



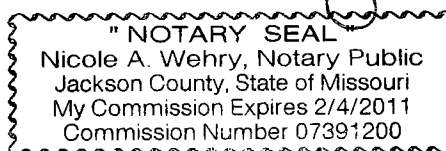
Curtis D. Blanc

Subscribed and sworn before me this 3rd day of December, 2010.



Notary Public

My commission expires: Feb. 4, 2011



Analysis of Costs for Iatan 1 and Iatan 2 Billed by Schiff Hardin through April 2010

| | Dollars (c) - Labor Only | | Group 1 (a) | | Group 2 (b) | | Other Schiff-Hardin | | Subtotal Schiff Hardin | | J. Wilson & Assoc | | Other | |
|------------------------------|--------------------------|-------------|--------------|-------------|---------------|-------------|---------------------|-------------|------------------------|-------------|-------------------|-------------|--------------|-------------|
| | Hours | % of Total | Hours | % of Group | Hours | % of Group | Hours | % of Group | Hours | % of Group | Hours | % of Group | Hours | % of Group |
| Iatan Oversight | 9,231 | 25% | 2,321 | 36% | 5,553 | 41% | 378 | 6% | 8,253 | 32% | 0 | 0% | 978.25 | 100% |
| Iatan Project Controls | 12,755 | 34% | 81 | 1% | 1,502 | 11% | 1,071 | 18% | 2,654 | 10% | 10,101 | 100% | 0.00 | 0% |
| Contracts | 2,577 | 7% | 746 | 11% | 1,704 | 13% | 127 | 2% | 2,577 | 10% | 0 | 0% | 0.00 | 0% |
| Contract Administration | 11,982 | 32% | 3,201 | 49% | 4,631 | 34% | 4,150 | 71% | 11,982 | 46% | 0 | 0% | 0.00 | 0% |
| Kiewit & Boiler Tube | 475 | 1% | 155 | 2% | 163 | 1% | 158 | 3% | 475 | 2% | 0 | 0% | 0.00 | 0% |
| | <u>37,019</u> | <u>100%</u> | <u>6,504</u> | <u>100%</u> | <u>13,552</u> | <u>100%</u> | <u>5,883</u> | <u>100%</u> | <u>25,940</u> | <u>100%</u> | <u>10,101</u> | <u>100%</u> | <u>978</u> | <u>100%</u> |
| Percent - Group 1 and 2 only | | | <u>32%</u> | | <u>68%</u> | | | | | | | | | |
| Staff Assumption | | | <u>20%</u> | | <u>80%</u> | | | | | | | | | |
| Percent- All Billed Hours | | | <u>100%</u> | | <u>37%</u> | | <u>16%</u> | | <u>70%</u> | | <u>27%</u> | | <u>3%</u> | |
| Weighted cost per hour | | | <u>\$267</u> | | <u>\$286</u> | | <u>\$208</u> | | <u>\$297</u> | | <u>\$174</u> | | <u>\$322</u> | |
| Staff Assumption | | | <u>\$434</u> | | <u>\$322</u> | | | | | | | | | |

- a) Per Staff Report, the individuals in this group were performing true "legal" work.
- b) Per Staff Report, the individuals in this group were performing "project control" rather than true "legal" work.
- c) Dollars reflect total amounts billed for direct labor, excluding expenses. Disbursements made by Schiff Hardin to its subcontractors were omitted from the analysis of Schiff Hardin costs and were reflected separately in the analysis based on invoices submitted to Schiff Hardin by the subcontractors. Costs and hours are for the total project before allocation to joint partners.

Summary of ROE History in Missouri Electric Rate Cases (2005-present)

| Year | Utility Company | Requested ROE (%) | Staff ROE (Using Midpoint) (%) | OPC ROE (Using Midpoint) (%) | Intervenor ROE (Using Midpoint) (%) | MPSC Awarded ROE (%) | National Average Awarded ROE (%) | Case No. | Filing Date |
|------------------------|---------------------|-------------------|--------------------------------|------------------------------|-------------------------------------|----------------------|----------------------------------|--------------|-------------|
| 2009 | Empire | 11.00 | 9.40 | NA | NA | NA | NA | ER-2010-0130 | 10/29/2009 |
| | Ameren | 10.80 | 9.35 | 10.20 | 10.00 | 10.10 | 10.10 | ER-2010-0036 | 7/24/2009 |
| | 2009 Average | 10.90 | 9.38 | 10.20 | 10.00 | 10.10 | 10.52 | | |
| 2008 | KCP&L | 10.75 | 9.75 | 10.30 | NA | NA | NA | ER-2009-0089 | 9/5/2008 |
| | GMO | 10.75 | 9.75 | 10.30 | NA | NA | NA | ER-2009-0090 | 9/5/2008 |
| | Ameren | 10.90 | 9.50 | NA | 10.20 | 10.76 | 10.76 | ER-2008-0318 | 4/4/2008 |
| 2008 Average | 10.80 | 9.67 | 10.30 | 10.20 | 10.76 | 10.37 | | | |
| 2007 | Empire | 11.60 | 9.98 [1] | NA | 10.00 | 10.80 | 10.80 | ER-2008-0093 | 10/1/2007 |
| | KCP&L | 11.25 | 9.72 | 10.10 | NA | 10.75 | 10.75 | ER-2007-0291 | 2/1/2007 |
| | 2007 Average | 11.43 | 9.85 | 10.10 | 10.00 | 10.78 | 10.31 | | |
| 2006 | Ameren | 12.00 | 9.25 | 9.65 | 9.80 | 10.20 | 10.20 | ER-2007-0002 | 7/7/2006 |
| | GMO | 11.50 [2] | 9.625 | NA | 10.00 | 10.25 | 10.25 | ER-2007-0004 | 7/3/2006 |
| | Empire | 11.70 | 9.35 [3] | 9.65 | NA | 10.90 | 10.90 | ER-2006-0315 | 2/1/2006 |
| KCP&L | 11.50 | 9.37 | 9.90 | 9.00 | 11.25 | 11.25 | ER-2006-0314 | 1/31/2006 | |
| 2006 Average | 11.68 | 9.40 | 9.73 | 9.60 | 10.65 | 10.35 | | | |
| 2005 | GMO | 11.50 | 9.00 | 9.95 | 9.80 | NA | NA | ER-2005-0436 | 5/24/2005 |
| | Empire | 11.65 | 8.75 | 9.185 | NA | 11.00 | 11.00 | ER-2004-0570 | 4/30/2004 |
| | 2005 Average | 11.58 | 8.87 | 9.57 | 9.80 | 11.00 | 10.51 | | |
| Overall Average | 11.28 | 9.43 | 9.98 | 9.92 | 10.66 | | | | |

[1] Later revised to 10.28%
 [2] Later revised to 11.25%
 [3] Later revised to 9.55%

ORIGINAL



STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF NORTHERN INDIANA PUBLIC SERVICE)
COMPANY ("NIPSCO") FOR (1) AUTHORITY TO MODIFY)
ITS RATES AND CHARGES FOR ELECTRIC UTILITY)
SERVICE; (2) APPROVAL OF NEW SCHEDULES OF RATES)
AND CHARGES APPLICABLE THERETO; (3) APPROVAL)
OF REVISED DEPRECIATION ACCRUAL RATES; (4))
INCLUSION IN ITS BASIC RATES AND CHARGES OF THE)
COSTS ASSOCIATED WITH CERTAIN PREVIOUSLY)
APPROVED QUALIFIED POLLUTION CONTROL)
PROPERTY PROJECTS; (5) AUTHORITY TO IMPLEMENT)
A RATE ADJUSTMENT MECHANISM PURSUANT TO IND.)
CODE § 8-1-2-42(a) TO (A) TIMELY RECOVER CHARGES)
AND CREDITS FROM REGIONAL TRANSMISSION)
ORGANIZATIONS AND NIPSCO'S TRANSMISSION)
REVENUE REQUIREMENTS; (B) TIMELY RECOVER)
NIPSCO'S PURCHASED POWER COSTS; AND (C))
ALLOCATE NIPSCO'S OFF SYSTEM SALES REVENUES; (6))
APPROVAL OF VARIOUS CHANGES TO NIPSCO'S)
ELECTRIC SERVICE TARIFF INCLUDING WITH RESPECT)
TO THE GENERAL RULES AND REGULATIONS, THE)
ENVIRONMENTAL COST RECOVERY MECHANISM AND)
THE ENVIRONMENTAL EXPENSE MECHANISM; (7))
APPROVAL OF THE CLASSIFICATION OF NIPSCO'S)
FACILITIES AS TRANSMISSION OR DISTRIBUTION IN)
ACCORDANCE WITH THE FEDERAL ENERGY)
REGULATORY COMMISSION'S SEVEN-FACTOR TEST;)
AND (8) APPROVAL OF AN ALTERNATIVE REGULATORY)
PLAN PURSUANT TO IND. CODE § 8-1-2.5-1 *ET SEQ.* TO)
THE EXTENT SUCH RELIEF IS NECESSARY TO EFFECT)
THE RATEMAKING MECHANISMS PROPOSED BY)
NIPSCO.)

CAUSE NO. 43526

APPROVED: AUG 25 2010

BY THE COMMISSION:
David E. Ziegner, Commissioner
Aaron A. Schmoll, Senior Administrative Law Judge
Angela Rapp Weber, Administrative Law Judge

FINAL ORDER

equity” is inconsistent with the *Indiana Bell* case and “our guidance [from the Court] could not be clearer”).

Here, the Commission finds that NIPSCO’s actual capital structure shall be used to determine NIPSCO’s cost of capital. Therefore, the Commission will use the capital structure set forth in Petitioner’s Exhibit LEM-5 (2nd Revised), p. 1, but adjusted to include the long-term debt amount of \$906,631,137 shown on Petitioner’s Exhibit VVR-2, p. 1. The adjustment reflects the actual terms of the August 25, 2008 bond remarketing, which are discussed below. Rea Direct at 7.

While we approve NIPSCO’s actual capital structure for purposes of determining NIPSCO’s weighted cost of capital in this Cause, we note that NIPSCO is approaching the edge of what this Commission finds to be a reasonable capital structure for a large investor-owned electric utility. Going forward, we would encourage NIPSCO to take prudent steps to reduce its equity to debt ratio.

B. Cost of Capital.

(1) Petitioner’s Evidence. Ms. Miller calculated NIPSCO’s weighted cost of capital to be 8.37%, based on NIPSCO’s December 31, 2007 actual capital structure, as adjusted, a debt cost rate of 6.56% and a common equity cost rate of 12.00%. Miller Direct at 44; Petitioner’s Ex. LEM-5 (2nd Revised), p. 1. The 6.56% debt cost rate included an estimate of the interest rate and transaction costs that would be incurred in remarketing \$254 million of Jasper County tax-exempt bonds. Rea Direct at 7. Mr. Rea testified that the remarketing occurred only four days before NIPSCO’s case-in-chief was to be filed and NIPSCO did not have time to revise its case-in-chief to incorporate the actual terms. However, he provided a schedule showing the effect on the amount of debt and the weighted cost of debt when the Jasper County debt cost estimates were trued-up to actual. *Id.* at 7-8; Petitioner’s Ex. VVR-2, p. 1. There was only a minor difference, i.e., \$906,631,137 instead of \$906,997,137 and 6.52% instead of 6.56%. Dr. Woolridge used the estimated 6.56% debt rate. Public’s Ex. JRW-1. Mr. Gorman used the actual amount and rate. IG Ex. MPG-1. Although the impact on NIPSCO’s cost of capital is very slight, we find the actual amount and rate shown in Petitioner’s Exhibit VVR-2, p. 1, should be used in determining NIPSCO’s cost of capital.

NIPSCO proposed a cost of common equity rate of 12.00% through the testimony of Mr. Moul. Mr. Moul considered the risk factors that affect electric utilities in general and NIPSCO in particular. He noted that electric utilities, including NIPSCO, face substantial increases in operating and capital costs due to increasingly stringent environmental regulations including future greenhouse gas regulation. He noted environmental investments increase risk without adding to a utility’s generating capacity and this risk is aggravated by the “moving target” nature of evolving environmental regulation. He said NIPSCO’s risk profile is strongly influenced by the magnitude of its sales to industrial customers that represent 53% of its sales in kWh but are less than 1% of its customers. Mr. Moul testified that NIPSCO’s industrial sales far exceed the utility average. He said 64% of NIPSCO’s industrial sales are to steel-related industries that face international competition, increased costs and fluctuating demand for their products. Mr. Moul pointed out that the credit rating agencies have cited Indiana’s high level of industrial employment and high concentration of steel, chemical, metals, auto parts and refining businesses as creating risks for NIPSCO. According to Mr. Moul, NIPSCO is exposed to significant sales and bad debt risk because of the magnitude of its industrial load and the reliance of its service

area on heavy industry. Moul Direct at 7-8. Mr. Moul also discussed NIPSCO's substantial future capital expenditure requirements and stated a fair rate of return will be key to attracting the capital necessary to meet NIPSCO's needs. *Id.* at 9.

Mr. Moul developed a proxy group of publicly traded utility companies ("Electric Group" or "Group") for use in the models he applied to estimate NIPSCO's cost of equity. These companies are all included in Value Line Investment Survey ("Value Line"), have electric utility subsidiaries that are Midwest ISO members or formerly had transmission assets that were transferred to separate Midwest ISO-participating transmission companies, have not recently reduced their common dividend and are not the target of a merger or acquisition. Moul Direct at 4; Petitioner's Ex. PRM-2, p. 7. Mr. Moul then compared NIPSCO and the Group with respect to nine separate risk factors. He concluded that on some counts NIPSCO's risk is higher than the Group and on other counts lower or approximately equal. On balance, he considered the factors to average out so that, in Mr. Moul's opinion, the Group provides a reasonable basis for measuring NIPSCO's cost of equity.

Mr. Moul first applied the discounted cash flow approach. This model considers the cost of equity to be equal to a stock's dividend yield plus expected long-term growth. In applying the model, Mr. Moul used a divided yield of 4.54% based on the average dividend yield for the Electric Group for the six months ended May 2008 adjusted to a forward-looking basis using three generally accepted methods to reflect the prospective nature of dividends. Mr. Moul used a growth rate of 6.50% after analyzing historical and forecasted per share growth in earnings, dividends, book value and cash flow for the members of the Electric Group. Mr. Moul gave the greatest emphasis to projected earnings per share ("EPS") growth because he considered it to be the principal focus of investor expectations. Moul Direct at 18-19.

Mr. Moul said the historical rates were not good measures for the Electric Group because they include many negative rates of change that provide no reliable guide to gauge investor expectation of future growth. He explained rational investors expect positive returns on their investments. Moul Direct at 22. Mr. Moul commented that Professor Myron Gordon, the foremost proponent of the use of the DCF model in rate cases, concluded EPS forecasts were the best measure of the DCF growth rate. *Id.* at 25. Mr. Moul added a flotation cost adjustment of 0.17% to cover issuance expenses. *Id.* at 28; Petitioner's Ex. PRM-1, Appendix E. To support the flotation cost adjustment, Mr. Moul provided issuance expenses in public offerings of electric utility stocks from 2003 to 2007. Petitioner's Ex. PRM-2, p. 14, Sch. 8. The result of Mr. Moul's DCF analysis was a cost of equity rate of 11.21%, i.e., 4.54% + 6.50% + 0.17. *Id.*

Mr. Moul also performed a risk premium analysis. This method determines the cost of equity by adding a premium to corporate bond yields to account for the fact that the equity investor is exposed to greater risk than debt capital. Moul Direct at 28-29. In this approach, Mr. Moul used a 6.00% estimate of the prospective yield on long-term A-rated public utility bonds. The 6.00% yield was based on consensus forecasts of 30-year treasury bond yields reported in Blue Chip Financial Forecasts ("Blue Chip") plus 1.50% representing the spread between returns on utility bonds and treasury bonds during recent three month, six month and twelve month periods. *Id.* at 30. Mr. Moul developed a 5.50% equity risk premium by first comparing the difference in market returns on utility stocks in the S&P Public Utility Index and market returns on utility bonds during four different historical time periods, each of which began with a financial market defining event. Mr. Moul then made a downward adjustment for the risk differences between the S&P Public Utility Index and his Electric Group. *Id.* at 32-33. He then

added the 0.17% flotation cost adjustment to derive a risk premium result of 11.67, i.e., 6.00% + 5.50% + 0.17%. Moul Direct at 34.

Mr. Moul also applied the Capital Asset Pricing Model ("CAPM") approach which measures the cost of equity as the yield on a risk-free interest bearing obligation plus an equity risk premium proportional to the non-diversifiable or systematic risk of an investment. Moul Direct at 34; Petitioner's Ex. PRM-1, Appendix H, p. H-1. Mr. Moul used a 4.50% risk-free rate based on recent historical yields on long-term treasury bonds, Blue Chip forecasts and the recent trend. *Id.* at 35-36. In the CAPM, systematic risk is represented by a company's beta which measures how the stock price changes compared to the overall market. Mr. Moul used a beta of 0.85 which is the average of the Value Line betas for the companies in the Electric Group. *Id.* at 35. Mr. Moul selected a market premium of 8.44% by averaging the difference between (a) historical market returns and treasury bond returns (6.5%) and (b) the difference between forecasted market returns and treasury bond returns (10.37%). The historical market premium was derived from data published by Ibbotson Associates in *Stocks, Bonds, Bills and Inflation Yearbook* ("SBBP") for the period 1926-2007. Mr. Moul said arithmetic mean returns were used because the CAPM is a single period model. He quoted an explanation from SBBP as to why arithmetic returns must be used. Petitioner's Ex. PRM-1, Appendix H, p. H-6. Mr. Moul added a size premium of 0.92% to adjust for the size of the Electric Group. This adjustment reflects the size premium for mid-capitalization stocks published in SBBP. He also added the 0.17% flotation cost adjustment. These inputs produced a CAPM result of 12.76%, i.e., 4.50% + (0.85 × 8.44%) + 0.92% + 0.17%.

Mr. Moul also pointed out that in *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923), the United States Supreme Court held a public utility is entitled to rates that will permit it to earn a return on the value of its property equal to that generally being made on investments in other business undertakings which are attended by corresponding risks. Therefore, Mr. Moul testified, it is important to identify the returns earned by comparable risk companies that compete for capital with the public utility and are subject to competitive marketplace forces. Moul Direct at 38-39. To implement this approach, Mr. Moul applied the following screening criteria to identify non-utility companies followed by Value Line that reflect the risk of the Electric Group – Timeliness Rank, Safety Rank, Financial Strength, Price Stability, Betas and Technical Rank. *Id.* at 39. Mr. Moul considered a ten year business cycle for these firms consisting of five historical years and five projected years. The historical return on equity of 15.4% and the projected return on equity of 16.0% were averaged to produce a Comparable Earnings result of 15.70%. *Id.* at 40-41.

Mr. Moul then considered the results of each of his approaches to analyzing NIPSCO's cost of equity. He recommended that the Commission find a cost of common equity for NIPSCO of 12.00% to be reasonable. He explained that the average of the DCF and CAPM results were 11.99%, the average of the three market models (DCF, CAPM and Risk Premium) was 11.88% and the average of all four methods was 12.84%. Moul Direct at 6. Mr. Moul said his proposed 12.00% cost of equity made no provision for the prospect that the rate of return may not be achieved due to unforeseen events such as unexpected spikes in costs, abrupt changes in customer usage and abnormal weather. *Id.*

(2) OUCC's Evidence. Dr. Woolridge testified in support of the OUCC's recommendation that the Commission find NIPSCO's cost of common equity to be 10.00%. Dr. Woolridge first discussed the effect of the current financial crisis on the difference

in yields on treasury bonds and utility bonds, noting that the differential increased significantly due to tightening credit markets and the flight to quality that drove treasury yields to historic lows. But he stated the differential has declined over the past several months. Woolridge Direct at 7. Dr. Woolridge recognized that the credit market for corporate and utility debt experienced higher rates due to the credit crisis and that the long-term market remains tight, but he said the market has improved in response to unprecedented actions by the federal government. *Id.* at 10-11. Dr. Woolridge expressed his opinion that the Obama administration is committed to bringing the economy around, utilities are likely to benefit under an Obama administration, the worst of the credit crisis appears to be over and credit spreads, while still high, have declined. *Id.* at 11-12. Dr. Woolridge asserted his viewpoint that the volatility of stocks relative to bonds has declined recently and relied on an article authored by employees of McKinsey & Co., a consulting firm, expressing the opinion that the financial crisis has not significantly changed McKinsey's long-term estimate of the equity risk premium.⁶ *Id.* at 12-14. Dr. Woolridge also believed utility stocks have held up well compared to the overall market. *Id.* at 15.

Dr. Woolridge used two market-based models to estimate NIPSCO's cost of equity – a DCF model and a CAPM. To apply these models, he selected a nine member Electric Proxy Group consisting of companies that are listed as an electric utility or combination electric and gas company by AUS Utility Reports, listed as an electric utility by Value Line, have at least 75% regulated electric revenues, have operating revenues less than \$10 billion, have a 3-year history of paying dividends with no actual or pending cuts, and have an investment grade bond rating. Woolridge Direct at 15-16.

Before applying his models, Dr. Woolridge testified that in equilibrium the market value of a firm's securities will be equal to book value and that when a firm earns a return on equity in excess of its cost of equity, investors respond by valuing the firm's equity in excess of book value. Woolridge Direct at 23-24. In support, he cited a 1988 article by the founder of consulting firm Marakon Associates that said the value of a company is determined by its cash flow which is in turn affected by its return on equity and a 1987 Harvard Business School case study which concluded higher returns on equity provide higher market-to-book ratios. *Id.* 23-24.

Dr. Woolridge said he relies primarily on the DCF model to estimate the cost of equity capital. Woolridge Direct at 29. In his DCF analysis, he used a dividend yield of 5.4% which is the mid-point of the proxy group average for the six months ending April 2009 and the proxy group average in April 2009, adjusted for one-half year of expected growth. *Id.* at 33; Public's Ex. JRW-10, p. 1. Dr. Woolridge selected a growth rate of 5.0% after considering historical growth rates for the proxy companies in EPS, dividends per share ("DPS") and book value per share ("BVPS") as measured by both means and medians. He also considered Value Line's projections of EPS, DPS and BVPS, projected internal growth rates calculated by Dr. Woolridge from Value Line's projected retention rate and return on equity, and analyst EPS growth rate forecasts. *Id.* at 36-38. However, he discounted the analyst forecasts because of his belief that

⁶ Dr. Woolridge referred to this document as a study. A review of his workpapers shows he relies upon a 5 ½ page document on a McKinsey website expressing the subjective opinion that "there is no evidence of a substantial increase in the cost of long-term capital" but which acknowledges: "we cannot be certain that its cost will not increase over the next several years as the recession develops," cash flow "uncertainty has increased significantly," and "[i]t is particularly unclear what a normal level of growth and returns on capital will be in the future." *Id.* at pp. 5, 6.

they have an upward bias. *Id.* at 39. His DCF result was a common equity cost rate for NIPSCO of 10.4%, i.e., 5.4% + 5.0%.

In his CAPM, Dr. Woolridge used a risk free rate of 4.00% which was the upper end of the range of yields in 10-year and 20-year treasury bonds that he thought was reasonable for the near future. *Id.* at 43. He used a beta of 0.68 which was his proxy group average. *Id.* at 44; Public's Ex. JRW-11, p. 3. Dr. Woolridge used an equity risk premium of 4.61%. He stated that the "traditional way" to measure the equity risk premium was to use the difference between historical average stock and bond returns. This approach, Dr. Woolridge said, is often called the "Ibbotson approach" after Professor Roger Ibbotson, and usually suggests an equity risk premium of 5%-7% above the long-term treasury bond rate. *Id.* at 45. Dr. Woolridge asserted that some academic studies using "ex ante models" and "puzzle research" compute lower expected returns using market data without regard to historical returns. *Id.* at 46-48. According to Dr. Woolridge, the historical returns are "biased upwards" because "the expected equity risk premium has declined [as] stock prices have risen." *Id.* at 48. Dr. Woolridge's equity risk premium of 4.61% is an average of four different averages: (a) seven historical studies for periods beginning as early as 1872, most with both arithmetic results and geometric results included in the average; (b) 25 ex ante puzzle research studies, many with multiple low, high and midpoint results, published between 1999 and 2009; (c) four surveys of forecasters, Chief Financial Officers and academics; and (d) two estimates using the "building blocks" methodology, one of which was performed by Dr. Woolridge for this case. Public's Ex. JRW-11, p. 5. Dr. Woolridge's building blocks calculation derived an expected equity return for the market of 7.90% by adding a real growth rate of 2.50%, a dividend yield of 3.00% and an inflation rate 2.40%. Public's Ex. JRW-11, p. 7. Dr. Woolridge then deducted a recent 30-year treasury yield rate of 3.83% to derive an equity risk premium of 4.07%. *Id.* at 55-56. However, this is but one of 83 percentages included in the averages and averages of averages used to compute his 4.61% equity risk premium. Public's Ex. JRW-11, p. 5. Using the equity risk premium of 4.61%, Dr. Woolridge computed a CAPM result of 7.1%, i.e., 4.00% + (0.68 × 4.61%).

Although his calculated range was 7.1%-10.4%, Dr. Woolridge recommended an equity cost rate of 10.0% for NIPSCO, stating that the upper end of the range should be used due to the current volatile capital market conditions. Woolridge Direct at 59.

Dr. Woolridge also discussed his disagreements with Mr. Moul's testimony. With respect to the proxy group, Dr. Woolridge said Mr. Moul's Electric Group companies were not particularly good proxies for NIPSCO because five were combination gas and electric companies with an average only 57% of revenues from electric operations. He cited Avista, CMS, Integrys, NiSource and Vectren as companies with substantial gas operations. He also said Mr. Moul's group had lower common equity ratios and higher coefficients of variation of earned returns on common equity than NIPSCO. Woolridge Direct at 63-64.

With respect to Mr. Moul's DCF analysis, Dr. Woolridge criticized Mr. Moul's adjustment to state the dividend yield on a forward-looking basis by compounding quarterly dividends to the end of the year. Dr. Woolridge argued that compounding should not be used because the investor has the option of reinvesting the dividends as he or she chooses. Woolridge Direct at 66. Dr. Woolridge also criticized Mr. Moul's 6.50% growth rate on the ground that it gave too much weight to analysts' forecasts of EPS growth. Dr. Woolridge contended analysts' forecasts are overly optimistic and biased upwards. Dr. Woolridge said this was demonstrated

by a comparison he made of forecast and actual EPS growth rates since 1988 for the companies in the I/B/E/S data base. *Id.* at 68. Dr. Woolridge maintained that his findings indicated forecast errors for the long-term estimates were predominately positive which he interpreted as showing upward bias. *Id.* at 69. Although he recognized that analysts' EPS growth rate forecasts have subsided somewhat since 2000 and new regulations against conflicts of interest were adopted in 2003, in Dr. Woolridge's opinion, analysts' forecasts continue to be overly optimistic. *Id.* at 70. In support, he cited two Wall Street Journal articles, one of which reported on Dr. Woolridge's opinions about Wall Street analysts. *Id.* at 70-71; Public's Ex. JRW-13, p. 4. Dr. Woolridge testified that the upward bias is not as pronounced for electric utility companies but, in his opinion, analysts' projected electric growth rates still exceed the actual rates. *Id.* at 71-72. Dr. Woolridge also believes Value Line is upwardly biased which he attributed to its reluctance to forecast negative growth rates. *Id.* at 73.

Dr. Woolridge also opposed Mr. Moul's flotation cost adjustment on a variety of grounds: the Company has not identified any flotation costs; investors are not entitled to flotation costs when market prices exceed book value; underwriting spreads need not be recovered through the regulatory process; and brokerage fees that investors pay in secondary market transaction are not included in the DCF analysis. Woolridge Direct at 73-75.

Dr. Woolridge opposed Mr. Moul's use of a risk premium analysis because utility bonds are subject to interest rate risk and credit risk which do not apply to equity investors. *Id.* at 76. He reiterated his position discussed above that risk premiums based on historical returns are overstated. *Id.* at 77. He also contended historical bond returns were biased downward because of capital losses; geometric means only should be used; investors could not achieve the historical market returns because of transaction costs and without rebalancing their portfolios every month; stock index returns are affected by survivorship bias and the "Peso Problem" (less disruption in U.S. markets than other markets around the world); and market conditions today are different than in the past which has resulted in a decrease in the equity premium over bond yields. *Id.* at 78-87.

With respect to Mr. Moul's CAPM, Dr. Woolridge contended Mr. Moul's risk-free rate was overstated. He objected to the consideration of historic risk premiums for reasons previously mentioned. He also criticized Mr. Moul's prospective risk premium because of its reliance on forecasts of EPS growth by analysts and by Value Line (both of which Dr. Woolridge deems to be upwardly biased), because Mr. Moul considered only dividend-paying stocks and because the stocks are weighted equally. Woolridge Direct at 89-92. He said Mr. Moul's use of an 11.29% growth rate in his calculation of the prospective equity risk premium is excessive because it exceeds the historical nominal growth rate in gross domestic product ("GDP") of 7.20%. *Id.* at 93. Dr. Woolridge also asserted Mr. Moul's size adjustment is inappropriate for regulated electric utilities. *Id.* at 95-96.

Dr. Woolridge disagreed with Mr. Moul's Comparable Earnings analysis on the basis that it did not measure long-term earnings expectations. *Id.* at 97.

(3) IG's Evidence. IG Witness Michael Gorman used multiple methods to estimate NIPSCO's cost of common equity—three different versions of the DCF model, two versions of the Risk Premium model, and the CAPM. In applying his models, he used the same proxy group as Mr. Moul. Mr. Gorman recommended that the Commission find

that NIPSCO's cost of common equity is 10.3% with a capital structure that uses NiSource's capitalization ratios and 9.8% with NIPSCO's actual capital structure.

Mr. Gorman first used a constant growth DCF model with a dividend yield of 5.93% and a growth rate of 6.00% resulting in a cost of equity estimate of 11.77%. The dividend yield was calculated from average stock prices during the 13-week period ended March 13, 2009 and annualized dividends adjusted for next year's growth. Gorman Direct at 40-41. The growth rate came from security analysts' earnings growth forecasts available on March 17, 2009. *Id.* at 42. Mr. Gorman testified that analysts' forecasts have been shown to be more accurate predictors of future returns than growth rates derived from historical data and influence stock observable prices more than historical data. *Id.* at 41-42. The average forecast growth rate for the proxy group was 8.99%. *Id.* at 43. However, Mr. Gorman believed this growth rate was too high and substituted a 6.00% growth rate, which was the median of the proxy group growth rates. He said use of this lower growth rate was appropriate because it excluded the impact of the two highest growth rates (Empire District and Integrys) and was more consistent with consensus projections of GDP growth that he believed should be a "ceiling" on a utility's growth rate. *Id.* at 44. He said economists expect GDP growth over the next five to ten years of no more than 5.1%. *Id.* at 43. In support of his position that there should be a GDP growth ceiling on a utility's growth rate, Mr. Gorman cited the 2007 edition of the Brigham and Houston text, *Fundamentals of Financial Management*. *Id.* at 45. During cross-examination, Mr. Gorman stated he deleted from the quote in his testimony a statement by the authors on a GDP growth basis one might expect the dividends of an average or normal company to grow at a rate of 5% to 8% a year. Tr. at DD-80. Mr. Gorman said he deleted this statement because it was based on outdated information, and he did not believe the authors would have that same view today. Tr. at DD-80-82.

Mr. Gorman also contended that even after substituting the lower median for the average, the 6.00% growth rate was not sustainable. Therefore, he performed a second DCF calculation using a growth rate of 4.21% which he said was the sustainable growth rate.⁷ This rate was based on Value Line projections of returns on equity, payout ratios and earnings retention. *Id.* at 47. The result of the "sustainable growth" DCF model was 10.13%.

Mr. Gorman also performed a third DCF calculation that used decreasing growth rates for (a) the first five-years, (b) the next five-years and (c) year 11 through perpetuity. *Id.* at 48. The rates used in the first stage were the analysts' forecasts described above; the rates used in the second stage represented the difference between the analysts' forecasts and the Blue Chip 5 to 10 year GDP growth projection of 5.1%; and the rate used in the third stage (year 11 forward) was the 5.1% GDP growth estimate. Gorman Direct at 49. The result of the multi-stage DCF model was 11.23%. *Id.* at 50.

For his ultimate DCF recommendation, Mr. Gorman averaged his sustainable growth and multi-stage DCF results (10.13% and 11.23%) and rounded the average up to 10.70%. *Id.* at 50.

In his Risk Premium models, Mr. Gorman calculated the difference between regulatory commission-authorized returns for electric utilities in each year since 1988 as reported by

⁷ Mr. Gorman's testimony states that he used a 4.21% sustainable growth rate to derive a 10.13% DCF result. Gorman Direct at 48. However, IG Ex. MPG-13 appears to show that a growth rate of only 3.77% was used in the 10.13% calculation.

Regulatory Research Associates and average yields on treasury bonds and A-rated utility bonds in each of those same years. This method produced an average risk premium over treasury bonds of 5.10% and over A-rated utility bonds of 3.68%. IG Ex. MPG-16; IG Ex. MPG-17. Mr. Gorman then selected ranges of 4.40% to 6.01% for the treasury spread and 3.03% to 4.39% for the utility bond spread by focusing on where most of the annual results fell. Gorman Direct at 52. Mr. Gorman then added the treasury risk premium range to a projected treasury bond yield of 4.30% and the utility bond risk premium range to a current 13-week average yield on A-rated and Baa-rated utility bonds of 7.85%. From these results, Mr. Gorman recommended a 9.91% rate for the treasury bonds analysis (a rate between the mid-point and high end of his range) and a rate of 10.40% for the utility bond analysis (the low end of his range). *Id.* at 54-55. Mr. Gorman said he used the low end of the utility bond range to reflect his belief that yields would decline to more normal levels once economic conditions strengthen. *Id.* at 55.

In his CAPM, Mr. Gorman used a 4.30% risk-free rate based upon a Blue Chip projected treasury bond yield and a beta of 0.73 based on the average of the Value Line proxy group beta estimates. Gorman Direct at 56, 57. Mr. Gorman derived a forward looking market risk premium of 7.00% and a historical market risk premium of 6.50%. *Id.* at 58. The forward looking premium was determined by subtracting the 4.30% risk-free rate from Mr. Gorman's estimate of the expected return on the S&P 500 Index which was calculated by adding an estimated inflation rate of 2.1% to the long-term historical arithmetic average real return on the market as reported in the Valuation Edition of SBBI. Mr. Gorman's CAPM results are 9.05% to 9.41% with a midpoint of 9.20%. *Id.* at 60.

Based on the results of all of his analyses, Mr. Gorman recommended a return on equity range of 9.80% to 10.70% with the low end being the average of his risk Premium and CAPM results and the upper end being his DCF result. Gorman Direct at 61. He testified that if NIPSCO's actual capital structure was used (as proposed by NIPSCO), he recommended 9.80%, the low end of the range, because there is less financial risk. But if his proposed NiSource capital structure is used, he recommended 10.30%, the midpoint of his range. *Id.* Mr. Gorman contended his recommendations would support investment grade credit ratings under S&P's credit metric benchmarks. *Id.* at 62. However, he acknowledged S&P's new credit metrics are not as transparent as its former metrics and do not clearly identify utility-specific credit metric guidance ranges based on its business risk assessment. *Id.* at 62.

Mr. Gorman also commented on Mr. Moul's testimony. He said Mr. Moul's DCF growth rate of 6.50% was too high to be sustainable in the long run. Mr. Gorman asserted academics have found, and investors understand, long-term sustainable growth cannot exceed GDP growth over sustained periods of time. Gorman Direct at 74-75. Mr. Gorman argued the financial risk of a utility is based on book value leverage, not market value leverage, and analysts do not consider market value leverage to be of significance. *Id.* at 71. He said Mr. Moul's flotation cost adjustment was not appropriate because it was not based on NIPSCO's actual expenses. *Id.* at 73.

Mr. Gorman disputed the 5.50% risk premium used by Mr. Moul in the Risk Premium approach on the ground it was not based on observable and verifiable market evidence of NIPSCO's risk as compared to the proxy group. *Id.* at 77.

Mr. Gorman also objected to Mr. Moul's size adjustment in the CAPM. According to Mr. Gorman, a size adjustment is not proper because the SBBI mid-cap deciles used in the

adjustment include stocks with an average beta of 1.12 which is higher than the proxy group. *Id.* at 79. Mr. Gorman concurred with Mr. Moul's historical market risk premium of 6.50% but considered his prospective market risk premium of 10.37% to be excessive because the Value Line and S&P growth used by Mr. Moul project growth in excess of GDP growth.

Finally, Mr. Gorman disagreed with Mr. Moul's Comparable Earnings analysis on the grounds that it measures book returns instead of market required returns and includes non-regulated companies not comparable to NIPSCO. *Id.* at 82.

(4) Petitioner's Rebuttal Evidence. Mr. Moul responded to Dr. Woolridge's discussion of the credit crisis. Mr. Moul said that in response to the credit crisis investors have become more risk adverse thereby increasing their required return. He explained that market volatility is much higher than it was prior to the beginning of the financial crisis and yield spreads and debt costs have increased. Mr. Moul testified attracting capital would be more difficult for NIPSCO if the Commission accepted the returns proposed by Dr. Woolridge and Mr. Gorman. Moul Rebuttal at 8-11. Mr. Moul also provided updates of this cost of equity models using the latest information available. His updated results were as follows:

| | <u>Direct Testimony</u> | <u>Update</u> |
|---------------------|-------------------------|---------------|
| DCF | 11.21% | 12.62% |
| RP | 11.67% | 12.44% |
| CAPM | 12.76% | 11.24% |
| Comparable Earnings | 15.70% | 14.30% |
| Average | 12.84% | 12.65% |
| Median | 12.22% | 12.53% |
| Mid-point | 13.46% | 12.77% |

Id. at 12. He said the DCF and Risk Premium results increased because of increasing dividend yields and widening spreads over treasury yields. The CAPM result declined due to lower betas and a reduction in the market premium. The Comparable Earnings result was lower because of the recession. Because the average of the market-based models is 12.10% and the average of the DCF and CAPM methods is 11.93%, Mr. Moul concluded a rate of return of no less than 12.00% is still reasonable. *Id.* at 12-13.

Mr. Moul criticized Dr. Woolridge's proxy group because the companies have few characteristics that are comparable to NIPSCO. He said Dr. Woolridge should have considered combination companies and should not have included companies with speculative bond ratings, delivery-only utilities and utilities with significant hydro generation. Moul Rebuttal at 14-15.

Mr. Moul described Dr. Woolridge's criticism of Mr. Moul's quarterly compounding method of determining the dividend yield in the DCF as a "tempest in a teapot" because Dr. Woolridge's method produces precisely the same result. Moul Rebuttal at 16. However, for purposes of his rebuttal, Mr. Moul used Dr. Woolridge's method in his rebuttal updates. *Id.*

Mr. Moul reaffirmed his position that analysts' forecasts of EPS growth are the best measure of growth in the DCF model and should be given primary weight. He said they are the primary determinant of investor expectations. Moul Rebuttal at 16-17.

Mr. Moul noted that the results of Mr. Gorman's constant growth DCF model (the form previously used by this Commission) and Mr. Gorman's multi-stage model are both well above 11%. Moul Rebuttal at 17-18. He cited eight factors that contribute to investors' expectations of earnings growth that are not considered by Mr. Gorman's "sustainable" or "retention growth" model which only considers book value changes and accretion from the sale of stock. Id. at 18. Mr. Moul asserted BVPS growth, or its surrogate retention growth, does not represent a proper financial variable because utility stocks typically do not trade at book value. Id. at 8-19. Mr. Moul also said Mr. Gorman relies on projections not shown to be sustainable beyond the identified periods and has not provided recognition of transition growth through 2012 and growth beyond 2014. Id. at 19. Further, Mr. Gorman's result is entirely dependent upon his assumed return on equity of 10.15%. According to Mr. Moul, that is like having to know the end result in order to calculate it. Id. at 20.

Mr. Moul testified that Mr. Gorman has been inconsistent in his use of the multi-stage DCF model, citing cases since 2001 where Mr. Gorman used the model and others where he did not. Mr. Moul rejected Mr. Gorman's opinion that analysts' earnings forecasts cannot be reasonable estimates when in excess of current 5 and 10 years forecasts of GDP growth. Mr. Moul said Mr. Gorman has not shown any cause and effect relationship or linkage of these variables. Mr. Moul said one could as easily assume dividend growth and GDP growth understate investors' expectations of proxy group growth, thereby showing the need to use analysts' forecasts. Id. at 19-22.

Mr. Moul testified GDP growth is not the sole determinant of earnings growth. He described GDP as having a "product side" and an "income side," both of which are made up of many components. He contrasted Mr. Gorman's 5.1% GDP growth rate with Value Line's Industrial Composite earnings growth forecast of 6.5% and Blue Chip's forecasts of growth in pre-tax profits of 7.0% for 2011-2015 and 5.5% for 2016-2020. Mr. Moul said this showed future corporate profit growth will exceed GDP growth which has also been true historically. Moul Rebuttal at 22-23. Mr. Moul also pointed out FERC has rejected use of a two-stage DCF model for electric companies because objective measures showed electric companies do not display growth characteristics that fit a multi-stage model. Id. at 23. While FERC does use a two-stage model for natural gas pipelines, Mr. Moul showed that the FERC approach, if followed here, would raise Mr. Gorman's median result to 11.44% and his group average to 13.74%. Id. at 24.

Mr. Moul disputed Dr. Woolridge's contention that analysts' forecasts of EPS growth are biased. He considered Dr. Woolridge's opinions out-of-date because of the 2003 final judgment in the Global Research Analyst Settlement required Wall Street firms to separate their research and investment banking services. Moul Rebuttal at 25. Mr. Moul also considered Dr. Woolridge's position on analyst bias to be inconsistent with his DCF model which uses analysts' forecasts (Public's Ex. JRW-10, pp. 4 and 5) and Dr. Woolridge's reliance on the Claus and Thomas study that measures expected cash flow by using analysts' forecasts (Woolridge Direct at 25-26). Finally, Mr. Moul testified that regardless of what Dr. Woolridge thinks about their accuracy, analysts' forecasts are what investors actually use in their decisions to buy, sell or hold stocks. Id. at 26. Even if there were bias suggesting a downward adjustment might be

appropriate, stock prices would likewise require a downward adjustment because the growth rate must be synchronized with the price investors establish when valuing a stock. Id. at 26.

Mr. Moul criticized Dr. Woolridge's use of Value Line DPS forecasts in determining the DCF growth rate. Mr. Moul said the low DPS growth rates are attributable to Value Line's forecast of declining dividend payout ratios for Dr. Woolridge's proxy companies. Moul Rebuttal at 26. With respect to Dr. Woolridge's reliance on historical growth rates, Mr. Moul said analysts consider historical growth rates in the process of developing forecasted growth rates to assess how the future may diverge from historical practices. Id. at 27. Mr. Moul disagreed with the retention ratios of Dr. Woolridge and Mr. Gorman because they did not convert year-end book values to average book values in determining the return on equity. Mr. Moul said this causes an understatement of retention growth and that FERC requires this adjustment. Id. at 28-29. Mr. Moul testified Dr. Woolridge's and Mr. Gorman's retention growth calculations have an additional downward bias because they ignore future growth from external stock financing. Id. at 29.

Mr. Moul testified the analysts' forecasts of EPS growth for Dr. Woolridge's proxy companies average 6.52% and, if this rate of growth is used in Dr. Woolridge's DCF model, the result is a common equity cost rate of 11.99%. Moul Rebuttal at 29-30.

Mr. Moul said a flotation cost adjustment is appropriate because Value Line forecasts show the utilities will be issuing new common stock in the future and that has been historically true. Moul Rebuttal at 30. Mr. Moul stated flotation costs must be considered because only stock sale proceeds net of the underwriting spread and out-of-pocket expenses are available for utility investments. Id.

Mr. Moul criticized Dr. Woolridge for not using the Risk Premium method because it considers a company's own borrowing rate. Moreover, the Risk Premium approach considers additional risk, which is not reflected in the beta measure of systematic risk. Moul Rebuttal at 31. Mr. Moul believed this method was particularly pertinent today because of the credit crisis, which has significantly affected utility debt costs. Id. at 31-32. While Mr. Gorman used the Risk Premium method, his use of regulatory authorized returns to determine the risk premium is of limited usefulness because it reflects an arbitrary time period beginning in 1986. Id. at 32. Mr. Moul showed Mr. Gorman's premiums would be substantially higher if authorized returns since 1999 or 2004 were used. Id. Mr. Moul also said Mr. Gorman's approach was deficient because it mixed book equity returns with market-determined bond yields; does not synchronize the rate orders with the time of the evidentiary record (creating a potential time period mismatch); authorized returns do not necessarily reflect investor-required returns because they can be influenced by policy, political factors and regulatory practices; and past authorized returns do not reflect the risks faced by electric utilities today. Id. at 32-33.

Mr. Moul disagreed with each of the reasons Dr. Woolridge raised against the Risk Premium method. Mr. Moul also elaborated on the justification for using arithmetic means in the Risk Premium method. Moul Rebuttal at 34-38.

With respect to Dr. Woolridge's opinion that the risk return relationship that existed in the past no longer applies today, Mr. Moul provided a graph showing the historical performance of the Chicago Board of Options Exchange Volatility Index ("VIX") since 1990. Moul Rebuttal

at 39-40. Because the volatility of the market is higher today (as shown by the VIX), Mr. Moul concluded there has been no shrinkage in the equity risk premium. *Id.* at 41.

Although Mr. Moul agreed with the historical equity risk premium used by Mr. Gorman in the CAPM, he criticized Mr. Gorman for failing to also consider a prospective premium that reflected expected future market returns. Moul Rebuttal at 41. Mr. Moul criticized both Mr. Gorman and Dr. Woolridge for failing to include a size adjustment in their CAPM calculations. Mr. Moul described Dr. Woolridge's 7.1% CAPM result as "simply not credible" as evidenced by the fact that it is lower than the May 2009 Baa-rated utility bond yield of 7.76%. *Id.* at 42. He said Dr. Woolridge's CAPM assumes an expected market return of only 7.90% (Woolridge Direct at 54, l. 8), which is totally unrealistic as shown by Value Line's Industrial Composite forecasts. *Id.* at 43. Because Dr. Woolridge computes a DCF return for his proxy group of 10.4%, Mr. Moul said it is not possible for the total market return to be only 7.9%. *Id.* at 44.

With respect to the size adjustment, Mr. Moul testified that, contrary to Dr. Woolridge's opinion, the beta of the SBBI mid-cap decile provides no basis to reject the adjustment. He opined the Wong article relied on by Dr. Woolridge is not relevant because it relies on data going back to the 1960s when the utility business was fundamentally different. He cited the famous Fama/French study as identifying size as a separate risk factor not compensated for by the beta. Moul Rebuttal at 44-45.

Mr. Moul defended his Comparable Earnings analysis on the ground that it was supported by the underlying premise of rate regulation and was consistent with the views of the financial community that the regulatory process must consider returns achieved by the non-regulated sector to ensure regulated companies can compete effectively in the capital markets. Moul Rebuttal at 46. He noted investors would not be motivated by an opportunity to earn a 10% return for NIPSCO when they could obtain higher returns on alternative investment opportunities of equal risk. *Id.* at 46. Mr. Moul disputed Dr. Woolridge's contention that low cost of equity rates can be justified because market-to-book ratios typically exceed 1.0. *Id.* at 46-47.

(5) Discussion and Findings. The record contains a number of different methods of estimating NIPSCO's cost of common equity. We recognize the cost of common equity cannot be precisely calculated and estimating it requires the use of judgment. Due to this lack of precision, the use of multiple methods is desirable because no single method will produce the most reasonable result under all conditions and circumstances.

In summary, the parties have presented evidence that the cost of equity could be as low as 7.1% and as high as 12.76%, and recommended a cost of common equity between 9.80% and 12.00%. Having considered the evidence of record and giving such weight to the evidence as we deem appropriate, we find that a cost of equity range of 9.90% to 10.50% is reasonable and appropriate for NIPSCO in today's economic climate. This is comparable with our cost of equity findings in Duke Energy Indiana's (formerly PSI Energy, Inc., hereinafter referenced as "PSI") most recent rate case in Cause No. 42359 (finding 10.5% to be appropriate), our approval of the settlement agreement in I&M's rate case in Cause No. 43306 (approving 10.5% as part of the settlement), and our approval of the settlement agreement in Vectren South's rate case in Cause No. 43111 (approving 10.4% as part of the settlement).

Having found an appropriate range, we now turn to determining a specific return to apply to NIPSCO's common equity. In our Order in Cause No. 42359 concerning PSI's rates, we

recognized that a utility's operational and financial performance were appropriate considerations in determining a utility's cost of equity. The Commission has previously expressed concerns with the soundness of NIPSCO's managerial and operational decisions. For example, in Cause No. 42194, the Commission analyzed NIPSCO's plan to consolidate and close Local Operating Areas, or maintenance facilities, in its gas and electric service areas. The Commission questioned whether NIPSCO properly and thoroughly evaluated the impact of its plan on NIPSCO's ability to provide reasonably adequate service prior to the plan's implementation. Specifically, the Commission stated, "[T]he lack of any evidence on the part of NIPSCO that demonstrates that it undertook a careful and thoughtful review of the [plan] vis-à-vis its possible impact on customers and service quality, has resulted in uncertainties regarding its implementation." *In Re: An Emergency Complaint Against N. Ind. Pub. Serv. Co.*, Cause No. 42194 at 56 (Aug. 10, 2005). As a result, the Commission found that NIPSCO should not implement its plan.

The Commission continues to have concerns regarding NIPSCO's managerial and operational decisions. To illustrate, in the present case, NIPSCO developed new tariff provisions without consulting its industrial customers—the customers who would be most affected by the new provisions and who comprise the majority of NIPSCO's load. While we have seen recent positive efforts by senior management to address customer and operational shortcomings, the Commission will continue to monitor and evaluate managerial efforts, and we will review and revisit those efforts in NIPSCO's next rate case.

Further, in Cause No. 42359, we determined that PSI's reliability and quality customer service warranted some consideration in our ultimate cost of equity determination. The evidence showed that PSI, and its parent Cinergy Corp., scored in the top quartile of the most recent J.D. Power and Associates customer satisfaction studies. In contrast, the evidence presented in this Cause demonstrated that NIPSCO was in the bottom quartile of the J.D. Power studies in 2007 and 2008, and one of the worst-rated utilities in 2009. While we are hesitant to place undue weight on customer surveys, the three-year trend of poor customer satisfaction cannot be ignored.

We must also consider the effect tracking mechanisms have in reducing risk in order to ensure that these reduced risks are properly reflected in NIPSCO's cost of equity. See Order, Cause No. 42359 at 53. NIPSCO has a number of trackers in place currently, and we have approved additional trackers in this Cause. No witness for NIPSCO addressed the effects of trackers on NIPSCO's cost of capital, which could be considered a fatal failing of its analysis.

The Commission has a unique role in regulating its jurisdictional utilities, which at times requires us to send a clear and direct message to utility management concerning the need for improvement in the provision of its utility service. Our determination of the authorized cost of common equity capital can be a very direct means to incent improved service. We anticipate that NIPSCO will respond accordingly and therefore anticipate that such authorized cost of common equity capital will apply for a limited duration as identified below.

Based on the entirety of the evidence at issue, and giving such weight to the evidence as we deem appropriate, we find that NIPSCO's cost of common equity capital shall be 9.9% and NIPSCO's overall weighted cost of capital to be 7.29%, determined as follows:

| <u>Description</u> | <u>Amount</u> | <u>Percent</u> | <u>Cost</u> | <u>Weighted Average Cost</u> |
|------------------------------|-------------------------|----------------|-------------|--------------------------------------|
| Common Equity | \$ 1,395,245,772 | 49.95% | 9.90% | 4.94% |
| Long-Term Debt | \$ 906,631,137 | 32.46% | 6.52% | 2.12% |
| Customer Deposits | \$ 63,684,199 | 2.28% | 6.00% | 0.14% |
| Deferred Income Taxes | \$ 294,780,249 | 10.55% | 0.00% | 0.00% |
| Post-Retirement Liability | \$ 102,637,766 | 3.67% | 0.00% | 0.00% |
| Post-1970 ITC | \$ 30,350,460 | 1.09% | 8.57% | 0.09% |
| Totals | \$ 2,793,329,583 | 100.00% | | 7.29%⁸ |

The cost rate we have assigned to the post-1970 investment tax credits is the overall weighted cost of investor-supplied capital determined as follows:

| <u>Description</u> | <u>Amount</u> | <u>Percent</u> | <u>Cost</u> | <u>Weighted Average Cost</u> |
|--------------------|-------------------------|----------------|-------------|--------------------------------------|
| Common Equity | \$ 1,395,245,772 | 60.61% | 9.90% | 6.00% |
| Long-Term Debt | \$ 906,631,137 | 39.39% | 6.52% | 2.57% |
| Totals | \$ 2,301,876,909 | 100.00% | | 8.57% |

This is consistent with the methodology adopted by the Commission in Indianapolis Power & Light Co., Cause No. 37837, p. 18 (Aug. 6, 1986). Applying the weighted cost of capital to NIPSCO's original cost rate base, we find a net operating income level for NIPSCO of \$192,425,533 is just and reasonable.

The Commission recognizes that a 9.9% return reflects the low end of the range discussed above, and that a higher return may be appropriate if NIPSCO is able to demonstrate improved company performance in its next base rate proceeding. In order for NIPSCO's level of performance to be reevaluated by the Commission, NIPSCO is hereby directed to file a new base rate case with the Commission no later than September 30, 2012.

⁸ In comparison, PSI Energy of Indiana's weighted cost of capital in Cause No. 42359 was 7.30%, while I&M's weighted cost of capital, based on settlement approved in Cause No. 43306, was 7.62%, and SIGECO's weighted cost of capital, based on settlement approved in Cause No. 43111, was 7.32%.