

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of The Kansas Power and Light)
Company's tariffs to increase natural gas) CASE NO. GR-91-291
rates for certain customers.)

APPEARANCES: John K. Rosenberg, Executive Vice President, General Counsel and Secretary, and Michael C. Pendergast, Managing Attorney-Regulation, The Kansas Power and Light Company, P. O. Box 889, 818 Kansas Avenue, Topeka, KS 66612, and James M. Fischer, Attorney at Law, Akre, Wendt & Fischer, 102 East High Street, Suite 200, Jefferson City, MO 65101, for The Kansas Power and Light Company.
Stuart W. Conrad and Paul S. DeFord, Attorneys at Law, Lathrop & Norquist, 2345 Grand Avenue, Suite 2600, Kansas City, MO 64108, for Midwest Gas Users Association.
Paul W. Phillips, Deputy Assistant Counsel for Regulatory Interventions, 1000 Independence Avenue, S.W., Room 6D-033, Washington, DC 20585, for United States Department of Energy and Executive Agencies of the United States.
Diana Schmidt, Robert C. Johnson, and Arthur L. Smith, Attorneys at Law, Peper, Martin, Jensen, Maichel and Hetlage, 720 Olive Street, 24th Floor, St. Louis, MO 63101, for Adam's Mark Hotel, Ford Motor Company, Missouri Portland Cement Company, Quaker Oats Company, and Ralston Purina Company.
Michael A. Rump, Staff Attorney, Kansas City Power & Light Company, 1330 Baltimore Avenue, Kansas City, MO 64105, for Kansas City Power & Light Company.
Lewis R. Mills, Jr., First Assistant Public Counsel, Office of the Public Counsel, P.O. Box 7800, Jefferson City, MO 65102, for Office of the Public Counsel and the public.
Penny G. Baker, Deputy General Counsel, William M. Shansey, Thomas H. Luckenbill, and Lee C. Tieman, Assistant General Counsels, Missouri Public Service Commission, P.O. Box 360, Jefferson City, MO 65102, for the Staff of the Missouri Public Service Commission.

HEARING
EXAMINER: Beth O'Donnell

REPORT AND ORDER

Procedural History

On March 8, 1991, The Kansas Power and Light Company (KPL or Company) filed tariffs designed to increase its gross annual gas revenue in Missouri by approximately \$20.1 million or 6.43 percent, exclusive of applicable franchise and occupational taxes. By order issued April 3, 1991, the Commission suspended these tariffs to February 5, 1992, and established a procedural schedule. By notices issued October 9, 1991 and October 11, 1991, the Commission revised the procedural schedule established in this case. By orders issued May 29, 1991, and June 26, 1991, and orally on the record at the prehearing conference held September 30, 1991, the Commission granted the applications to intervene of Midwest Gas Users Association, St. Joseph Light & Power Company, Kansas City Power & Light Company, United States Department of Energy and the Executive Agencies of the United States, Missouri Public Service, Mountain Iron and Supply Company, and the Industrial Intervenors (Adam's Mark Hotel, Ford Motor Company, Missouri Portland Cement Company, Quaker Oats Company and Ralston Purina Company). The Commission's Staff (Staff) and the Office of the Public Counsel (Public Counsel) also participated in this case.

The parties participated in the prehearing conference commencing September 30, 1991. As a result of the prehearing conference the parties signed a hearing memorandum delineating some of the areas of agreement and all the areas of disagreement among some or all of the parties to this proceeding. After the hearing memorandum was filed with the Commission, the issue of weather normalization was settled. Stipulations on rate design and flex rates were concluded among the parties and received into evidence.

Testimony was prefiled by the parties and oral hearings were held October 23 through 25, 1991. Briefs were filed by the parties pursuant to a schedule established by the hearing examiner.

During the course of the Commission's deliberations the parties were asked to calculate and submit to the Commission numerical reconciliations based upon hypothetical resolutions of the issues litigated in this case. The Commission's requests and the submission filed in response to them have been marked as late-filed exhibits and will be received into the record.

Findings of Fact

The Missouri Public Service Commission, having considered all the competent and substantial evidence on the whole record, makes the following findings of fact.

I. TEST YEAR AND TRUE-UP

Staff recommended that the Commission use a test year in this case based on the twelve months ending December 31, 1990, updated through June 30, 1991. There was no opposition to this proposal. By order issued July 17, 1991, the Commission adopted a test year in this case ending December 31, 1990, updated through June 30, 1991.

II. RATE BASE

Future Plant

At the hearing Staff and Company informed the Commission that they had reached agreement on compensating Company for its safety-related pipeline replacement and cathodic protection program through August, 1992, in the amount of \$3.7 million. Public Counsel opposes recognition of this construction in these rates. No other party opposes this agreement.

Public Counsel believes that including the cost of this future construction in these rates is prohibited by Section 393.135, RSMo 1986. Section 393.135, RSMo 1986, provides, in pertinent part, that no electric plant be reflected in rates until it is used in provision of electrical service to customers. Public Counsel argues that this section applies to nonelectrical utilities as well. Public Counsel points to the Commission's decision in Case Nos. 18,660 and 18,661 to support its position.

Re Southwestern Bell Telephone Company, 18 PUR4th 27 (1976). Public Counsel notes that the Commission explicitly applied Section 393.135, RSMo 1986, to a telephone utility in that case.

In addition, Public Counsel argues that recognizing in rates the capital expenditures associated with this safety construction would violate the ratemaking principle that expenses, revenues and investment must all be examined in any given period in order to establish just and reasonable rates. Public Counsel asserts that reflecting in these rates investment associated with this future plant results in a mismatch because there has been no examination of revenues and expenses for this future period.

Staff and Company argue that Section 393.135, RSMo 1986, explicitly applies only to electric utilities so that the Commission may legally allow recognition in rates of future plant for nonelectrical utilities. In addition, Staff and Company assert that recognition of these costs will not violate matching of expenses, revenues and investment, since the construction in question is merely an upgrading of existing plant not the construction of new plant which would bring in additional revenues.

The Commission determines that the stipulation between Staff and Company should not be approved. Although Company has agreed to upgrade the safety of a set amount of its plant pursuant to its agreement with Staff, the Commission determines that costs associated with this future upgrade are necessarily speculative and should not be reflected in the rates to be established in this proceeding. In addition, the Commission determines that, since revenues and costs have not been examined for this future period, there is a risk that including such investment in the rates set by this proceeding will result in poorly crafted rates which could conceivably be recovered by Company long after the construction in question is completed.

The Commission notes that there is a method available to Company to have this investment deferred for consideration in a future rate case. If Company believes this investment is an extraordinary expenditure, Company may request an accounting authority order from the Commission as have other companies which are upgrading the safety of their gas plant pursuant to the Commission's recently promulgated gas safety rule. The Commission has recently demonstrated that it is willing to issue accounting authority orders where expenditures are shown to be extraordinary.

III. OPERATING EXPENSES

A. Pension

1. Minimum Contribution

The Staff supports an adjustment to the cost of service proposed by Company to reflect disallowance of Company's contribution to its pension plan. Staff argues that Company's pension plan is overfunded and, therefore, under the rules of the Employment Retirement Income Security Act of 1974 (ERISA), Company was not required to make a contribution to its pension plan during the test year ending December 31, 1990. Since Company was not required by ERISA to make a contribution to its pension plan, Staff argues the cost of service should not reflect Missouri's allocated share of this contribution.

Company believes its contribution during the test year to the pension plan should be included in the cost of service because its fund advisor, an actuarial expert on employee benefits, recommended that a contribution be made during 1990. Company points out that its actuarial expert has recommended yearly contributions for total Company of approximately \$6 million in order to avoid large swings in the required contribution from year to year due to yearly variations in the demands on the plan by its beneficiaries and the value of its assets as a result of changes in the financial markets. Company further points out that the ERISA minimum requirement

does not forbid a company to make a larger contribution. Company's actuary testified that, for 1991, Company will be permitted by ERISA to make a maximum, tax deductible contribution of \$7.8 million.

The Commission determines that Company should be permitted to include in its cost of service Missouri's allocated share of the contribution made to its pension plan during the test year. Company's contribution to its pension plan is based upon the advise of an expert in the management of pension plans whose recommendation was designed to avoid wide swings in the yearly contribution to the plan. Company's expert testified that, if Company had made no contributions in 1988 and 1989, there would have been a contribution required by ERISA in both the test year, 1990, and 1991, and the pension expense for 1990 would have been \$1.4 million higher than the total Company figure of \$5.8 million.

Although Staff takes issue with the method employed by Company to appraise the value of the plan, this testimony sponsored by Company remained uncontroverted. Since rates are set prospectively, it is not useful to use the zero minimum contribution required by ERISA during the test year, to set a reasonable annual pension plan contribution when this could result in inflated contribution requirements during the years when the rates are in effect.

2. Medical Benefits

Staff recommends that Company's cost of service be reduced to reflect the annualized medical and dental benefits paid retirees during the test year. Staff asserts that the Revenue Reconciliation Act of 1990 would allow Company to transfer excess pension assets to pay for these medical benefits. Staff states that Company has \$26.1 million in excess pension assets subject to transfer to pay for these medical benefits if the actual market value of the plan is considered. Staff argues that Company should request permission of the IRS to use the actual market value

method to appraise the value of the plan so that Company would be eligible to transfer pension assets to pay for these medical benefits.

Company disagrees with Staff that it may transfer assets from the pension plan to pay for postretirement medical obligations pursuant to the Revenue Reconciliation Act of 1990. Company notes that the Internal Revenue Code (Code) has a limit that any corporation must meet before a transfer can be made. Company's pension plan expert testified that Company's pension fund assets fall short of the limit required by the Code and, therefore, Company may not transfer any assets during the test year to meet postretirement medical obligations.

Company further argues that it would be inappropriate for Company to request permission from the Internal Revenue Service (IRS) to use the actual market value of the pension plan assets for determining if such a transfer may be permitted since this market valuation method exacerbates fluctuations in the value of the pension fund based upon movements of the stock market. Company's pension plan expert testified that he uses the market-related method of evaluation in order to smooth market fluctuations and mitigate the need for large increases or decreases in contributions to the pension plan.

The Commission determines that Company should be allowed to include in its cost of service postretirement medical payments without reducing such cost by transferring assets from its pension plan. The Commission will not require Company to transfer assets from the pension fund in order to pay for postretirement medical benefits. The plan does not meet the limit necessary for such transfer as established by the Code based on the valuation method chosen by Company's pension plan advisor to avoid large fluctuations from one year to the next in the required contribution to the fund.

B. Bad Debt

In ratemaking it is necessary to estimate the level of expense associated with bad debt during the period that rates will be in effect. In order to do that the ratemaker typically analyzes the bad debt expense occurring in previous years and establishes a representative figure either by averaging several previous years' expenses or using some other figure which seems more representative as, for example, the test year expense. A ratio is then developed by comparing the expense chosen to the revenue earned by the Company during that period. This percent is then applied to the revenue expected from the new rates, to arrive at a bad debt expense to be reflected in those rates. This last calculation is based upon the assumption that bad debt expense increases with an increase in rates.

Company proposes to use the average of the prior three-years' actual net charge-offs of uncollectible accounts to determine a ratio of bad debt expense to firm revenues to be applied to the increased revenues resulting from this rate case. The actual net charge-offs used by Company in its calculations represent the actual customer accounts written off during a given year minus the collections received that year on previous write-offs.

Staff is concerned that Company's bad debt expense has been increasing too precipitously and feels that the method employed by Company will result in ratepayers rescuing shareholders from the ill effects of Company's poor management of its bad debt collection. In order to give Company an incentive to manage its bad debt collections more efficiently, Staff has used the figure for Company's bad debt reserve in 1989 which is \$1,981,959. This figure would result in a bad debt expense which is approximately \$1,348,511 less than the bad debt expense proposed by Company.

In support of its alternative methodology, Staff notes that Company's bad debt expense increased 7.69 percent from 1988 to 1989 and by 13.07 percent from 1989 to 1990. The actual net write-offs of bad debt in Missouri for these three years

were \$2,959,564, \$3,187,215 and \$3,603,817, respectively. Staff further notes that Company's bad debt collection process suffered from mismanagement with inconsistencies in the treatment of similarly situated customers, delays in shutting off service to delinquent customers and delays in paper work reflecting the current status of service to delinquent customers.

Staff points out that Company's estimate of its bad debt expense increased by almost \$1 million in 1990 over 1989 from \$1,919,959 to \$2,979,333, or over 50 percent. Staff notes that Company's external auditors commented on the increase in uncollectible accounts occurring from 1989 to 1990. Staff also points out that Company has experienced no concomitant increase in revenues since the increase in firm sales in 1990 over 1989 was approximately 1.6 percent from \$274,494,637 in 1989 to \$278,978,710 in 1990. Finally, Staff criticizes Company's method of arriving at the increase in bad debt expense to be reflected in these rates since the percentage of bad debt write-offs to firm sales which Company arrived at was applied to the full amount of revenue that Company initially requested in this case. Staff argues that this percentage should be applied to the anticipated increase in rates resulting from this case.

Company argues that Staff's approach is inconsistent with the methodology typically employed to establish bad debt expense and uses a number to represent bad debt expense which was actually an estimate of the bad debt expense expected by Company in the following year. Company also argues that Staff's complaints about mismanagement of bad debt collection are largely anecdotal and unrepresentative of the true state of affairs. In addition, Company argues that it has cleared up the problem involving delay of paper work on delinquent customers and that its increase in bad debt expense is consistent with increases in bad debt expense in other similarly situated utilities.

The Commission determines that Company's figures used in establishing bad debt expense should not be adopted in this case given the amount of increase Company has experienced recently in its bad debt expense. The Commission finds Staff's criticisms persuasive since Company's bad debt expense has increased 21.76 percent from 1988 to 1990. Even assuming that Staff's criticism of Company's management of bad debt collection is anecdotal as argued by Company, the Commission wishes to give Company the incentive to manage its bad debt collection process more efficiently and fairly than the evidence indicates it has done in the past. Ratepayers should not subsidize shareholders when Company does not manage its bad debt collection process efficiently.

The Commission finds that the bad debt expense has increased dramatically without any concomitant increase in revenue. The Commission is not persuaded that this increase is reasonable merely because similar increases have been experienced by utility companies providing service in such cities as Detroit and Pittsburgh. However, the Commission is not persuaded that Staff's use of Company's bad debt reserve account figure for 1988 is the correct approach to establish the bad debt expense since this figure is merely the Company's estimate in 1988 of the bad debt to be experienced in 1989. The Commission determines that the actual net write-offs for the year 1988, \$2,959,564, should be compared to the firm revenues of that year to produce the percentage of 0.90 percent to be applied to the increased revenues resulting from the decisions in this case including this decision on bad debt.

The Commission believes it is appropriate to apply this ratio to the revenues resulting from the decisions in this case rather than the full amount of revenue which would have occurred had Company succeeded in obtaining the entire revenue increase originally requested. Since the method employed to establish the bad debt expense is based on the assumption that bad debt expense increases with

increased rates, the Commission determines that the bad debt expense should be calculated based upon the actual increased rates established by this proceeding.

C. Allocations

The allocation process involves charging costs to the service which caused the cost and the jurisdiction where the service causing the cost was rendered. The primary matter at issue in this process is the allocation of payroll and payroll-related costs. Over 84 percent of Company's payroll expenses is directly assigned to only one jurisdiction or department. The difficulty arises in dividing up the remaining 16 percent of Company's payroll costs among the departments and jurisdictions according to some reasonable method.

There are two areas of disagreement on this issue between Staff and Company. Staff disagrees with Company's method for allocating certain payroll costs among departments and jurisdictions stating that Company's approach is too subjective and difficult to audit. The second area of disagreement between Staff and Company centers on the difference between the percentage of benefit costs capitalized when compared to the percentage of payroll costs capitalized. This second issue will be addressed hereinafter. The difference between Company and Staff on the allocations issue is approximately \$3,160,747.

Company proposes to allocate administrative payroll and payroll-related benefits to the various departments and jurisdictions based on Company's updated reconstruction of how its administrative and general employees spend their time. Specifically, Company's annually-salaried employees prepare an estimate of how their time will be spent in the future based, in part, on how they spent their time in the past. These updated reconstructions are reviewed by their supervisors. Once reviewed and approved, these updated reconstructions become the basis for allocating costs for the following year. If an employee's responsibilities should change, the estimate is altered to reflect that change.

Where costs do not relate solely to one jurisdiction or department, allocation ratios are used to charge the costs to the various departments and jurisdictions. Company employs three common allocation ratios which are based on net plant in service, number of customers and administrative and general payroll.

The net plant in service allocation factor is developed from the net plant in service in each jurisdiction and reflects expenditures that relate to the entire Company, the gas department only or Missouri only. The number of customers allocation factor is based upon the number of customers within each jurisdiction. The third payroll allocation factor is a residual category used only when a cost cannot be directly assigned and does not fit either of the two previous allocation categories. Company states that this category contains only a small portion of Company's total expenditures. This allocation information is kept by Company in comprehensive accounting manuals which are distributed to each office and is updated on a regular basis by Company's accounting department personnel.

Staff takes issue with Company's method of establishing how salaried employees allocate their time. Staff believes that Company's salaried personnel should spend at least a month recording their actual hourly time use which would become the basis for allocating payroll and payroll-related expenses for that year among the departments and jurisdictions. Staff argues that this approach would be more objective than Company's present approach and, unlike Company's present method, would provide a time study which Staff could audit for reasonableness.

Since Staff doubts the accuracy of Company's methodology, Staff proposes an alternative methodology for allocating common costs to the appropriate department and jurisdiction. Staff has employed seven responsibility areas (RAs) for the purpose of allocating these common costs. The RAs, which define these costs in terms of the functions they serve, are set forth in a Company accounting bulletin. Allocation

factors have been assigned to each of the functions represented by these RAs. The seven RAs employed by Staff are:

- Net plant in service
- Gas plant in service
- Total number of customers
- Gas customers
- KC Metro customers
- Southern Region customers
- Administrative and general payroll

Company disagrees with Staff's approach as being less detailed than its own approach. Company points to its large three-ring binder full of the estimates of 425 employees as to how they will spend the coming workyear, as being superior to Staff's generic approach of allocating employee costs according to their responsibility areas. Company argues that they have much more documentation to support their approach than Staff does to support its approach. In addition, Company asserts that it had no notice that Staff was unhappy with Company's methodology. Therefore, Company argues that its methodology should be approved for this rate case since Company agreed in the merger case (Case No. EM-91-213) to conduct a time study to be utilized in future allocation procedures.

The Commission determines that Staff's methodology should be adopted in this case for the purpose of allocating these common costs. Although Company showed the Commission voluminous documentation, it is the quality of the documentation and not its quantity alone which is important. The Commission does not find estimates of employees as to their future time use based on recollections of past time use to be a sufficiently accurate and objective method for allocating these common costs. Therefore, the Commission finds that Company failed to meet its burden of proof to show that this level of expenses for salaried payroll should be included in the cost of service.

The Commission believes that Staff's suggestion that Company should have at least a month-long time study each year during which employees document their time

use on an hourly basis, is a more reasonable approach for allocating these common costs but the Commission believes that a month-long time study may be insufficient to ensure the desired accuracy. The Commission would like to see Company keep a record of the actual time spent by salaried employees rather than a study of such time use. The Commission is aware of the agreement between Company and Staff in the merger case which commits Company to a time study but strongly encourages Company to consider having its salaried employees fill out time sheets on a regular basis throughout the year thereby ensuring greater reliability in the allocation process. This approach would also provide Staff with documentation which could be audited for reasonableness.

In the absence of records of actual time spent or even a reliable time study, the Commission believes that Staff's approach in this case, generic as it is, is the only evidence for allocating these common costs since it is based upon well-defined RAs established by Company itself. The Commission is not persuaded that Company had no notice of Staff's dissatisfaction with Company's method for allocating these costs since Staff noted its dissatisfaction in its testimony filed in a previous Company rate case (Case No. GR-86-76).

Finally, Company criticizes Staff's allocation of two nonpayroll administrative and general costs. These are the injury and damages expense and computer lease expense. Staff has allocated the first on the basis of net plant and the second on the basis of four factors (net plant, customers, revenues and payroll). Company believes the injury and damages expense, which includes liability insurance premiums, should be allocated on the basis of number of customers in each jurisdiction as should the computer lease expense. Company argues that liability for injuries is a function of the risk of injury and damages and, therefore, has no relationship to the net plant in service and that, although computers are used for many activities, their main activities are related to the customer service system.

The Commission determines that Staff's approach should be adopted in this case since Company has not shown that there is a greater relationship between the number of customers in this jurisdiction and the Company's risk of liability than between the net plant in this jurisdiction and Company's risk of liability. Perhaps, the more reasonable allocation approach would use both categories to allocate these costs since some of Company's risk exposure is suffered from yard lines not included in net plant in service. However, in the absence of a showing of the relative influence of these two factors, the Commission finds Staff's approach to be a reasonable method for allocating this cost since the operation of Company's net plant in service obviously exposes Company to the risk of liability for injuries.

The Commission further finds that Staff's approach to allocating computer lease expense is reasonable since it reflects the various uses to which the computers are put with emphasis on the customer-related use. Staff allocates 50 percent of the computer expense on the basis of the number of customers, 16.6 percent to revenues, 16.6 percent to payroll and 16.7 percent to net plant.

The second allocation issue in this case involves an inconsistency between the amount of benefits Company has capitalized compared to the amount of payroll Company has capitalized. Staff argues that Company should capitalize the same amount of benefits as the amount of payroll it has capitalized so that the allocations are consistent. Company has expensed 84.52 percent of benefits but only 73.42 percent of payroll.

Company opposes Staff's adjustment saying that Staff has included in this adjustment not only employee medical, pension and other fringe benefit costs, but also office supplies and liability insurance costs. Company argues that these nonbenefit costs should not be capitalized. In addition, Company argues that an adjustment of its entire capitalization percentage, including the benefits portion, would require a parallel adjustment increasing the amount in Company's rate base in

this case. Company also argues that this adjustment would require Company to rebill line extension customers, showing an adjustment to the overheads reflected in their bills.

The Commission determines that Staff's adjustment is reasonable as to the medical, pension and other fringe benefit costs. To the extent that liability insurance costs and other nonbenefit costs have been included in Staff's adjustment, the Commission determines that these items need not be capitalized based upon the percent of payroll capitalized.

The Commission is not persuaded by Company's argument that it would need to true-up customers' bills and that a parallel increase in rate base would be necessary if the capitalization of these expenses is increased. The Commission agrees with Staff that Company should correct its overheads on a going-forward basis and not rebill customers and that the rate base to be established in this case does not reflect Company's books after this adjustment but Company's investment at the end of the test year.

D. Payroll

The payroll issue involves estimating a reasonable level of yearly payroll expense to be reflected in the rates established by this proceeding. Company and Staff disagree over the method used to establish annualized payroll for Missouri operations. The difference between Company and Staff's position amounts to approximately \$2,729,846.

Company proposes to use its annualized payroll for the year ending December 31, 1990, in Missouri less \$711,042 to reflect 36 employees who left the Company since December 31, 1990, and will not be replaced.

Staff disagrees with Company's approach and developed its own method of estimating the appropriate payroll level to be reflected in these rates. Staff states that Company assigned no employee time or salaries to the merger and,

therefore, booked allocation factors for the first six months of 1991 may include activities associated with the merger. Staff further states that Company used 1990 data with a four percent increase to develop overtime and that this does not reflect Company's recent experience of dramatic decreases in overtime. Finally, Staff states that Company incorporated in its payroll projection positions vacated since the end of the test year and remaining unfilled as late as September 30, 1991.

Staff derives the annualized level of Company's payroll expense by multiplying the total Company gross payroll per calendar year 1990 by the percentage of payroll charges allocated to Missouri in 1990 to arrive at the Missouri gross payroll. The Missouri gross payroll is then multiplied by the percentage of payroll costs expensed in Missouri in 1990 in order to exclude the portion of the payroll capitalized and arrive at the annualized payroll expense. Staff then updates these salaries and employee levels through June 30, 1991, including a four percent pay increase effective for union workers July 1, 1991.

Staff updated the salary and employee levels through June 30, 1991, because significant changes in employee and salary levels have occurred between the end of Staff's test year on December 31, 1990, and June 30, 1991, including the union pay increase and a company-wide decrease of 76 full-time employees. Staff states that Missouri's allocation representing elimination of these 76 full-time positions is 19, or 25 percent, although Company projects an actual permanent reduction of full-time employees in Missouri for 1991 of 36. Staff argues that its approach is more fair than Company's in that it reflects both gains and losses in payroll expenses and utilizes more recent data.

Company opposes Staff's methodology as being based on total Company rather than Missouri figures and eliminating positions only temporarily frozen pending completion of the merger as well as utilizing budgeted rather than actual overtime.

The Commission determines that Staff's method should be adopted to establish the payroll expense to be reflected in these rates. Staff applies the allocation factors developed by Company for the year ending December 31, 1990, thereby avoiding the allocation factors booked for the first six months of 1991 which reflects no employee time or salaries assigned to merger activities. However, Staff applies these allocation factors to Company's total annualized payroll as of June 30, 1991, thereby using more recent data. Staff then adjusts these total Company figures to obtain the percentage to be allocated to the Missouri jurisdiction.

The Commission is not persuaded by Company that Staff has determined Company's payroll expense on a total Company rather than Missouri specific basis. Staff's procedure clearly adjusts the total Company figures for Missouri jurisdictional purposes. Nor is the Commission persuaded that Staff is wrong to use budgeted overtime for 1991 since the amount of Company's overtime costs appear to be falling. In answer to a data request, Company has stated that it is making a concerted effort to control overtime and expects actual overtime for 1991 to be at the budgeted level.

Finally, the Commission is not persuaded that Staff erred in removing positions from the payroll that have not been filled as of September 30, 1991. Company has not identified the additional positions they believe will be refilled in the future and, therefore, Company has not met its burden to establish that these positions should be included in estimating Company's future payroll expense.

IV. RATE OF RETURN

A. Capital Structure

In ratemaking it is necessary to establish a rate of return to be applied to a company's rate base or facilities. This rate of return is an overall weighted cost of capital which is derived by establishing the relative amounts of various kinds of capital obtained by the company to finance its facilities and by

establishing the cost for company to obtain these various kinds of capital. The relative amounts of various kinds of capital obtained by company is called the company's capital structure. Typically, this capital structure consists of common and preferred stocks, long-term debt and, sometimes, short-term debt. Once the relative amounts of ratios of these various forms of capital are established and the cost of each is fixed, the overall weighted cost of capital or rate of return can be ascertained.

In this case Staff and Company disagree as to the ratio of preferred stock and long-term debt to be ascribed to Company's capital structure. Public Counsel takes no position on the capital structure issue. Company proposes using its actual capital structure in establishing a rate of return in this case. Staff proposes an imputed capital structure since Staff argues that Company's actual capital structure has been affected by its recently approved merger with Kansas Gas and Electric Company (KGE).

In support of its argument, Staff argues that a recently approved preference stock issue was placed by Company instead of long-term debt to avoid a lower bond rating resulting from the merger. Staff points out that long-term debt is a cheaper form of capital than preference stock. Company responds that the issuance of the preference stock in question was contemplated prior to the merger. Staff replies that Company's management informed the Audit and Finance Committee of its Board of Directors on January 23, 1991, that additional mortgage debt could not be issued at this time outside of the merger credit agreement and management recommended issuance of preference stock in lieu of debt.

The Commission determines that the imputed capital structure proposed by Staff should be adopted in establishing rates in this proceeding. In its Report and Order issued September 24, 1991, approving the merger of Company with KGE (Case No. EM-91-213), the Commission made it clear that Missouri ratepayers would be protected

from any cost arising from the merger including its effect on capital costs. Company does not deny the statement of its management quoted by Staff. The evidence indicates that the preference stock issuance increased Company's requested revenue requirement in this case by an estimated \$180,000 over what it would have been with the issuance of long-term debt. Therefore, the Commission finds that the higher cost of the preference stock issue must be borne by Company's shareholders and that Staff's imputed capital structure should be used in establishing Company's rate of return in this case.

B. Return on Equity

The rate of return for Company is established by estimating its cost of common equity and combining it with its costs for debt and preferred stock. Company, Staff and Public Counsel, used the discounted cash flow (DCF) method of estimating the cost of common equity. These parties differ, however, on which values should be used in the formula and how those values should be established. These parties also differ as to whether the return on equity arrived at should be adjusted to reflect costs incurred by the Company in issuing its common stock. The issue of these flotation costs will be addressed in the following section.

In the DCF formula the return on equity equals the sum of the yield term, determined by dividing the dividend per share by the stock price per share, and the growth rate in dividends. Typically, with the DCF formula it is assumed that the Company's stock is traded on the stock market and that the Company pays a dividend to its shareholder.

In its DCF analysis, Staff calculated the growth rate factor of the formula by using a weighted average of the historical growth rate and the projected growth rate of Company to produce an overall average growth rate of 4.39 percent. In calculating the yield, Staff found the dividend per share expected to be paid by Company over the next twelve months ending December 31, 1992, by increasing Company's

current annual dividend rate of \$1.86 per share by the estimated rate of dividend increase of 4.39 percent, arriving at a dividend of \$1.94.

To establish the price per share element of the yield factor in the DCF model, Staff used the monthly high and low average market price for Company's publicly traded common stock during the period from May 1, 1991 through August 31, 1991. This price per share of between \$23.688 to \$25.125 when divided into the expected dividend of \$1.94 per share produces an expected dividend yield range for Company of 7.72 to 8.19 percent. Combining this yield range with the growth factor previously established produces an estimated cost of common equity for Company ranging from 12.11 percent to 12.58 percent.

To offset the effect of imputing long-term debt for the preference stock recently issued by Company, Staff analyzed the required returns on equity for companies the bonds of which are rated AA and A and, on the basis of this analysis, Staff added 26 basis points to its recommended range for return on equity for Company producing a new range of 12.37 percent to 12.84 percent. Staff further recommends that the Commission use the high end of its recommendation in calculating a rate of return for Company, i.e., a 12.84 percent return on common equity.

To check the reasonableness of its estimate, Staff selected a group of natural gas distribution companies and calculated their average DCF cost for equity. This average was 12.93 percent which Staff believes shows the reasonableness of its estimate for KPL since KPL is traded on the stock market as a combination electric and gas utility which is considered less risky than a utility which is solely a gas distribution company.

As a further test of the reasonableness of its estimate, Staff checked the *Value Line Investment Survey* of July 19, 1991, which had estimated that KPL would earn a 12.5 percent return on common equity in 1991. In addition, the *Value Line Investment Survey* of July 5, 1991, had projected that the natural gas distribution

utility industry on average would earn 11.5 percent on common equity for 1991 and 12 percent for 1992.

Company also used the DCF model to estimate its return on equity. However, Company did not use data from the public trading of its own stock to establish the price per share element of the yield factor in the DCF formula. Rather, Company calculated the price per share based upon an analysis of nine publicly traded gas utilities representing risks similar to those of Company's gas operations. Company supports this approach by stating that investors consider whether to invest in KPL based upon the lower risks associated with its combination of electric and gas services rather than on the higher risks associated with its operations in Missouri which are wholly in the area of gas service. Therefore, Company concludes that KPL's publicly traded stock does not accurately reflect the cost of capital for its Missouri division.

In addition, Company asserts that the value of its stock has risen as a result of the recently approved merger causing its rate of return to be artificially deflated. Finally, Company's DCF analysis is different from Staff's analysis in that it assumes the quarterly reinvestment of dividends on common stock by its shareholders.

Public Counsel's DCF analysis resembles Staff's DCF analysis in all significant respects and Public Counsel and Staff both oppose Company's approach for essentially the same reasons. Staff and Public Counsel state that the public trading of KPL's own stock should be used in the DCF analysis because prospective investors will consider KPL as a whole in deciding whether to buy KPL's stock and not merely the Missouri division of that Company and, therefore, such prospective shareholders will consider KPL's stock based on the lower risks associated with a combination utility rather than on the higher risks associated with a gas distribution company. Therefore, Staff and Public Counsel conclude that a DCF analysis employing KPL's

actual stock prices will result in a more accurate estimate of the appropriate cost of KPL's equity capital.

In addition, Staff and Public Counsel note that KPL's shareholders should not be shielded from their decision to vote to merge with KGE by protecting them from the effects of the merger upon the value of their stock at the expense of ratepayers who would have to pay KPL's shareholders a higher return on equity than the value of the stock warrants.

Finally, Staff and Public Counsel oppose adjusting the DCF analysis on the assumption that KPL's shareholders reinvest their dividends quarterly. Staff and Public Counsel argue that Company has not presented evidence that this is the case and, if they had, ratepayers should not be required to provide an additional return to shareholders on their reinvested dividends.

The Commission determines that the DCF analysis presented by Staff should be adopted in this case. The purpose of the DCF analysis is to estimate the return on equity necessary to attract investors to KPL given the future value of the stock based upon its projected price and dividend per share. This projected return on equity allows the Commission to establish the rates which should be charged by Company in the future in order to meet its costs for rendering service including its cost of capital. The Missouri division of KPL is not a publicly traded company but the total KPL company is publicly traded. Therefore, prospective investors will consider the entire company in deciding whether to invest in KPL. Therefore, it is not reasonable or necessary to base an estimate of its future cost of equity upon data gathered from other companies.

The Commission further determines that Staff's approach is preferable because it shields ratepayers from the effect of Company's merger with KGE. In its Report and Order approving the merger with KGE issued September 24, 1991, the Commission vowed to shield Missouri ratepayers from any adverse effects arising from

the merger, including effects on Company's cost of capital. To raise the return on equity to counteract its deflation resulting from the rise in the value of KPL's stock following the merger announcement, would be to force ratepayers to shield shareholders from the effects of their decision to merge. Such a decision would be diametrically opposed to the intention of the Commission as set forth in its Report and Order approving the merger.

The Commission also finds that it is inappropriate to include in the DCF analysis an adjustment for quarterly reinvestment of dividends by shareholders as suggested by Company. Company has not shown that shareholders are reinvesting their dividends each quarter to such a degree that such activity should even be considered in calculating the return on equity.

Finally, the Commission notes that the results of Staff's analysis are not greatly different from the results of Company's analysis when Company's analysis is updated to reflect more recent economic developments. Company's cost of equity analysis was based on April, 1991 data when the prime interest rate was 9 percent. As of September 17, 1991, the prime interest rate was 100 basis points lower at 8 percent. Staff's analysis indicates that Company's DCF cost of equity range would be lowered to 12.11 to 12.25 percent based upon the updated interest rate information in the record, provided the adjustment for flotation costs is removed. The Commission further notes that Company's data is even more outdated when it is considered that the hearing in this case was held October 23 through 25, 1991, and that this decision is being issued in the latter part of January, 1992.

C. Flotation Costs

Company has made an adjustment to its DCF analysis to reflect the effect of flotation costs on the amount of capital Company can raise. As a result of these flotation costs, a public utility receives less for the securities it issues than investors actually pay for these securities while being forced to pay a return to the

investors on the total amount of the securities. Company notes that the Commission historically makes a flotation cost adjustment to the cost of equity when the public utility intends to issue common stock within one year of the effective date of the new rates. Company states that it intends to issue common stock within the near future. Therefore, Company argues that it is appropriate to include these flotation costs in estimating the appropriate cost of equity.

Public Counsel opposes recognition of the flotation costs in establishing Company's cost of equity. Public Counsel points to the statement of Company's rate of return witness that the impending issuance of common stock is merger related. Public Counsel also points to the Commission's commitment to shield Missouri ratepayers from costs associated with the merger as a reason to exclude any flotation costs associated with the impending issuance of common stock. Public Counsel notes that the effect on Missouri ratepayers of including a flotation cost adjustment in establishing Company's cost of equity would be roughly \$650,000 annually.

The Commission determines that these flotation costs should not be accounted for in establishing the appropriate cost of equity for Company. Since Company's witness has admitted that the imminent common stock issuance is merger related, the Commission believes that flotation costs associated with such issuance should not be paid by Missouri ratepayers in order to shield them from any adverse effect arising from the merger.

D. Overall Weighted Cost of Capital

The Commission has adopted Staff's capital structure and Staff's method for establishing the appropriate range for Company's return on equity. The Commission agrees with Staff that the high end of this range, 12.84 percent, should be adopted in this case. The high end of Staff's range is compatible with the rates of return projected by Value Line Investment Survey for natural gas distribution companies in 1992 and computed by Staff as an average DCF cost of equity for its selected group of

natural gas distribution companies. Although the Commission has found that investors will regard KPL as a combination utility when considering investment choices, the Commission determines that this compatibility with the projected return for gas distribution companies, is further evidence of the reasonableness of the 12.84 percent return on equity chosen for KPL.

Given the embedded cost of the other forms of capital, preferred stock, long-term debt and short-term debt, about which no disagreement has been expressed by the parties, the return on equity for Company of 12.84 percent translates into a rate of return on Company's rate base of 10.54 percent to be applied to the rate base agreed to in this case as adjusted by the Commission's decisions set forth herein.

V. RATE DESIGN

Rate design is the process by which a change in rates is distributed among the classes of customers taking Company's service such as industrial, residential and commercial customers. The parties to this case have concluded a stipulation and agreement as to the appropriate rate design to be applied to this rate increase. The Commission finds that the rate design agreed to by the parties is reasonable and should be adopted in this case. In addition, Company, Staff and the Office of the Public Counsel have concluded a stipulation and agreement in regard to Company's authority to charge less than the maximum for transportation services where necessary to retain or expand services to an existing customer, to reestablish service to a previous customer or to acquire new customers. One of the major purposes of this agreement on flex rates is to prevent the loss of customers to alternative energy sources where the retention of that customer benefits the gas system as a whole.

The Commission determines that this flex rate stipulation is reasonable and should be adopted in this case since the agreement provides that Company shall have the burden of proof to demonstrate that extending flex rates to the customer in question will benefit the system as a whole.

Conclusions of Law

The Missouri Public Service Commission has arrived at the following conclusions of law.

Company is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 393, RSMo 1986, as amended. Company's tariffs herein were suspended pursuant to authority vested in this Commission by Section 393.150, RSMo 1986, which places upon Company the burden of proof to show that the proposed increase in rates is just and reasonable.

Pursuant to Section 536.060, RSMo 1986, the Commission may approve a stipulation and agreement concluded between parties to a contested case. The Commission has determined that the agreements among the parties as to rate design and flex rates are reasonable and, therefore, the Commission concludes that these stipulations should be approved.

Based upon the Commission's findings in this case the Commission concludes that Company should be allowed to file revised tariffs designed to increase its revenues exclusive of gross receipts and franchise taxes by \$7,272,490 or 2.357 percent on an annual basis. The result is based upon Late-filed Exhibit 70. Since the rate increase approved herein does not exceed seven percent, the provisions of Section 393.275, RSMo 1986, do not apply.

IT IS THEREFORE ORDERED:

1. That pursuant to the findings and conclusions in this Report and Order the proposed tariffs filed by The Kansas Power and Light Company in this case be disapproved hereby and that The Kansas Power and Light Company be authorized hereby to file in lieu thereof, for the approval of this Commission, tariffs designed to increase gross revenues exclusive of gross receipts and franchise taxes by the amount of \$7,272,490 on an annual basis over the currently effective rates.

2. That the tariffs to be filed pursuant to this Report and Order shall become effective for service rendered on and after February 5, 1992.

3. That the stipulations concluded among the parties as to rate design and flex rates, as set forth in Exhibits 28 and 29, respectively, be approved hereby.

4. That Late-filed Exhibits 67, 68, 69 and 70 be received hereby into evidence. Late-filed Exhibit 67 is a memorandum from Examiner O'Donnell dated January 17, 1992, requesting an updated reconciliation based upon a hypothetical set of decisions on the issues in this case. Late-filed Exhibit 68 is a corrected version of Late-filed Exhibit 67. Late-filed Exhibit 69 is the response of the parties to Late-filed Exhibits 67 and 68, and Late-filed Exhibit 70 is the corrected response of the parties to Late-filed Exhibits 67 and 68.

5. That any objections not heretofore ruled upon be overruled hereby and any outstanding motions be denied hereby.

6. That this Report and Order shall become effective on the 5th day of February, 1992.

BY THE COMMISSION

Brent Stewart

Brent Stewart
Executive Secretary

(S E A L)

McClure, Chm., Mueller, Rauch, and Perkins, CC., Concur and certify compliance with the provisions of Section 536.080, RSMo 1986. Kincheloe, C., Not Participating.

Dated at Jefferson City, Missouri, on this 22nd day of January, 1992.