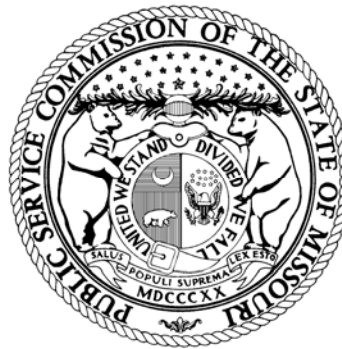


MISSOURI PUBLIC SERVICE COMMISSION

STAFF REPORT REVENUE REQUIREMENT COST OF SERVICE



VEOLIA ENERGY KANSAS CITY, INC.

FILE NO. HR-2011-0241

*Jefferson City, Missouri
August 8, 2011*

**** Denotes Highly Confidential Information ****

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COST-OF-SERVICE REPORT

I. Executive Summary

This Cost of Service Report provides the results of Staff's review into the general rate increase request made by Veolia Energy Kansas City, Inc. (Veolia Kansas City or Company) on April 22, 2011.

Staff's review involved several members of the Missouri Public Service Commission (Commission) Staff who examined all relevant and material components making up the revenue requirement calculation. These items can be broadly defined as capital structure and return on investment, rate base investment and income statement results including revenues, operating and maintenance expenses, depreciation expense, and related taxes, including income taxes.

Staff's audit findings, based on its review of Veolia Kansas City's current cost structure, supports an increase in rates of between \$1,014,995 to \$1,097,273 based on a range of rate of return from 7.07% to 7.56% with an increase of \$1,056,298 using Staff's mid-range of the rate of return of 7.31%, and the latest information available through June 30, 2011, for the material items affecting the revenue requirement calculation. In its direct filing, Veolia Kansas City calculated a revenue requirement of \$3,692,253 based on use of a 2010 test year, but chose to limit its rate increase request to an amount of \$1,379,000 for the reasons stated in its filing.

Staff Expert/Witness: Karen Lyons

II. Background of Veolia Energy Kansas City, Inc.

Veolia Energy Kansas City, Inc., formally known as Trigen Kansas City Energy Corporation (Trigen), is a steam production and distribution company, serving the downtown central district of the City of Kansas City, Missouri, and two industrial process steam users.

1 Originally, Veolia Kansas City steam operations were owned and operated by Kansas City
2 Power & Light Company (KCPL). Trigen purchased the Grand Avenue production facilities
3 and the distribution system from KCPL in 1990. The Commission approved the sale in Case
4 No. HA-90-5.

5 On March 10, 2011, Trigen filed a request with the Commission to change its name to
6 Veolia Energy Kansas City, Inc., in Case No. HN-2011-0286. The Commission approved the
7 name change and the accompanying tariffs sheets on April 10, 2011.

8 Veolia Energy Missouri (Veolia Missouri) is a non-regulated affiliate of Veolia Kansas
9 City providing chilled water service in the central downtown district of Kansas City. Veolia
10 Kansas City and Veolia Missouri are wholly owned subsidiaries of Thermal North America Inc.
11 (Thermal North America or TNAI). Veolia Energy North America, LLC, a management service
12 company, is a wholly owned subsidiary of Thermal North America. Thermal North America
13 was purchased by Veolia Energy North America Holdings, Inc., in December 2007. Thermal
14 North America has several other wholly owned subsidiaries managed by Veolia Energy North
15 America, LLC, and are referred to herein as the Veolia Companies. Veolia Energy North
16 America, LLC, directly assigns or allocates certain corporate costs it incurs directly to the Veolia
17 Companies. The Veolia Companies are located in the following locations: Baltimore,
18 Maryland; Boston, Massachusetts; Trenton, New Jersey; Philadelphia, Pennsylvania; Oklahoma
19 City, Oklahoma; Tulsa, Oklahoma; St. Louis, Missouri; Kansas City, Missouri; Las Vegas,
20 Nevada; Atlanta, Georgia; and Los Angeles, California. The Veolia Companies located in
21 Philadelphia, Pennsylvania, St. Louis, Missouri and Kansas City, Missouri are subject to state or
22 local regulation. Veolia Kansas City currently serves approximately 54 retail customers all
23 located in the downtown central district of the City of Kansas City, otherwise known as the

1 “downtown loop.”¹ In addition to the retail customers, Veolia Kansas City also sells process
2 steam to two large industrial customers located outside the downtown loop. The Company
3 meters the steam sold to these customers at the Grand Avenue production facility.

4 A corporate organizational chart for Veolia and its subsidiaries is attached to Staff
5 witness Featherstone’s direct testimony as Schedule 2.

6 *Staff Expert/Witness: Karen Lyons*

7 **A. Veolia Energy Kansas City, Inc. 2011 Rate Case**

8 On April 22, 2011, Veolia Kansas City filed a general rate increase case for \$1,379,000, a
9 19% increase. This is the third rate increase request that Veolia Kansas City has filed since
10 taking over the steam operations in 1990. However, the Company withdrew its first rate increase
11 request filed in the early 1990s. So, in actuality, this case is the Company’s second full rate
12 relief request since acquiring the steam system in Kansas City in early 1990.

13 Rates in the last rate case became effective November 1, 2008. Prior to that change in
14 rates, Veolia Kansas City’s customers had not experienced a rate increase since KCPL owned the
15 steam operations, occurring in 1982, in Case No.HR-82-67.

16 *Staff Expert/Witness: Karen Lyons*

17 **B. Test Year**

18 The test year used in this case is calendar year 2010. The Commission authorized the use
19 of the test year in its *Order Setting Test Year (Order)*, issued May 19, 2011.

20 Known and measurable changes are ratemaking events that have occurred subsequent to
21 the test year. These events are certain to occur, or have occurred, and can be quantified for

¹ The downtown KC area is no longer served by a true “loop.” In the construction of the Sprint Arena, a steam pipe was truncated in Case No. HC-2005-0331.

1 measurement. Included in the Commission's *Order* establishing the 2010 test year, the
2 Commission also established an update period for known and measurable changes through the
3 first quarter 2011. However, Staff's audit found that the Company planned a payroll rate
4 increase on July 1, 2011. Staff determined that the payroll increase was a material cost to the
5 Company, so the Staff included it in the payroll annualization in the case. To maintain the
6 integrity of the relationship between revenues, costs and rate base, Staff reflected all material
7 costs including plant in service, accumulated depreciation reserve, depreciation expense and
8 other items through June 30, 2011.

9 *Staff Expert/Witness: Karen Lyons*

10 **III. Rate of Return and Capital Structure**

11 **A. Introduction**

12 An essential ingredient of the cost-of-service ratemaking formula provided above is the
13 rate of return (ROR), which is designed to provide a utility with a return of the costs required to
14 secure debt and equity financing. This ROR is equal to the utility's weighted average cost of
15 capital, which is calculated by multiplying each component ratio of the appropriate capital
16 structure by its cost and then summing the results. While the proportion and cost of most
17 components of the capital structure are a matter of record, the cost of common equity must be
18 determined through expert analysis. Staff's expert financial analyst, Zephania Marevangepo,
19 has determined Veolia Energy Kansas City, Inc.'s cost of common equity by applying a
20 well-respected and widely-used methodology² to data derived from a carefully-assembled group
21 of comparable companies.

² Staff relied primarily on its Discounted Cash Flow (DCF) analysis of a group of comparable utilities, checking the reasonableness of its result with a Capital Asset Pricing Model (CAPM) analysis as well as by other corroborating data.

Due to the limited amount of publicly-traded market data available for steam-heat utility operations such as those of Veolia Energy Kansas City, Inc.'s, Staff used a proxy group of natural gas distribution companies as a proxy for a fair and reasonable cost of equity, debt and capital structure for purposes of ratemaking for Veolia Energy Kansas City, Inc.'s operations. Natural gas distribution companies operate in a similar economic and capital market environment as Veolia Energy Kansas City, Inc. regulated operations and are limited to the distribution of utility services. As can be derived from the debt and equity ratios (see Appendix 2, Schedule 7, attached to this report), the proposed capital structure is based on an approximate average of the proxy group of natural gas distribution companies used by Staff.

Staff then used that cost of common equity, together with other capital component information as of December 31, 2010, to calculate Veolia Energy Kansas City, Inc.'s fair rate of return, as follows:

TABLE ONE: Veolia Energy Kansas City, Inc.'s Rate of Return:

Capital Component	Percentage of Capital	Embedded Cost	Weighted Cost of Capital Using Common Equity Return of:		
			8.25%	8.75%	9.25%
Common Stock Equity	49.00%	----	4.04%	4.29%	4.53%
Long-Term Debt	51.00%	5.93%	3.03%	3.03%	3.03%
	100.00%		7.07%	7.31%	7.56%

See Schedule 13

As reflected in Table One, Staff recommends, based on its expert analysis, a return on common equity ("ROE") range of 8.25 percent - 9.25 percent and an overall ROR range of 7.07 percent - 7.56 percent, with point estimates of 8.75 percent and 7.31 percent respectively. Staff's recommended ROE incorporates a 43-basis point credit-rating differential adjustment.

1 Veolia Environnement, parent to Veolia Energy Kansas City, Inc., has a “BBB+” credit rating
2 and Staff’s proxy group has an average credit rating of “A.”³ Staff used Veolia Environnement’s
3 credit rating because, to Staff’s knowledge, it is the only entity in the Veolia family of companies
4 that is rated. Presumably, this rating would also apply to its subsidiaries, at least based on
5 Standard & Poor’s (S&P) ratings methodology. Further details of Staff’s analysis and
6 recommendations are presented in Appendix 2, Schedules 1-13, attached to this report.

7 **B. Analytical Parameters**

8 The determination of a fair rate of return is guided by principles of economic and
9 financial theory; and by certain minimum Constitutional standards. Investor-owned public
10 utilities such as Veolia Energy Kansas City, Inc. are private property that the state may not
11 confiscate without appropriate compensation. The Constitution requires, therefore, that utility
12 rates set by the government must allow a reasonable opportunity for the shareholders to earn a
13 fair return on their investments. The United States Supreme Court has described the minimum
14 characteristics of a Constitutionally-acceptable rate of return in two frequently-cited cases. In
15 *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*,
16 the Court stated:⁴

17 A public utility is entitled to such rates as will permit it to earn a return on
18 the value of the property which it employs for the convenience of the
19 public equal to that generally being made at the same time and in the same
20 general part of the country on investments in other business undertakings
21 which are attended by corresponding risks and uncertainties; but it has no
22 constitutional right to profits such as are realized or anticipated in highly
23 profitable enterprises or speculative ventures. The return should be
24 reasonably sufficient to assure confidence in the financial soundness of the
25 utility and should be adequate, under efficient and economical
26 management, to maintain and support its credit and enable it to raise the

³ Standard and Poor’s summary: Veolia Environnement S.A, February 23, 2011.

⁴ 262 U.S. 679, 692-93, 43 S.Ct. 675, 679, 67 L.Ed. 1176, 1182-83 (1923).

1 money necessary for the proper discharge of its public duties. A rate of
2 return may be reasonable at one time and become too high or too low by
3 changes affecting opportunities for investment, the money market and
4 business conditions generally.

5 Similarly, in the later of the two cases, ***Federal Power Commission v. Hope Natural Gas Co.***,
6 the Court stated:⁵

7 ‘[R]egulation does not insure that the business shall produce net
8 revenues.’ But such considerations aside, the investor interest has a
9 legitimate concern with the financial integrity of the company whose rates
10 are being regulated. From the investor or company point of view it is
11 important that there be enough revenue not only for operating expenses
12 but also for the capital costs of the business. These include service on the
13 debt and dividends on the stock. By that standard the return to the equity
14 owner should be commensurate with returns on investments in other
15 enterprises having corresponding risks. That return, moreover, should be
16 sufficient to assure confidence in the financial integrity of the enterprise,
17 so as to maintain its credit and to attract capital.

18 From these two decisions, Staff derives and applies the following principles to guide it in
19 recommending a fair and reasonable ROR:

- 20 1. A return consistent with returns of investments of comparable risk;
- 21 2. A return sufficient to assure confidence in the utility’s financial
22 integrity; and
- 23 3. A return that allows the utility to attract capital.

24 Embodied in these three principles is the economic theory of the opportunity cost of investment.

25 The opportunity cost of investment is the return that investors forego in order to invest in similar
26 risk investment opportunities, which will vary depending on market and business conditions.

27 The methodology of financial analysis has advanced greatly since the ***Bluefield*** and ***Hope***
28 decisions. Additionally, today’s utilities compete for capital in a global market rather than a
29 local market.⁶ Nonetheless, the parameters defined in those cases are readily met using current

⁵ 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333, 345 (1943).

⁶ Neither the DCF nor the CAPM methods were in use when those decisions were issued.

1 methods and theory. The principle of the commensurate return is based on the concept of risk.
2 Financial theory holds that the return an investor may expect is reflective of the degree of risk
3 inherent in the investment, risk being a measure of the likelihood that an investment will not
4 perform as expected by that investor. Any line of business carries with it its own peculiar risks
5 and it follows, therefore, that the return Veolia Energy Kansas City, Inc. may expect is equal to
6 that required for comparable-risk utility companies.

7 Financial theory holds that the company-specific Discounted Cash Flow (DCF) method
8 satisfies the constitutional principles inherent in estimating a return consistent with those of
9 companies of comparable risk;⁷ however, Staff recognizes that there is also merit in analyzing a
10 comparable group of companies as this approach allows for consideration of industry-wide data.
11 Because Staff believes the cost of equity can be reliably estimated using a comparable group of
12 companies and the Commission has expressed a preference for this approach, Staff relies
13 primarily on its analysis of a comparable group of companies to estimate the cost of equity for
14 Veolia Energy Kansas City, Inc.

15 In this case, Staff established the following: 1) Veolia Energy Kansas City, Inc. is not a
16 publicly traded entity; and 2) Veolia Energy Kansas City, Inc. and its parent company,
17 Veolia Energy North American Holdings, Inc. (VENAH), do not have market-based capital
18 structures that represent a fair and reasonable capitalization when compared to the manner in
19 which the natural gas distribution companies in Staff's proxy group are generally capitalized.
20 In order to derive a hypothetical capital structure, Staff selected 7 companies (proxy group)

⁷ Because the DCF method uses stock prices to estimate the cost of equity, this theory not only compares the utility investment to other utilities, but it compares the utility investment to all available assets. Consequently, setting the allowed ROE based on a market-determined cost of equity is necessarily consistent with the principles of *Hope* and *Bluefield*.

1 and computed an average capital structure for these companies (see Appendix 2, Schedules 5, 6
2 and 7).

3 Staff then applied the comparable company approach through the use of both the DCF
4 and the Capital Asset Pricing Model (CAPM). Properly used and applied in appropriate
5 circumstances, both the DCF and the CAPM methodologies can provide accurate estimates of a
6 utility's cost of equity. Because it is well-accepted economic theory that a company that earns
7 its cost of capital will be able to attract capital and maintain its financial integrity, Staff believes
8 that authorizing an *allowed* return on common equity based on the *cost* of common equity is
9 consistent with the principles set forth in *Hope* and *Bluefield*.

10 **C. Current Economic and Capital Market Conditions**

11 Determining whether a cost of capital estimate is fair and reasonable requires a good
12 understanding of the current economic and capital market conditions, with the former having a
13 significant impact on the latter. With this in mind, Staff emphasizes that an estimate of a utility's
14 cost of equity should pass the "common sense" test when considering the broader current
15 economic and capital market conditions.

16 **1. Economic Conditions**

17 The United States is still recovering from the effects of the most severe recession since
18 the Great Depression. The Federal Open Market Committee (FOMC) participants are optimistic
19 that the economic recovery will continue at a moderate pace.⁸ As a result, economists generally

⁸ Minutes of the Federal Open Market Committee, Summary of Economic Projections – page, June 21–22, 2011

1 expect the long-term Gross Domestic Product (GDP) growth rate to be approximately
2 4.5 percent, of which approximately 2.25 percent is attributed to the GDP deflator.⁹

3 Because of the Federal Reserve Bank's ("Fed") concern about the weakness of the
4 economic recovery, the Fed continues to maintain the Fed Funds Rate at historically low levels
5 between 0.00 and 0.25 percent (see Appendix 2, Schedules 2-1 and 2-2). The following is an
6 excerpt the FOMC meeting – June 21-22, 2011:

7 To promote the ongoing economic recovery and to help ensure that
8 inflation, over time, is at levels consistent with its mandate, the Committee
9 decided today to keep the target range for the federal funds rate at 0 to ¼
10 percent. The Committee continues to anticipate that economic
11 conditions—including low rates of resource utilization and a subdued
12 outlook for inflation over the medium run—are likely to warrant
13 exceptionally low levels for the federal funds rate for an extended
14 period.¹⁰

15 **2. Capital Market Conditions**

16 **a. Utility Debt Markets**

17 Utility debt markets clearly indicate a lower cost-of-capital environment. If one were to
18 assume that the risk premium¹¹ required to invest in utility stocks rather than utility bonds
19 were constant, then these lower utility debt yields clearly translate into a lower required return
20 on equity. In other words, lower cost of debt is indicative of lower cost of capital, all else
21 being equal.

22 Unlike the short-term capital costs directly influenced by the Fed, long-term
23 capital costs are market-based. Long-term interest rates, as measured by 30-year Treasury bonds
24 ("T-bonds"), are still at relatively low levels when compared to the 80s and 90s. The monthly

⁹ The Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2010-2020*, June 11 2011; and The Energy Information Administration's *2011 Annual Energy Outlook*.

¹⁰ Minutes of the FOMC - June 21 – 22, 2011.
<http://www.federalreserve.gov/monetarypolicy/fomcminutes20110622.htm>

¹¹ Risk Premium in this context is the excess required return to invest in a company's equity rather than its debt.

1 yields on 3-year T-bonds for the most recent three months (April, May and June)
2 were 4.50 percent, 4.29 percent and 4.23 percent respectively (see Appendix 2, Schedules 4-2
3 and 4-3). Long-term utility bond yields are also at relatively low levels. Matching the same
4 periods indicated earlier, the three month averages were 5.76 percent, 5.57 percent and
5 5.52 percent respectively (see Appendix 2, Schedules 4-1 and 4-3). As of June 2011, the average
6 spread between 30-year T-bonds (4.23 percent) and average utility bond yields (5.52 percent)¹²
7 was 25 basis points, which is 21 basis points below the average of such yields displayed in the
8 period since 1980 (see Appendix 2, Schedule 4-3).

9 While the cost of investment-grade utility debt capital has reached historic lows, the
10 risk premium to invest in bonds of lower credit quality is higher than the premium for higher
11 credit quality bonds. Thus, while utilities with at least investment grade credit ratings can obtain
12 capital quite cheaply, utilities with lower credit quality will pay a higher risk premium relative to
13 risk-free rates. However, the total required return on even borderline investment-grade debt is at
14 levels more consistent with that realized during 2005.

15 The present low cost of utility capital is illustrated by the case of Great Plains Energy,
16 which recently sold \$350 million of 10-year debt. The 10-year traded at 3.118 - late Tuesday,
17 May 17, 2011 - compared with 3.725 percent in February, 2011.¹³ The debt was rated by
18 Moody's and Standard and Poor's at 'Baa3' and 'BBB-' respectively.¹⁴

¹² The 5.52 percent yields is based on an average from data obtained from BondsOnline.com. For utility bond yields Staff provides prior to September 2010, Staff used Mergent Bond Record. Staff has canceled its subscription to Mergent Bond Record and will rely on data it receives from BondsOnline pursuant to a subscription agreement.

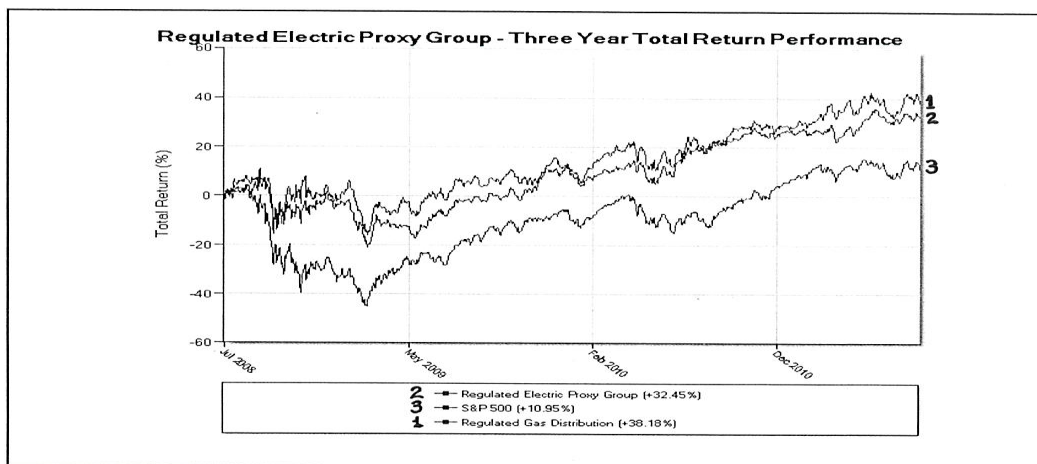
¹³ THE WALL STREET JOURNAL - Companies Rush to Borrow – Firms Fill Up on Debt Before Fed Closes Door on Easy Credit, page A1, May 18, 2011

¹⁴ Great Plains Energy Preparing a 10-Yr Sr Unsecured Note Sale - <http://online.wsj.com/article/BT-CO-20110516-707718.html>

b. Utility Equity Markets

Investors view regulated utility company stock investments as a close alternative to bond investments. Therefore, like bond investments, when long-term interest rates fall, regulated utility company stock prices typically increase. Assuming there is no change in the fundamentals of the industry, this translates directly into a lower cost of equity for regulated utility companies.

The graph below illustrates Staff's position that utility stocks are a safe haven especially in periods of financial turmoil. For that reason, utility stocks, especially regulated stocks, are known as defensive stocks and holders of value.



Line 1 clearly depicts that Staff's regulated gas distribution proxy group used in this case has slightly outperformed Staff's regulated electric utility proxy group in the most recent Ameren Missouri rate case, Case No. ER-2011-0028, (Line 2) and significantly outperformed the S&P 500 (Line 3) for the past 3 years. This stock performance data supports Staff's assertion that the cost of equity for utilities has trended lower as compared to that of the S&P 500, especially so for regulated gas distribution companies.

1 Therefore, the current low levels of long-term interest rates on 30-year T-bonds and
2 public utility bonds; and corroborating trends, substantiate Staff's opinion that the cost of equity
3 to regulated gas utility companies is currently lower.

4 **D. Veolia Energy Kansas City, Inc. Operations**

5 The following excerpt from Veolia Energy North America website provides a good
6 description of Veolia Energy Kansas City, Inc.'s current business operations:

7 In Kansas City, Veolia Energy's district energy network serves
8 approximately 60 customers in the central business district, with more
9 than 4 million square feet of commercial space.

10 The district energy network provides centrally-produced steam and chilled
11 water for their customers, and the facility also cogenerates electricity.¹⁵

12 **E. Veolia Energy Kansas City, Inc.'s Credit Ratings**

13 Veolia Energy Kansas City, Inc. is not publicly traded and is not rated on a stand-alone
14 basis. However, its ultimate French parent company, Veolia Environnement has a 'BBB+' credit
15 rating from S&P. The following excerpt from Veolia Environnement's 2010 Annual Financial
16 Report provides a good description of Veolia Environnement's share capital management
17 objectives, policies and procedures:

18 Veolia Environnement manages its share capital within the framework of a
19 prudent and rigorous financial policy that seeks to ensure easy access to
20 French and international capital markets, to enable investment in projects
21 that create value and provide shareholders with a satisfactory
22 remuneration, while maintaining a credit rating in excess of BBB.

23 Veolia Environnement's "BBB" credit rating is a reflection of its consolidated risk profile. The
24 rating implies that Veolia Environnement and its subsidiaries are more risky than that of the
25 average risk of the companies in Staff's proxy group, which has an average "A" credit rating.

¹⁵ <http://www.veoliaenergyna.com/veolia-energy-north-america/locations/kansas-city.htm>

F. Cost of Capital

In order to arrive at Staff's recommended ROR, Staff specifically examined (1) an appropriate ratemaking capital structure, (2) the embedded cost of debt and finally (3) the cost of common equity.

1. Capital Structure

Schedule 13, of Appendix 2, presents the hypothetical capital structure for Staff's proxy group. As can be derived from the debt and equity ratios, the proposed capital structure is fairly consistent with the way in which natural gas distribution companies are generally capitalized. The resulting hypothetical capital structure consists of 49 percent common stock equity and 51 percent long-term debt.

2. Embedded Cost of Debt and Preferred Stock

Staff's embedded cost of debt of 5.93 percent is an average of the stated cost of outstanding long-term debt for its proxy group – see Appendix 2, Schedules 9 and 10.

3. Cost of Common Equity

Staff's expert financial analyst, Zephania Marevangepo, estimated Veolia Energy Kansas City, Inc.'s cost of common equity through a comparable company cost-of-equity analysis of a proxy group of seven companies using the DCF methodology. Additionally, Staff used a CAPM analysis and a survey of other indicators as a check of the reasonableness of its recommendations.

a. The Proxy Group

First, Staff formed a group of comparable companies for the commensurate

1 return analysis. Starting with 11 market-traded natural gas utilities (see Appendix 2,
2 Schedule 6), Staff applied a number of criteria to develop a proxy group comparable in risk to
3 Veolia Energy Kansas City, Inc.

- 4 1. Stock publicly traded (0 companies eliminated, 11 remaining);
- 5 2. Information printed in Value Line (0 companies eliminated, 11 remaining);
- 6 3. Ten years of data available (0 companies eliminated, 11 remaining);
- 7 4. At least investment grade credit rating (0 companies eliminated, 11 remaining);
- 8 5. Two sources for projected growth available with one of those being from Value
9 Line (1 company eliminated, 10 remaining); and
- 10 6. No reduced dividend since 2008 (3 companies eliminated, 7 remaining).

11 This final group of seven publicly-traded natural gas utility companies (“the comparables”) was
12 used as a proxy group to estimate the cost of common equity for Veolia Energy Kansas City, Inc.
13 The comparables are listed on Appendix 2, Schedule 7.

14 **b. The Constant-growth DCF**

15 Next, Staff calculated Veolia Energy Kansas City, Inc.’s cost of common equity applying
16 values derived from the proxy group to the constant-growth DCF model. The constant-growth
17 DCF model is widely used by investors to evaluate stable-growth investment opportunities, such
18 as regulated utility companies. The constant-growth version of the model is usually considered
19 appropriate for mature industries such as the regulated utility industry.^{16,17} It may be expressed
20 algebraically as follows:

¹⁶ Aswath Damodaran, *Investment Valuation: Tools and techniques for determining the value of any asset*, University Edition, John Wiley & Sons, Inc., 1996, p. 195-196.

¹⁷ John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p.64.

$$k = D_1/P_0 + g$$

Where: k is the cost of equity;

D_1 is the expected next 12 months dividend;

P_S is the current price of the stock; and

g is the dividend growth rate.

The term D_1/P_0 , the expected next 12 months dividend divided by current share price, is the dividend yield. Staff calculated the dividend yield for each of the comparable companies by dividing the weighted average of the 2011 (50 percent) and 2012 (50 percent) Value Line projected dividends per share (see Appendix 2, Schedule 13) by the monthly high/low average stock price for the three months ending June 30, 2011 (see Appendix 2, Schedule 13).¹⁸ Staff weighted the Value Line projections in this manner in order to reflect the approximate amount of time remaining in 2011. Staff used the above-described stock price because it reflects current market expectations. The projected average dividend yield for the seven comparable companies is 4.00 percent, unadjusted for quarterly compounding.

c. The Inputs

In the DCF method, the cost of equity is the sum of the dividend yield and a growth rate (“g”) that represents the projected capital appreciation of the stock. In estimating a growth rate, Staff considered both the actual dividends per share (DPS), earnings per share (EPS) and book value per share (BVPS) for each of the comparable companies and also the projected DPS, EPS and BVPS. In reviewing actual growth rates, Staff found the historical growth rates to be unsustainable in perpetuity. Additionally, the growth rates were greater than the current

¹⁸ The monthly high/low averaging technique minimizes the effects of short-term stock market volatility on the calculation of dividend yield. P_0 is calculated by averaging the highest and the lowest price for each month during the selected period.

1 long-term GDP projections of approximately 4 – 5 percent.¹⁹ Staff then analyzed the projected
2 DPS, EPS and BVPS estimated by Value Line for each of the comparable companies over the
3 next five years (see Appendix 2, Schedule 10-3). The average for seven comparables was
4 4.55 percent. Equity analysts' 5-year EPS estimates on *Reuters.com* also showed an average
5 growth rate of 4.43 percent (see Appendix 2, Schedule 10-4).

6 Due to the Staff's concerns about the sustainability of historical DPS, EPS, and BVPS
7 growth rates, Staff does not believe significant weight should be afforded these growth rates in
8 estimating the cost of equity using the constant-growth DCF. However, the range of projected
9 DPS, EPS and BVPS (3.93 – 5.14 percent) and the average appears to be more consistent with
10 expected economic conditions going forward. Staff used an estimated constant-growth rate
11 range of 4.0 percent to 5.0 percent for its constant-growth DCF cost of equity estimate.

12 Using the constant-growth DCF model and the inputs described above -- a projected
13 dividend yield of 3.80 percent, a growth rate range of 4.0 percent to 5.0 percent and 43 basis
14 points credit rating differential -- Staff has calculated Veolia Energy Kansas City, Inc.'s cost of
15 common equity at 8.25 percent to 9.25 percent (see Appendix 2, Schedule 13).

16 **G. Tests of Reasonableness**

17 Staff has tested the reasonableness of its DCF results, both by use of a CAPM analysis
18 and by consideration of other evidence.

¹⁹ Schedule 10-1 depicts the annual compound growth rates for DPS, EPS and BVPS for each comparable company for the past ten years. Schedule 10-2 lists the annual compound growth rates for DPS, EPS and BVPS for each of the comparable companies for the past five years. Schedule 10-3 shows the averages of the growth rates shown in Schedules 10-1 and 10-2.

1. The Capital Asset Pricing Model

The CAPM is built on the premise that the variance in returns is the appropriate measure of risk, but only the non-diversifiable variance (systematic risk) is rewarded. Systematic risks, also called market risks, are unanticipated events that affect almost all assets to some degree because the effects are economy wide. Systematic risk in an asset, relative to the average, is measured by the Beta of that asset. Unsystematic risks, also called asset-specific risks, are unanticipated events that affect single assets or small groups of assets. Because unsystematic risks can be freely eliminated by diversification, the reward for bearing risk depends on the level of systematic risk. The CAPM shows that the expected return for a particular asset depends on the pure time value of money (measured by the risk free rate), the reward for bearing systematic risk (measured by the market risk premium), and the amount of systematic risk (measured by Beta). The general form of the CAPM is as follows:

$$k = R_f + \beta (R_m - R_f)$$

Where: k is the expected return on equity for a security;

R_f is the risk-free rate;

β is beta; and

$R_m - R_f$ is the market risk premium.

For inputs, Staff relied on historical capital market return information through the end of 2010. For the risk-free rate (“ R_f ”), Staff used the average yield on 30-year U.S. Treasury bonds for the three-month period ending June 30, 2011; that figure was 4.34 percent. For Beta, Staff used Value Line’s betas for the comparable companies (see Appendix 2, Schedule 12). The average beta (“ β ”) for the proxy group was 0.66. For the market risk premium (“ $R_m - R_f$ ”), Staff relied on risk premium estimates based on historical differences between earned returns on stocks and

1 earned returns on bonds.²⁰ The first risk premium was based on the long-term, arithmetic
2 average of historical return differences from 1926 to 2010, which was 6.00 percent. The second
3 risk premium was based on the long-term, geometric average of historical return differences
4 from 1926 to 2010, which was 4.40 percent.

5 Staff's CAPM is presented on Appendix 2, Schedule 12. The results using the long-term
6 arithmetic average risk premium and the long-term geometric risk premium are 8.33 percent and
7 7.26 percent, respectively. These low cost of common equity results support the reasonableness
8 of Staff's higher cost of equity estimates derived from its DCF analysis. Staff again notes that
9 both U.S. Treasury yields and utility bond yields are quite low (at levels last experienced in the
10 early 1960s) and the spread between them is presently below their long-term average. It is not
11 improbable that investors are only requiring returns on common equity in the 7.5 to 8.5 percent
12 range for utility stocks.

13 **2. Other Tests**

14 **a. The "Rule of Thumb"**

15 A "rule of thumb" method allows estimation of the cost of equity by adding a risk
16 premium to the yield-to-maturity of the subject company's long-term debt. Based on experience
17 in the U.S. markets the typical risk premium is in the 3 to 4 percent range.²¹ Considering this is
18 based on general U.S. capital market experience and regulated utilities are on the low end of the
19 risk spectrum of the general U.S. market, a risk premium closer to 3 percent seems logical. This
20 is especially true considering that regulated utility stocks behave like bonds. For the months of
21 April, May and June 2011, "A" rated 30-year utility bonds and "Baa" rated 30-year utility bonds

²⁰ From Ibbotson Associates, Inc.'s *Stocks, Bonds, Bills, and Inflation: 2010 Yearbook*.

²¹ John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p. 54.

1 had average yields of 5.55 percent and 6.13 percent respectively.²² Adding a 3 percent risk
2 premium, the “rule of thumb” predicts a cost of common equity between 8.55 percent and
3 9.35 percent. Adding a 4 percent risk premium, the “rule of thumb” predicts a cost of common
4 equity between 9.55 percent and 10.13 percent.

5 **b. Average Authorized Returns**

6 In the past, the Commission has applied a test of reasonableness using the average
7 authorized returns published by Regulatory Research Associates (RRA) as a benchmark.
8 According to RRA, the average authorized cost of common equity for natural gas utility
9 companies for the first two quarters of 2011 was 9.99 percent based on nine decisions
10 (first quarter – 10.10 percent based on five decisions and second quarter – 9.85 percent based on
11 four decisions). The average authorized cost of common equity for natural gas utility companies
12 for 2010 was 10.08 percent based on thirty-seven decisions (first quarter – 10.24 percent based
13 on nine decisions; second quarter – 9.99 percent based on eleven decisions; third quarter –
14 9.93 percent based on four decisions; fourth quarter – 10.09 percent based on twelve decisions).

15 The average authorized ROR for natural gas utilities for the first two quarters of 2011
16 was 8.02 percent based on nine decisions (first quarter – 8.07 percent based on six decisions and
17 second quarter – 7.93 percent based on three decisions). The average authorized ROR for
18 natural gas utilities in 2010 was 7.95 percent based on thirty-eight decisions (first quarter –
19 8.20 percent based on ten decisions; second quarter – 7.80 percent based on eleven decisions;
20 third quarter – 8.13 percent based on four decisions; fourth quarter – 7.84 percent based on
21 thirteen decisions).

²² BondsOnline.com pursuant to a subscription agreement Staff has with BondsOnline.

H. Conclusion

A just and reasonable rate is one that is fair to the investors and fair to the ratepayers. Fairness to the ratepayers means rates that are not one penny more than is necessary to be fair to the shareholders. Fairness to the shareholders means rates that will produce revenues, on an annual basis, sufficient to cover Veolia Energy Kansas City, Inc.'s prudent cost of service, which includes its cost of capital. Using widely-accepted methods of financial analysis, Staff has developed a hypothetical weighted average cost of capital for Veolia Energy Kansas City, Inc. in the range of 7.07percent to 7.56 percent (see Appendix 2, Schedule 13). This rate was calculated by applying a hypothetical embedded cost of long-term debt of 5.93 percent and a cost of common equity range of 8.25 percent to 9.25 percent to a capital structure consisting of 49.00 percent common equity and 51.00 percent long-term debt. Staff urges the Commission to accept its recommendation and allow Veolia Energy Kansas City, Inc. to earn a fair return on its net rate base of 7.07 percent to 7.56 percent.

Staff Expert/Witness: Zephania Marevangepo

IV. Rate Base

A. Plant-in-Service and Accumulated Depreciation Reserve in this Case

Staff has included the plant-in-service and accumulated depreciation reserve balances in this case as of June 30, 2011, taken from the Company's Fixed Asset Subledger – Regulated Basis. The Company uses a plant model developed during much of the 2000s and over several cases filed with the Commission. This plant model identifies Veolia Kansas City's regulated plant and accumulated depreciation reserve balances for additions and retirement amounts by Federal Energy Regulatory Commission (FERC) Uniform System of Account (USOA) since

1 1990. The June 30, 2011 account balances are reflected in Schedule 3--Plant in Service, and
2 Schedule 6-- Accumulated Depreciation Reserve.

3 As can be seen on Schedule 6--Accumulated Depreciation Reserve, there are several
4 depreciation reserve accounts that exceed the plant balances identified on Schedule 3--Plant in
5 Service.

6 Staff has calculated the depreciation expense in this case using the June 30, 2011 plant
7 balances and the depreciation rates recommended by Staff witness David Williams of the
8 Engineering and Management Services Department. Fully depreciated accounts have
9 depreciation rates of zero, as explained by Mr. Williams herein. Staff examined the plant
10 and accumulated depreciation reserve amounts and ensured that these levels tied back to
11 the Company's plant and reserve records. As such, the plant-in-service and
12 accumulated depreciation reserve balances filed by the Company in this rate case are a
13 reasonable representation of the appropriate balances on which the Commission should set rates
14 for the future.

15 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

16 **B. History of Veolia Energy Kansas City, Inc. Plant and Depreciation**
17 **Reserve Records**

18 In 2004, Veolia Kansas City (then known as Trigen) filed an asset transfer case, Case No.
19 HM-2004-0618, regarding a pending sale of the Veolia (Trigen) Companies to Thermal North
20 America Inc. In rebuttal testimony filed in that case, Staff identified numerous problems with
21 Trigen's record keeping system, affecting specifically the Company's plant and depreciation
22 reserve valuations. Staff also recognized that the Company did not use the original cost theory to
23 establish plant-in-service values at the time Trigen acquired the district heating and industrial
24 assets from KCPL in March 1990—Case Nos. HM-90-4 and HA-90-5. In addition, Staff

1 discovered that Trigen did not use or recognize the FERC USOA. Set forth below is information
2 concerning the Plant-in-Service and the Accumulated Depreciation Reserve for Veolia's Kansas
3 City operations since Trigen purchased the system in 1990.

4 From the start of its ownership, Trigen set up the books and records incorrectly and was
5 never in compliance with the USOA. Trigen instead recorded the plant balances at the purchased
6 price amount paid for the property and not the "original cost" amount. This recording of the
7 plant assets was incorrect per the FERC USOA, and that error continued to be carried forward
8 yearly with additions and retirements until the Company tried to correct this problem during
9 2003. As part of the review process of the Company's books and records for the asset sale
10 application in Case No. HM-2004-0618, Staff made an inquiry into the plant-in-service balances
11 and accumulated depreciation accounts of the Company. Staff discovered that Trigen incorrectly
12 recorded the plant-in-service balances at the net book value with the accumulated depreciation
13 reserve starting with a zero balance. Compounding the problem, Trigen added the amount of the
14 premium paid to KCPL for the purchased assets into the plant-in-service balances. This resulted
15 in the plant asset balances being inflated by what is referred to as an "acquisition adjustment."
16 An acquisition adjustment is a premium paid over the net original cost of those assets. The net
17 original cost value is plant less accumulated depreciation reserve. The USOA requires that any
18 acquisition adjustment be accounted for in FERC Account 114 - Electric Plant Acquisition
19 Adjustments. By ignoring net original costs concepts, Trigen in essence accounted for the
20 premium paid to KCPL for the 1990 purchase transaction by spreading the acquisition
21 adjustment to individual plant accounts, which is not permitted by the USOA requirements for
22 plant asset acquisitions.

1 The FERC USOA Account 114 states, in part, that:

2 This account shall include the difference between (1) the cost to the
3 accounting utility of electric plant acquired as an operating unit or system
4 by purchase, merger, consolidation, liquidation, or otherwise, and (2) the
5 original cost, estimated, if not known, of such property, less the amount or
6 amounts credited by the accounting utility at the time of acquisition to
7 accumulated provisions for depreciation and amortization and
8 contributions in aid of construction with respect to such property.

9 As such, Trigen's plant and depreciation reserve books and records were incorrect from
10 the very beginning of the Company's ownership of this utility system.

11 To compound the issue of what the proper plant valuation should be, the Company
12 never used Commission-authorized depreciation rates to depreciate the utility property.
13 Trigen also did not properly retire plant from its plant and depreciation books and records as
14 property was removed from utility service. Trigen did not properly identify and value its plant
15 records using correct capitalization and expense concepts prescribed in the FERC USOA.
16 In some cases Trigen Kansas City's plant was understated or overstated depending on whether
17 costs should be capitalized (i.e., included in plant) or if the costs should have been charged to
18 expense. This caused plant not to be properly valued in rate base, and since plant in rate base is
19 subject to depreciation, this too caused the accumulated depreciated reserve to be incorrect. As a
20 result of all the errors and improper accounting of the plant assets and resulting depreciation
21 reserve, the Company's asset valuation was incorrect. Also, using improper depreciation rates
22 resulted in an overstatement of depreciation expense that caused an understatement of earnings
23 for most years until the corrections were made. Thus, the need for the correction and restatement
24 of Trigen Kansas City's books and records was recognized, and corrective action was undertaken
25 by the Company.

26 During 2000 Trigen initially took an asset impairment write-down of their plant assets
27 under Financial Accounting Standard No. 144 (FAS 144), *Accounting for the Impairment or*

1 *Disposal of Long-Lived Assets.* The Company wrote-down the value of the assets on their
2 financial statements and on its FERC Form 1 filing for the 12-months ended December 31, 2000.
3 The Company's Financial Statements and the FERC Form 1 for the years 2000, 2001 and 2002,
4 reflected the plant balances at the written-down values. During the spring of 2003, while
5 completing the 2002 FERC Form 1, the Company requested an extension of time to file. The
6 Company performed a historical analysis of the books and records and determined the need to
7 restate the plant-balances starting when the assets were purchased from KCPL. The Company
8 restated the FERC Form 1 balances as if the assets were never written-down under FAS 144, and
9 accordingly reversed its previous write-down.

10 Case No. HM-2004-0618 resulted in a Commission-approved agreement with Trigen to
11 reflect in that case any write-down of the assets that the corporate office may have made. As
12 such, in the last rate case, Staff ensured Trigen Kansas City's books and records were restated
13 and corrected to remove any effects of those so-called write-down. Thus, the agreed upon levels
14 of plant did not reflect any amount for the write-down.

15 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

16 **C. Staff Review of Plant Records in this Rate Case**

17 Staff completed its review of the Company's restated Plant-in-Service and Accumulated
18 Depreciation Reserve accounts during the Company's last rate case—Case No. HR-2008-0300.

19 Staff notes that the Company, as a result of discussions with Staff in the past and in
20 compliance with the Commission's Order Approving The Stipulation and Agreement in
21 Case HM-2004-0618, has made considerable effort and a good faith attempt to correct the
22 problems concerning the Plant-in-Service and Accumulated Depreciation Reserve recorded
23 balances. These original problems were a result of the incorrect booking of the original purchase

1 of the plant in 1990, and the subsequent booking errors that occurred over the ensuing years
2 since Trigen Kansas City came into existence. Over the years, the Company has hired
3 consultants and regulatory experts to review the plant and depreciation reserve and the additions
4 and retirements by year to determine the proper balances for regulatory purposes. The Company
5 has spent considerable time and money to correct the problems with the plant and depreciation
6 reserve balances. The Company reviewed work orders (work type summary reports), vendor
7 invoices, vendor payment histories, general ledger activity reports and general ledger entries to
8 make the appropriate corrections.

9 The Company's analysis started with the balances for plant-in-service and accumulated
10 depreciation reserve agreed to in Case HM-2004-0618 and ordered by the Commission. The
11 Company then identified the proper additions and removed retired plant by year for each year
12 back to approximately 1995. Although Trigen Kansas City agreed to use the net original cost
13 investment at the time of the transfer of assets from KCPL, the Company believed that it would
14 be cost prohibitive and not worthwhile to go back to the beginning of its ownership in 1990.
15 Trigen Kansas City's detailed analysis reviewed over 75% of the total plant additions made
16 during the ensuing years from 1990 to 2006. The analysis looked at over \$26,000,000 in gross
17 plant. The Company determined that there was approximately \$1.4 million recorded in its plant
18 records that it should have expensed and not capitalized. The Company updated its analysis
19 monthly and continues to revise it as new plant additions and retirements occur.

20 The subsequent corrections made by the Company to the plant and depreciation records
21 resulted in the Company making the necessary correcting entries to reflect the proper
22 adjustments in October, 2007. These corrections became the foundation for the asset ledger
23 currently being used by the Company for financial reporting purposes, and was the basis for

1 plant and depreciation reserve balances used by Staff for the revenue requirement calculation in
2 the last rate case and in this rate case through June 30, 2011.

3 Staff, as a part of its review in the last rate case, reviewed the Company's and
4 consultants' work, including related documents identified by the analysis to correct the plant and
5 depreciation reserve. In response to Staff Data Request No. 33 (Case No. HR-2008-0300) and
6 Staff Data Request No. 33 in this case, the Company provided the analysis performed to restate
7 the plant and depreciation reserve. During its audit in this case as well as the last rate case, Staff
8 reviewed each of the summaries provided by the Company in support of its analysis. This
9 review included each of the general ledger activity reports for each plant entry and the
10 documentation the Company included for support. In the last rate case, the support included
11 work orders, vendor invoices, vendor payment histories and general ledger entries. Staff
12 examined the supporting material and recalculated the entries to tie back or match the plant and
13 depreciation reserve balances identified in the consultants' work papers. In the last rate case,
14 Staff concluded the analysis performed by the Company was the best representation of the
15 true plant-in-service and depreciation reserve that could be calculated at that time. Staff
16 continues to believe the Company's analysis is the best representation of plant and depreciation
17 reserve balances.

18 The Company has restated the plant-in-service and accumulated depreciation reserve
19 balances using the original costs of the assets transferred to Trigen in 1990 from KCPL. Veolia
20 Kansas City is currently booking plant and reserve balances to reflect the proper USOA accounts.
21 The Company is also using the depreciation rates currently authorized by the Commission.
22 Therefore, Veolia Kansas City continues to be in compliance with the plant and reserve accounting
23 requirements set forth in Case No. HM-2004-0618.

24 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

1 **D. Truman Medical Center Pipeline**

2 Veolia Kansas City came before the Commission in early 2006 to request permission to
3 expand its district heating service area to allow the Company to run a service line to the Truman
4 Medical Center (Truman) complex. In its May 25, 2006 Order in Case No. HA-2006-0294, the
5 Commission authorized the expansion of Veolia Kansas City's district heating service area. The
6 Commission's order required Truman to pay for the entirety of construction costs of the steam
7 distribution pipeline. Truman and Veolia entered into a Highly Confidential agreement entitled

8 ** _____

9 ** This agreement provides for ** _____

10 _____

11 _____

12 ** _____

13 On May 21, 2007, Veolia filed its Compliance Filing regarding Case No. HA-2006-0294,
14 which included two highly confidential documents: 1) ** _____

15 **; and 2) ** _____

16 **. On June 1, 2011, Staff filed its Recommendation with the Commission stating
17 that Veolia had met all the requirements imposed on the Company by the Commission in Case
18 No. HA-2006-0294 and as such recommended the case be closed. Staff's recommendation stated
19 the following:

20 In an order issued May 25, 2011, the Missouri Public Service Commission
21 ("Commission") directed the Missouri Public Service Commission Staff
22 ("Staff") "... to review the report and make a recommendation as to
23 whether this file may be closed."

24 As directed, Staff has reviewed the Final Report filed by Trigen and is
25 satisfied that the Company has complied with the Commission's original
26 Order in this case dated May 25, 2006. The Commission stated in Ordered
27 Paragraph 3 of its May 25, 2006 Order that authorized the expansion of

1 Trigen's service territory that "this Certificate is conditioned upon Truman
2 Medical Center funding the cost of construction for the proposed
3 extension of Trigen's facilities to serve Truman Medical Center."

4 Staff recommends this case be closed....

5 On June 6, 2011, the Commission issued an order closing Case No. HA-2006-0294. The
6 following is an excerpt from this order:

7 On June 1, 2011, the Commission's Staff filed its report stating that
8 Veolia's final report is in compliance with the Commission's orders and
9 recommended that this file be closed. Therefore, the Commission will
10 close this file.

11 The Company treated the pipeline construction costs as construction work in
12 progress (CWIP) and transferred the costs to plant-in-service as of June 30, 2008, as the result of
13 Truman taking steam service beginning June 16, 2008. Veolia Kansas City recorded the final
14 payment received from Truman in July of 2009. Since Truman agreed to pay for the pipeline
15 construction costs, Staff has included the amount paid by Truman as a Customer Advance for
16 Construction (FERC Account 252) (Customer Advances) as an off-set to rate base. Since the
17 Staff reflected the amount of the advance for the pipeline construction costs as a Customer
18 Advance, the effect of this treatment is to disallow a return on rate base amounts not provided or
19 invested by the Company. The Staff also excluded depreciation expense for the
20 Truman pipeline.

21 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

22 **E. Cargill Pipeline**

23 During 2006 Veolia Kansas City constructed and paid for a distribution pipeline to
24 connect and serve the Cargill Inc., Grain and Oilseed Supply (Cargill) process steam load, which
25 started in 2006. Cargill did not fund the construction of this distribution pipeline.

1 The Company completed construction for the Cargill distribution pipeline during the
2 spring of 2006 and, at that time, the pipeline was transferred from CWIP to plant-in-service.
3 Staff has included the Cargill distribution pipeline costs in the plant and depreciation reserve
4 balances, and also an amount for depreciation expense in the revenue requirement calculation.
5 Like any other plant investment included in rate base, and not offset by a Customer Advance,
6 Veolia Kansas City will earn a return on this investment. (Accounting Schedule 2)

7 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

8 **F. Recommendation Concerning Plant-in-Service and Accumulated**
9 **Depreciation Reserve**

10 The Commission concluded on page 26 of its Order in Case No. HR-2008-0300
11 “that Trigen-Kansas City Energy Corporation has complied with the requirements of Case No.
12 HM-2004-0618 regarding the correction and restatement of its plant-in-service and accumulated
13 depreciation reserve.”

14 Staff recommends that for regulatory purposes, the Commission adopt the current plant
15 and depreciation reserves as modified, restated, corrected, and revised by Veolia Kansas City.
16 The Company should: (1) continue to maintain its plant and depreciation reserve accounts based
17 on the FERC USOA for electric companies using Commission approved depreciation rates, as
18 well as continue to maintain new plant additions and retirements according to the USOA as
19 identified in the Electric Plant Instructions; (2) continue to maintain its books and records in
20 compliance with proper capitalization concepts; (3) continue to maintain its books and records
21 using the Plant model that correspondently ties to the plant ledger component of the
22 general ledger; and (4) maintain the supporting documentation relating to the
23 modifications and restatement of the plant and depreciation reserve as part of its regulated

1 books and records should the need arise to review this material in the future. (Accounting
2 Schedule 3)

3 *Staff Experts/Witnesses: Sean Furey and Cary G. Featherstone*

4 **G. Fuel Inventories**

5 Coal is the only fuel Veolia Kansas City maintains in inventory at the Grand Avenue
6 plant location. The coal is stored by the Company in a plot of land adjacent to the actual steam
7 production facility. Veolia transports coal, via truckload, to the Company fuel yard daily
8 throughout most weeks of the year.

9 Staff reviewed the monthly coal stock balances, provided in Staff Data Request No. 68,
10 as well as the Staff's workpapers from Case No. HR-2008-0300, and determined that a thirteen
11 month average was the correct methodology to determine the appropriate amount to include in
12 the rate base schedule for coal inventories. The Staff choose this methodology because of
13 constant fluctuations in the account balances from month to month. Since Staff recognized no
14 discernable trend in the balances, a thirteen month average leveled out any significant and
15 noticeable fluctuations within the accounts. (Accounting Schedule 2)

16 *Staff Expert/Witness: Bret G. Prenger*

17 **H. Prepayments**

18 Prepayments are amounts for certain costs incurred by the Company and paid in advance
19 of their date payable. Prepayments are treated as an asset investment of the Company and are
20 typically reflected in the rate base of the utility.

21 During Staff's audit, Staff was able to discern an appropriate balance for the prepayments
22 account, FERC Account No. 165. Staff reviewed the monthly balances for prepayments for the
23 last several years and determined that a thirteen month average was an appropriate amount to

1 include in rate base for this inventory item. The Staff determined a thirteen month average to be
2 appropriate because of the fluctuations in the account balances from one month to the next,
3 resulting in no discernable trend in the monthly prepayment account balances. By using a
4 thirteen month average, Staff was able to smooth out any of the fluctuations that occurred during
5 the year. (Accounting Schedule 2)

6 *Staff Expert/Witness: Sean Furey*

7 **I. Materials and Supplies**

8 Materials and supplies include spare parts and other miscellaneous items used in daily
9 operations and maintenance activities, such as gauges, casting, paint, conduit, etc. Staff
10 reviewed the monthly balances for materials and supplies over the last several years, provided in
11 Data Request Nos. 13 and 87. From this review, the Staff determined that a thirteen month
12 average was an appropriate amount to include in rate base for this inventory item. The Staff used
13 a thirteen-month average due to the fluctuations in the account balances from one month to the
14 next and the lack of a discernable trend in the monthly material and supplies inventory account
15 balances. By using a thirteen month average, Staff was able to smooth out any of the
16 fluctuations that occurred during the year. (Accounting Schedule 2)

17 *Staff Expert/Witness: Sean Furey*

18 **J. Customer Deposits**

19 During Staff's Audit, Staff identified amounts for the Customer Deposits account, FERC
20 Account No. 242. There is only one Customer Deposits account included as an offset to rate
21 base. (Accounting Schedule 2)

22 *Staff Expert/Witness: Sean Furey*

1 **V. Depreciation**

2 Veolia has not requested modification of its depreciation rates in this case. Staff has
3 reviewed the depreciation rates ordered by the Commission in Case No. HR-2008-0300 and
4 verified that those rates are being applied to plant balances.

5 In Case No. HR-2008-0300, due to over-accrual of reserve, several account rates were set
6 to 0%. Veolia has acquired additional plant in two of those accounts since the conclusion of
7 Case No. HR-2008-0300. Staff recommends that Veolia create subaccounts in those accounts
8 (311 and 312) for this new property, to be depreciated at the rates previously approved in

9 Depreciation Authority Order Number 148 on June 9, 1986. Staff recommends that the
10 other four accounts (314, 315, 316 and 361), as well as the pre-2008 property in accounts 311
11 and 312 remain at 0%, as indicated in the table below.

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Veolia Energy Kansas City				
DEPRECIATION RATES				
HR-2011-0241				
ACCOUNT NUMBER	ACCOUNT DESCRIPTION	DEPRECIATION RATE	AVERAGE SERVICE LIFE (YEARS)	NET SALVAGE
311	Structures and Improvements (HR-2008-0300)	0.00%	30.5	-1%
311.1	Structures and Improvements (additions post-HR-0300)	3.31%	30.5	-1%
312	Boiler Plant (HR-2008-0300)	0.00%	28.6	-4%
312.1	Boiler Plant (additions post-HR-0300)	3.63%	28.6	-4%
314	Turbogenerator Units	0.00%	32.3	-1%
315	Accessory Electric Equipment	0.00%	31.3	-1%
316	Miscellaneous Power Plant Equipment	0.00%	28	2%
361	Distribution Structures	0.00%	32	-1%
362	Distribution Station Equipment	2.40%	42	1%
366	Underground Conduit and Manholes	2.02%	50	1%
369	Services	2.50%	40	0%
370	Meters	4.76%	21	0%
391	Office Furniture and Equipment	4.17%	24	0%
394	Tools, Shop and Garage Equipment	3.68%	28	3%
397	Communications Equipment	3.70%	27	0%
398	Miscellaneous Equipment	3.71%	24	11%

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Staff Expert/Witness: David Williams

VI. Income Statement

A. Weather Normalization

1. Developing Weather Normal Variables

Steam usage and revenues vary from year to year based on weather conditions. Since each year's weather is unique, Staff calculates an adjustment to the test year (January 1, 2010 to December 31, 2010) usage to account for deviations from "normal" weather in order to recommend reasonable rates. The time period used by Staff to determine the normal values of weather variables in this case is the same 30-year period (January 1, 1971 to December 30, 2000) used by the U.S. National Oceanic and Atmospheric Administration ("NOAA") and the World Meteorological Organization to calculate normal weather variables.

Steam sales are influenced by "ambient air temperature"²³, so "daily average temperature"²⁴ and the derivative variables, "heating degree days" (HDDs) and "cooling degree days" (CDDs), are the measures of weather used in adjusting steam revenues. The Staff analyses this data to determine an adjustment to usage to account for "normal" weather. "Degree days" are weather measures used to evaluate the relationship between temperature and steam usage.

Degree days are based on the variation of the daily average temperature from a comfort level of 65 °F. HDDs are calculated as the difference between 65 and the daily average temperature when the average daily temperature is below 65 °F, and is equal to zero when the daily average temperature is above 65 °F. The Staff calculates CDDs as the daily average temperature minus 65 when the daily average temperature is above 65 °F, and is equal to zero when the daily average temperature is below 65 °F.

²³ Ambient air temperature is the outside temperature of the surrounding air without taking into account the humidity or wind in the air.

²⁴ Average daily temperature is the sum of the daily maximum and minimum temperatures divided by two.

To develop “normal” average temperatures, HDDs and CDDs, Staff used weather records from the NOAA weather station at the Kansas City International Airport located in Kansas City Missouri. NOAA calculates monthly normal temperature variables such as maximum temperature, minimum temperature, average temperature, HDDs, and CDDs over the 30-year climate normals period. These monthly normal variables are not directly usable for Staff’s purposes because NOAA derives its daily normal variables statistically “fitting” smooth curves through these monthly values.

Case HR-2011-0241 Veolia Service Area - Kansas City International Airport Heating Degree-Days (HDD) and Cooling Degree-Days (CDD) For The 12 Calendar Months Beginning January 01, 2010 And Ending December 31, 2010							
YEAR	MONTH	TOTAL HDD BY MONTH			TOTAL CDD BY MONTH		
		OBSERVED TOTALS HDD	NORMAL TOTALS HDD	ADJUSTMENT ACTUAL TO NORMAL	OBSERVED TOTALS CDD	NORMAL TOTALS CDD	ADJUSTMENT ACTUAL TO NORMAL
2010	1	1278	1182	(96)	0	0	0
2010	2	1057	898	(159)	0	0	0
2010	3	612	662	50	6	3	(3)
2010	4	172	344	172	35	21	(14)
2010	5	138	107	(31)	106	81	(25)
2010	6	0	8	8	377	264	(113)
2010	7	0	1	1	477	418	(58)
2010	8	0	2	2	503	361	(141)
2010	9	28	72	44	154	165	11
2010	10	210	282	72	11	25	14
2010	11	610	669	59	0	1	1
2010	12	1107	1047	(60)	0	0	0
12 MONTHS		5210	5272	63	1667	1340	(327)

Therefore, Staff develops daily normal temperature variables by adjusting actual daily average temperature data such that the average of the adjusted daily average temperature is consistent with NOAA’s normal monthly average daily temperature. Using these adjusted daily

1 average temperatures, Staff calculates HDDs and CDDs for each day of the 30 year history.
2 Staff calculates daily normal HDDs and CDDs as the average of the adjusted daily actual HDDs
3 and CDDs for each calendar date. For example, Staff averaged the 30 observations of actual
4 HDDs for January 1, of each year for the years 1971 through 2000, to determine the normal
5 HDDs for January 1.

6 The below represents calendar month summaries of the adjusted daily actual and normal
7 HDDs and CDDs during the test year for the Veolia service area. This information was used by
8 Staff expert Kim Cox to calculate Staff's weather normalization adjustment factor.

9 *Staff Expert/Witness: Seoung Joun Won, PhD*

10 **2. Developing Factors Used for Weather Normalization of Sales**

11 Weather data shows that the test year in this case (January 1, 2010 – December 31, 2010)
12 had a mild winter and a hot summer, compared to normal temperatures. Warmer than normal
13 temperatures in winter often result in decreased energy consumption because consumers use less
14 heat. Hotter than normal summer temperatures, like those experienced in April through
15 August of the test year, often result in increased energy consumption due to higher than normal
16 cooling usage.

17 In order to weather normalize energy usage²⁵ Staff prepared two, ten year (2001
18 through 2010) regression analyses. The Staff generated the regression analyses by using
19 monthly billed tariff steam sales and actual monthly HDDs and CDDs. Staff expert Seoung Joun
20 Won, PhD provided the monthly actual and monthly normal HDDs and CDDs, and discussed his
21 calculations in his section of this cost of service report.

²⁵ To "Weather normalize" energy usage means to adjust energy usage to correct for deviations from normal weather conditions.

1 The regression equation develops quantitative measures that describe the relationship
2 between monthly HDDs and CDDs and steam usage. The estimated slope from the regression
3 produced a coefficient that the Staff multiplied by the monthly HDD and CDD difference, and
4 then multiplied by Veolia Kansas City's customer count for each month to obtain the monthly
5 adjustment. The monthly adjustment was then added to or subtracted from the actual monthly
6 usage. The Staff then took this normalized usage and divided it by the actual usage to result in
7 the monthly normalization factors.

8 *Staff Expert/Witness: Kim Cox*

9 **3. Weather Normalization of Sales**

10 Veolia Kansas City has three tariff rate schedules--Standard Commercial Service (SCS),
11 Large Commercial Service (LCS), and Interruptible Heating Service (IHS). Staff weather
12 normalized each individual customer in all three classes. The Staff adjusted all customers, with
13 the exception of Veolia Missouri and Truman Medical Center, to reflect normal HDDs. Veolia
14 Missouri only uses the service for cooling purposes, so the Staff adjusted its usage to reflect
15 normal CDDs. Truman Medical Center uses the service for both cooling and heating; therefore
16 Staff normalized its usage during the months of April through September to reflect normal CDDs
17 and the months of October through March to reflect normal HDDs.

18 In summary, Staff weather-normalized steam sales to correct for deviations from normal
19 weather conditions during the test year ending December 31, 2010. Staff applied the weather
20 normalization factors to actual monthly usage to calculate the adjustment. The adjustment was
21 then added to or subtracted from the actual usage to obtain the normalized usage. The Staff
22 provided the revenue adjustment associated with these calculations to Staff expert Karen Lyons

1 for calculation of the revenue requirement. The Staff also provided the adjusted billing units to
2 Staff expert Henry E. Warren, PhD for use in the Rate Design portion of this case.

3 *Staff Expert/Witness: Kim Cox*

4 **B. Commercial Customer Adjustments**

5 Staff annualized monthly usage and the associated rate revenues for the 2010 test year
6 updated through June 30, 2011 for Veolia Kansas City commercial customers. Commercial
7 customers are billed based on the three customer classes established in Veolia Kansas City's
8 last rate case, Case No. HR-2008-0300. The customer classes consist of LCS, SCS, and IHS.

9 Revenue annualization adjustments are made to account for changes to Veolia's
10 revenues, typically due to tariff customers discontinuing steam service, beginning to take steam
11 service or switching customer class rate structures during the test year. During the 2010 test year
12 in this case, Veolia Kansas City did not have any customers discontinue steam service, but did
13 have one customer return to its system and two customers change customer classes.

14 In June 2010 the Bolling Federal Building, a former customer of Veolia Kansas City,
15 returned to its system and began receiving steam service on an emergency basis. During the
16 period of June 2010 through April 2011 the Company billed the Bolling Federal Building under
17 the tariff rate for SCS customers. Effective April 2011 the Bolling Federal Building entered into
18 a contract to receive steam service from Veolia Kansas City under the tariff rate for LCS
19 customers. As a result, Staff made an adjustment in its annualized revenue analysis to reflect the
20 return of this customer and the change from the SCS customer class to the LCS customer class.
21 In April 2010 Veolia Kansas City converted the State Office Building to the tariff rate for SCS
22 customers. Prior to April 2010 the State Office Building was billed under the tariff rate for LCS

1 customers. Staff made an adjustment in its annualized revenue analysis to reflect the change of
2 this customer from the LCS customer class to the SCS customer class.

3 Staff calculated annualized revenues using the weather normalized usage for each
4 customer, provided by Staff expert Kim Cox and tariff rates for each customer class. The
5 annualized commercial revenues can be found on Schedule 10 of Staff's Accounting Schedule,
6 Adjustments Rev-7.2 and Rev-10.2.

7 *Staff Expert/Witness: Karen Lyons*

8 **C. Annualization of Special Customer Revenues**

9 Veolia Kansas City serves two large industrial steam customers, National Starch &
10 Chemical Company ("National Starch") and Cargill. National Starch and Cargill have entered
11 into contractual agreements with Veolia Kansas City. As such, the revenues received from
12 National Starch and Cargill are based on their respective agreements with Veolia Kansas City.
13 Since National Starch and Cargill are billed based on a contract rate, Staff annualized the
14 revenues associated with National Starch and Cargill separately. Staff analyzed actual loads for
15 National Starch for the calendar years 2006-2010 and the 12-month period ending June 30, 2011.
16 As a result of its analysis, Staff included a 2-year average of 2009-2010 National Starch
17 revenues. Staff calculated the revenues for National Starch by pricing the annualized load times
18 the average price billed to National Starch during the 2010 test year.

19 Similar to National Starch, Staff analyzed actual loads for the calendar years 2006-2010
20 and the 12-month period ending June 30, 2011 for Cargill. Staff determined the actual load and
21 respective revenues for the 2010 Test Year for Cargill represented the appropriate level of revenues
22 to include in Staff's Revenue Requirement calculation. (Accounting Adjustment Rev-9.2)

23 *Staff Expert/Witness: Karen Lyons*

D. Veolia Kansas City Lease Space at Grand Avenue

Veolia Kansas City currently leases approximately ** ____ ** square feet of industrial space in their production facility to their non-regulated affiliate, Veolia Missouri. Veolia Missouri produces and distributes chilled water services to several customers located within Veolia Kansas City's service territory. Currently, Veolia Kansas City leases this space to its affiliate at the rate of ** ____ ** per square foot per month. Staff believes that the amount being charged to Veolia Missouri is not reasonable and has thus made an adjustment to increase the cost of the lease to ** ____ ** per square foot per month. Staff has based this increase upon research and data obtained from local realtors' websites concerning market values for industrial rental space in the Downtown Kansas City industrial area in areas in close approximation to the Grand Avenue production facilities. The information reviewed has taken into account an average monthly rent amount for the Kansas City area, and would be representative of a rate that Veolia Missouri would pay were they forced to relocate to a differing industrial building within the area of downtown Kansas City.

Staff believes there are other "factors" besides simply the space being rented to consider in developing the monthly fee. These factors, which provide a significant benefit to Veolia Missouri and serve as justifications to increase the rental rate charged to Veolia Missouri, include:

- 1) Grand Avenue is the ideal location for Veolia Missouri operations as it is the headquarters of Veolia Kansas City and thus provides opportunity for management oversight and assistance that would not be available in another building location.
- 2) The non-regulated entity (Veolia Missouri) MUST be located within the Veolia Steam service territory to receive service, so there are very few locations within the "Downtown Loop" where Veolia Missouri

1 could rent industrial space and still receive steam—the Grand Avenue
2 location is ideal.

3 3) By being located at the Grand Avenue production facility, the operation of
4 Veolia Missouri does not require a separate structure/building for the
5 chilled water operations, allowing for significant savings to the
6 non-regulated operations.

7 4) By being located at the Grand Avenue production facility, Veolia Missouri
8 did not have to construct a steam line to connect its facilities to take
9 steam—a substantial savings to the chilled water operations of the
10 non-regulated Veolia Missouri.

11 5) The net benefits of shared labor--The workforce (outside of management
12 oversight) is already on sight to monitor, maintain and operate the chilled
13 water service provided by Veolia Missouri.

14 Given the current market values of industrial space around the Grand Avenue production
15 facility, Staff believes that ** _____ ** per square foot is a more reasonable rental fee than the
16 amount Veolia Kansas City negotiated with its non-regulated entity, Veolia Missouri.
17 (Accounting Adjustment Rev-13.1)

18 *Staff Expert/Witness: Bret G. Prenger*

19 **E. Grand Avenue Station's Production Expenses**

20 Fuel, purchased power, and consumables expenses are costs that the Company incurs to
21 produce steam at the Grand Avenue Station. Purchased power costs in this context relate to the
22 exchange of electricity between KCPL and Veolia Kansas City to operate the Grand Avenue
23 Station's auxiliary systems.

1 **1. Fuel Expense**

2 The annualized fuel costs are determined by making adjustments to reflect Staff's
3 annualized load and current fuel prices. Staff's methodology used to calculate fuel expense
4 starts with the customer sales in units of Mlbs, referred to as "loads", provided by Staff expert
5 Karen Lyons, and includes the following inputs:

- 6 1) Distribution system losses;
7 2) Station use and auxiliaries;
8 3) Plant heat rate;
9 4) Fuel mix for coal and natural gas fuels;
10 5) Fuel heat rate for coal and natural gas;
11 6) Delivered coal price per ton;
12 7) Coal hauling and disposal factor;
13 8) Ash hauling and disposal per ton; and
14 9) Delivered cost of natural gas per mmbtu.

15 Staff examined several years worth of data for the various cost components of fuel using
16 actual costs and compared those actual costs to the production plant's steam output—the actual
17 amount of steam produced at Grand Avenue.

18 The fuel components are based on categories of costs, such as the delivered fuel costs for
19 coal and natural gas—the two fuel sources used to produce steam at Grand Avenue. The fuel
20 components also include water and sewer costs. A significant amount of water is needed to
21 produce steam. When the steam is converted back to water, the condensate goes to the city
22 sewer system. Both the water and sewer costs are based on Company invoices reviewed for the
23 period of 12 months ending May 2011.

24 Another fuel component is the chemicals used to treat the water used to make steam.
25 These chemicals are referred to as "consumables." The analyses for all these fuel inputs are
26 based on actual information of one to four years, depending on the consistency of the historical
27 values for that input.

Specifically, the various fuel components are based on:

- the distribution system losses—referred to as line loss, station use and auxiliaries—the energy it takes to operate and heat the Grand Avenue plant site-- are based on calendar year 2010
- the plant heat rate is based on the test year for 12 months ending December 31, 2010
- the fuel heat rate for coal is based on the average level of actual btu's in the coal per pound deliveries determined by the actual coal btu's purchased from the coal supplier
- the coal hauling and disposal factor is based on calendar year 2010
- the ash hauling and disposal per ton is based on calendar year 2010

The fuel mix input reflects the percentage of fuel that is coal and the percentage that is natural gas. Staff used the average percentages in fuel mix for the 3-year period of 2008-2010, due to the significant variances throughout this three-year period. Staff used a three year average of the 2008 through 2010 calendar years to determine the fuel mix percentages.

The fuel prices used for the delivered coal price per ton and the delivered cost of natural gas cost per mmbtu are based upon the most current information Staff had available. Natural Gas prices were calculated using actual prices as of June 2011, while coal prices were based on a 3-year average using the most recent 3 months of Company data, April-June 2011. The fuel prices were determined by Staff witness Bret G. Prenger and provided to Staff witness Daniel I. Beck of the Commission's Energy Department--Operations Division.

The costs to dispose of fly ash and bottom ash--the waste product from the burning of coal-- were based on actual costs for 2010. Veolia Kansas City has to pay a contractor to haul and properly dispose of ash produced from the Grand Avenue plant.

1 For coal handling, the Company gave Staff updated prices that reflect the current contract
2 for coal handling. Staff used the current prices in its calculation for coal handling costs.
3 (Accounting Adjustments E-15.1, E-16.1, E-17.1 and E-19.1)

4 *Staff Experts/Witnesses: Daniel I. Beck and Bret G. Prenger*

5 **2. Consumables Expense Adjustments**

6 Veolia Kansas City purchases water from Kansas City's Water Department
7 (Water Department) for the production of steam at its Grand Avenue Station. The steam system
8 does not have a dedicated system to return the water that is left when the steam cools and
9 condenses. Therefore, Veolia Kansas City must pay the Water Department to dispose of the
10 water through the sewer lines. Staff examined the actual Water Department's water bills for the
11 periods of 2009 through May 2011 and decided the only way to incorporate the recent rate
12 increases Veolia Kansas City received from the Water Department would be to base the Staff
13 adjustment on water and sewer invoices for 12 months ending May 2011. The total water and
14 sewer costs were included as part of operation expenses.

15 Water expense is unique to Veolia Kansas City in that it is a variable cost based on the
16 total amount of actual steam produced—for every mlb (1,000 pounds) of steam produced there is
17 a direct amount of water consumed. Therefore, annual water expense is calculated similarly to
18 the calculation of other direct consumables such as fuel. In Veolia Kansas City's case, its sewer
19 cost is also a variable cost resulting from the surrounding municipality's billing procedures. The
20 most current water and sewer rates determined by billings were incorporated by Staff by using
21 12 months ending June 2011 for the water and sewer adjustments. Staff also included other costs
22 associated with water and sewer service, such as meter, stormwater, and primacy charges. The
23 water and sewer costs were included in the fuel expense calculation.

1 Staff also examined “other” consumables, which are chemicals such as ammonia and salt,
2 and decided the test year was the most accurate reflection of on-going chemical cost levels, and
3 included the balances as of December 2010 (test year). The other consumable costs were
4 included in the fuel expense calculation. (Accounting Adjustments E-21.1 and E-22.1)

5 *Staff Expert/Witness: Bret G. Prenger*

6 **3. Purchased Power and Electric Expense**

7 In order to meet its own energy needs to operate the Grand Avenue Station; Veolia
8 Kansas City must either generate electricity using a small five-megawatt steam turbine generator
9 located at the plant, or purchase electricity from KCPL. When it purchases electricity from
10 KCPL, that transaction is considered purchased power. The purchased power (electricity) is
11 used to power the equipment at the Grand Avenue Station, which is required to operate the steam
12 production facility. The annualized expense is included in the total fuel and energy costs
13 calculation, which is treated as part of total cost of service.

14 Whenever the opportunity presents itself, Veolia Kansas City sells any excess electricity
15 it produces to KCPL at an agreed upon rate. There is a significant difference between the rates
16 KCPL charges Veolia Kansas City for electricity and the amount Veolia Kansas City charges
17 KCPL for electricity. The selling of power (electricity) to KCPL is taken into account in the
18 revenues calculation of Staff expert Karen Lyons. The electricity sold back to KCPL is treated as
19 an increase in revenues for Veolia Kansas City.

20 Staff has reviewed the electric bills from KCPL to determine the annualized amount of
21 electricity expense to include in the current rates. Staff annualized this expense using kilowatt
22 hour usage data from the test year, 12 months ending December 2010, and included KCPL's

1 most current electric rates as of June 30, 2011 by applying those rates to the test year usage.
2 (Accounting Adjustment E-18.1)

3 *Staff Expert/Witness: Bret G. Prenger*

4 **4. Environmental Fees**

5 Environmental fees were included in the rate case to reflect the current test year fee as
6 shown by Veolia Kansas City. The environmental fees allowance reflect the latest payments
7 from the Company to Department of Natural Resources during the test year of 2010.

8 *Staff Expert/Witness: Bret G. Prenger*

9 **F. Payroll, Related Benefits, and Payroll Taxes**

10 The Staff based its revenue requirement calculation of payroll, payroll related benefits
11 and taxes on the Company's current employee levels and wage rates as of June 30, 2011. During
12 the audit, Staff learned that Veolia Kansas City planned an annual 3% increase to payroll
13 effective July 1, 2011. Because of this increase, Staff included this payroll increase in its payroll
14 annualization for all Veolia Kansas City employees. The Company confirmed there will be no
15 additional salary increases during 2011. Utilizing the most current wage rates provided by the
16 Company, Staff was able to adjust the Company's payroll, payroll tax, and related benefits in the
17 annualized payroll levels to reflect a more accurate level of expense in the revenue requirement
18 calculation.

19 *Staff Expert/Witness: Patricia Gaskins*

1 **1. Base Payroll**

2 Base payroll was calculated by multiplying each active employee's monthly salary or
3 wage rate as of June 30, 2011, by 12 months to obtain an annualized amount. Staff included the
4 planned 3% payroll increase, effective July 1, 2011, in its payroll annualization.

5 Veolia Kansas City has a regional vice president whose costs are included in the
6 Company's allocation of corporate costs. To avoid duplication, the Staff payroll annualization
7 does not include the salary and related costs of the Regional Vice President. Corporate wages
8 and allocations were annualized separately and are not included in this payroll calculation.
9 Corporate wage calculations are discussed in detail later in this report.

10 Staff also reviewed overtime costs in the Company general ledger for 2009 and 2010,
11 and reviewed the Company's work papers for payroll that included overtime balances from
12 2008-2010. Staff determined Veolia Kansas City employee overtime decreased each year
13 during this three year period. Since overtime was trending downward from 2008-2010, Staff
14 included the 2010 test year overtime balance for inclusion in Base Payroll. (Accounting
15 Adjustments E-9.1, E-10.1, E-11.1, E-34.1, E-35.1, E-36.1, E-65.1, E-66.1 and E-67.1)

16 *Staff Expert/Witness: Patricia Gaskins*

17 **2. Allocation between Veolia Kansas City and Veolia Missouri**

18 Staff reviewed Veolia Kansas City employee timesheets from January 2010 to
19 December 2010 to determine the employees who had identified time worked on Veolia
20 Missouri's operations, a non-regulated affiliate of Veolia Kansas City. Veolia Missouri provides
21 chilled water services to customers using steam purchased from Veolia Kansas City. The two
22 companies have common employees, causing the need for each employee to allocate a portion of
23 time between the non-regulated Veolia Missouri and the regulated Veolia Kansas City

1 operations. Each employee is required to document and allocate his/her time on a weekly basis
2 between these two entities. Employee time dedicated to Veolia Missouri should not be included
3 in rates charged to the steam customers, since this is a non-regulated affiliate of Veolia
4 Kansas City.

5 Staff calculated the allocation factor on an individual employee basis using the time
6 actually charged to the regulated steam operations of Veolia Kansas City. Staff then applied
7 each allocation factor to individual annualized wage rates. The same allocation factors were
8 used to develop an appropriate amount of payroll taxes, overtime and employee benefits to
9 include in the payroll annualization.

10 Veolia Kansas City currently has a position with the title of Vice President
11 General Manager, whose responsibilities include oversight of Veolia Energy St. Louis, Inc.
12 (Veolia St. Louis), Veolia Kansas City and Veolia Missouri. This position existed in the
13 Company's last rate case; however, the responsibilities of the position at that time did not include
14 oversight of Veolia St. Louis. Since the responsibility of the Vice President General Manager
15 now includes oversight of Veolia St. Louis, Staff had to ensure the portions of the time dedicated
16 to Veolia St. Louis operations and Veolia Missouri were not included in Veolia Kansas City's
17 payroll annualization. After discussions with the Company, the Staff determined the Vice
18 President General Manager divided his time equally between Veolia Kansas City and
19 Veolia St. Louis. Staff then allocated the remaining portion of the salary directly attributable to
20 Veolia Kansas City between Veolia Kansas City and Veolia Missouri. As such, Staff included
21 only the time spent on the Veolia Kansas City's operations in the payroll annualization.

22 *Staff Expert/Witness: Patricia Gaskins*

3. Allocation between Expense and Construction

In general, public utilities are capital intensive entities where ongoing construction activity is necessary to meet the energy needs of current and future customers; therefore, construction is a significant and on-going activity of a utility company. Construction activity not only involves actual physical construction projects, but also the planning, budgeting, monitoring and record keeping activities associated with construction projects. Utility management provides oversight of the construction activities of a public utility, including the approval of all construction projects. Some of these activities can be directly identifiable with specific construction projects, while some of these activities cannot be directly identified with a specific project. The fact that the activity cannot be directly identified with a project does not mean that the activity was not performed in support of the construction. Where construction activities take place and funds are expended, some portion of indirect administrative and general (A&G) costs should also be charged to construction. The payroll expense ratio should reflect a proper allocation of total payroll cost between operations and maintenance activity (expensed in the current year) and construction activity (capitalized to plant in service).

Executive management has oversight responsibility for all of Veolia Kansas City's operations, including construction. Although the Company does not anticipate large projects in the near future, the Company still incurs some construction costs going forward, which would include payroll related costs. Staff developed a ratio using hours related to capital projects to total payroll hours in 2008, 2009, and 2010 and found them to be trending downward. With the completion of the Truman Medical Center construction project and no foreseeable large capital projects anticipated in the near future, Staff utilized the 2010 capitalization ratio in its payroll annualization. The Staff applied the expense allocation percentage to the total payroll costs to

1 include the expense levels in the revenue requirement calculation. The amount related to
2 construction activity will be included in future plant balances.

3 *Staff Expert/Witness: Patricia Gaskins*

4 **4. FERC Account Distribution**

5 After the payroll allocation between Veolia Kansas City and Veolia Missouri and the
6 allocation between expense and construction, the Staff distributed, as much as possible, the
7 adjustment for payroll by the FERC USOA. The Company currently distributes payroll between
8 FERC Accounts 500, 510, and 920, which does not include all the appropriate FERC accounts.
9 The following statement was taken directly from the FERC USOA description of account 500;
10 “For Major Utilities, this account shall include the cost of labor and expenses incurred in the
11 general supervision and direction of the operations of steam power generating stations. Direct
12 supervision and direction of specific activities, such as fuel handling, boiler room operations,
13 generator operations, etc., shall be charged to the appropriate account.” Consistent with Staff’s
14 recommendation in Case No. HR-2008-0300, Staff recommends that Veolia Kansas City in the
15 future distribute payroll to all the appropriate FERC accounts. Staff does not have the necessary
16 information to properly distribute the payroll costs to the various FERC accounts. Staff would
17 need this information to be able to properly distribute the costs in the future. Staff recommends
18 Veolia Kansas City to expand the use of additional FERC accounts to properly identify the costs
19 incurred to operate the steam system. The Staff based its payroll adjustment for each account on
20 the Company’s actual account distributions for the 2010 test year period.

21 *Staff Expert/Witness: Patricia Gaskins*

1 **5. 401K, Defined Contribution Plan and Group Benefits**

2 The Veolia Companies offer a 401K Retirement Plan, Defined Contribution Plan,
3 comprehensive medical, dental, and disability coverage for their employees. Staff reviewed the
4 employer costs for each benefit in 2009 and 2010. The Staff developed a ratio on the 12-month
5 test year period ending December 31, 2010, utilizing the employer portion of the employee
6 benefits and the direct relationship to the employee salaries. The Staff then applied this ratio to
7 Staff's annualized base payroll as of June 30, 2011 to calculate the appropriate expense level for
8 employee benefits. (Accounting Adjustments E-12.1, E-68.1, E-74.1 and E-75.1)

9 *Staff Expert/Witness: Patricia Gaskins*

10 **6. Payroll Tax**

11 The adjustments made to payroll taxes serve to ensure that Staff included in rates the
12 appropriate level of Social Security (FICA) and Medicare taxes associated with the
13 Staff's annualized payroll. The Staff's calculation used the current 2011 tax rates for the
14 individual tax components. Applying these rates to the current annualized level of payroll
15 expense produces the best available allowance for payroll taxes on a going forward basis.
16 (Accounting Adjustment E-91.1)

17 *Staff Expert/Witness: Patricia Gaskins*

18 **7. Corporate Cost Allocations**

19 Corporate overhead costs are administrative and general (A&G) costs that are directly
20 assigned or allocated from various Veolia entities including the parent corporation Veolia North
21 America Holdings (Veolia Holdings) to its subsidiaries for various supporting services. Thermal
22 North America and Veolia Energy North America, LLC (Veolia Energy), provide executive
23 management and centralized support services to the Veolia district heating and cooling

1 companies. These services are provided to the district heating and cooling operating companies
2 on an allocated basis and include “executive management, accounting, finance, treasury, tax,
3 human resources, employee benefits administration, legal and other general corporate
4 services.”²⁶ Veolia Energy North America, a management services company, provides
5 management oversight and A&G services to Veolia Kansas City and Veolia Missouri from two
6 corporate headquarter locations, Chicago and Boston on an allocated cost basis. The corporate
7 office located in Chicago provides A&G services for Veolia Energy North America’s four
8 divisions, Veolia Energy—this is the Veolia division that the district heating and cooling
9 operations reside, Veolia Water, Veolia Environmental Services, and Veolia Transportation. The
10 corporate office located in Boston provides A&G services for only the Veolia Energy division
11 which includes Veolia Kansas and Veolia Missouri²⁷.

12 Veolia Energy North America, the management services company, allocates all of its
13 costs either directly to individual district heating and cooling subsidiaries, including Veolia
14 Kansas City or back to its parent company Veolia Energy North America Holdings
15 (Veolia Holdings). The A&G costs of Veolia Energy North America that are charged back to
16 Veolia Holdings along with A&G costs of Thermal North America ultimately are allocated to
17 each Veolia district heating and cooling subsidiary including Veolia Kansas City. It is these
18 costs that Staff believes to be excessive. Those costs directly incurred for the management,
19 maintenance and operations of district heating and cooling in Kansas City—either provided by
20 Veolia Kansas City or its affiliate, Veolia Missouri—are not an issue. The directly assigned

²⁶ The shared corporate services are identified by the Company in response to Data Request 108 and 109 in Case No. HR-2011-0241.

²⁷ See Direct Testimony of Staff witness Cary G. Featherstone, Case No. HR-2011-0241, pages 25 and 26.

costs have been included in Staff's revenue requirement calculation either as payroll, payroll benefits or operation and maintenance costs.

The costs that are in conflict relate to Thermal North America and Veolia Holdings' A&G costs that are allocated to each Veolia district heating and cooling subsidiary based on sales of each entity in relation to the total sales of Veolia Holdings. The percentage derived from Veolia Kansas City's sales to Veolia Holdings' total sales is applied to A&G costs resulting in its allocated share of the costs. The allocation process ensures that each entity receives its allocated share of the total A&G costs. The following table identifies Veolia Kansas City's allocated share of A&G costs from 2006-2010.

Year	Allocation Percentage for Veolia Kansas City
2006	** _____ ** Case No. HR-2008-0300
2007	n/a
2008	** _____ **
2009	** _____ **
2010	** _____ ** Case No. HR-2010-0241

Source: Data Request 80

Although Veolia Holdings allocates its A&G costs to each entity as described above, it retains some of its corporate costs. The Company is not seeking reimbursement of these retained costs in this current rate case because some of these costs may be considered controversial for ratemaking purposes. Mr. Steve Carver, the Company's consultant addresses this point in his direct testimony at page 33,

In the normal course of business, certain cost center expenses are retained and not allocated to the various operating entities. In addition, other cost center expenses were removed for regulatory purposes and not allocated to VEKC for purposes of this rate case. The voluntary removal of certain

1 common costs initially allocated to VEKC was undertaken with the
2 intention of conservatively eliminating elements of expense that are
3 sometimes controversial in the rate setting process.²⁸

4 While Staff concluded in its review of corporate costs that Veolia Energy North America
5 distributed corporate costs consistently to all Veolia Companies using the percentage of sales
6 method, Staff has not concluded those corporate functions are entirely necessary to the
7 operations of Veolia Kansas City; that Veolia Kansas City could provide some or many of those
8 functions at a local level more effectively; that the overall levels of corporate costs allocated to
9 Veolia Kansas City were necessary to the regulated operations or proper as to the overall amount
10 allocated. The amount of corporate costs allocated from Veolia Energy North America and
11 assigned to Veolia Kansas City may simply be excessive considering the size of the Company's
12 Kansas City regulated operations.

13 One factor contributing to increased corporate costs is an increased allocation percentage
14 used to calculate Veolia Kansas City's share of corporate costs. Although Veolia Energy North
15 America used the same approach to allocate corporate costs in the last case, Veolia Kansas City's
16 allocated share increased from ** _____ ** to ** _____ **. However, the most significant
17 factor causing the increase in corporate costs allocated to the Company is the substantial increase
18 in the amount of total corporate costs since the 2007 corporate ownership change. In the last
19 case, allocated 2006 corporate costs for Veolia Kansas City were ** _____ ** of which the
20 Company only requested ** _____ ** for rate recovery (Company work paper Case No.
21 HR-2008-0300). For this 2010 rate case, the corporate costs allocated to Veolia Kansas City
22 increased to \$782,995 with the Company requesting ** _____ ** for rate recovery (Company
23 work paper Case No. HR-2010-0241). Staff used in the last rate case an amount of \$198,114 as

²⁸ Types of costs not allocated to Veolia Kansas City include executive officer compensation, incentive or bonus pay, project development and sale/acquisition costs, lobbying and charitable contributions.

1 the basis for its 2006 corporate costs. Based on the costs requested by the Company for rate
2 recovery, Veolia Kansas City's share of corporate costs has increased 295% over a five year
3 period. The following chart identifies corporate costs assigned to Veolia Kansas City:²⁹

Year	Company Response to Data Request 80 in Case No. HR-2011-0241	Percentage Increase from previous year	Veolia Kansas City Annual Report (FERC Form 1)	Percentage Increase from previous year
2006	n/a	n/a	\$198,114	n/a
2007	n/a	n/a	\$238,392	20%
2008	** _____ **	n/a	\$273,377	15%
2009	** _____ **	82%	\$508,331	86%
2010	** _____ **	63%	\$782,994	54%

4
5 It should be noted there are some relative small differences in corporate costs the Company
6 identified in a data request response and those reported in the annual report submission to the
7 Commission (the FERC Form 1).

8 Staff believes Veolia Kansas City's share of corporate costs is excessive with respect to
9 the size and scope of the Veolia Kansas City operations. Staff believes that Veolia Holdings and
10 Veolia Energy North America needs to review the corporate costs allocated to Veolia Kansas
11 City, including the types of corporate activities charged to Veolia Kansas City, and the overall
12 level of corporate costs Veolia Energy North America allocates to this Company. While the
13 current allocation process using the revenues (sales) methodology seems to be appropriate, the

²⁹ The data was retrieved from Company response to Data Request 80 in Case No. HR-2011-0241, Veolia Energy Kansas City Annual Reports filed with the Missouri Public Service Commission and Company workpapers supporting its direct filing in Case Nos. HR-2008-0300 and HR-2011-0241.

1 review of the total corporate costs should include the appropriateness of the ultimate amount of
2 total allocated costs being made to Veolia Kansas City.

3 Veolia Kansas City has had ** _____ ** in every year since the
4 beginning of its operations when the system was purchased from Kansas City Power & Light
5 Company in 1990. According to the Company, Veolia Kansas City has never ** _____
6 _____ ** since taking over the operations of the district heating system (Data Request
7 No. 113). Clearly, the pressure of the high corporate costs has contributed to the difficulty in the
8 Company showing ** _____ ** despite the rate increase on November 1, 2008 authorized by
9 the Commission in Case No. HR-2008-0300.

10 In order to address the excessive nature of Veolia Kansas City's corporate costs, Staff is
11 proposing an adjustment to reduce the level of corporate costs for inclusion in rates compared to
12 the 2010 test year. Based on Staff's analysis, Veolia Kansas City's share of corporate costs
13 increased 86% in 2009 over the Company's share of corporate costs in 2008. In comparison, the
14 Company's share of corporate costs in 2007 and 2008 increased 20% and 15% respectively. The
15 increase in 2009 of 86% is directly related to the 2007 corporate ownership change and the
16 transition period immediately following the ownership change. Although Staff understands there
17 may be reasons for an increase in allocated corporate costs from year to year, an increase of 86%
18 in a one year period and 295% over a five year period is excessive. Therefore, Staff has
19 proposed an adjustment to hold the level of increase for corporate costs to a 50% increase over
20 Veolia Kansas City's 2008 share of corporate costs levels. A 50% increase is excessive but in
21 order to be conservative with the increase over the 2009 level, Staff is recommending this level
22 be included in rates in this case. Staff further recommends the Commission Order a
23 comprehensive analysis be conducted regarding the allocation process of corporate costs; the

1 appropriate types of corporate activities that should be assigned to Veolia Kansas City and the
2 proper level of overall total corporate costs allocated to Veolia Kansas City. (Accounting
3 Adjustment E-79.1)

4 *Staff Experts/Witnesses: Karen Lyons and Cary G. Featherstone*

5 **G. Operations and Maintenance Expense, Non-Wage**

6 Operations and maintenance expenses reflect costs to operate and maintain Veolia
7 Kansas City's Grand Avenue production facilities, as well the steam distribution plant. Utility
8 companies typically incur two types of costs for this type of expense: labor costs to pay Veolia
9 Kansas City employees for operations and maintenance of these plant facilities and costs
10 incurred for non-payroll charges, or non-wages. Staff expert Patricia Gaskins is responsible for
11 the payroll component of operations and maintenance costs, as well as determining the proper
12 level of costs relating to the non-wage component.

13 Staff analyzed maintenance costs from 2008-2010 by functional area and for production
14 and distribution by FERC account. Several steps were taken to analyze maintenance data. Since
15 labor costs are treated separately, Staff analyzed non-labor maintenance costs separately as well.
16 The Staff examined the non-labor maintenance amounts to identify any characteristics of the
17 maintenance dollars to trend or fluctuate from one period to another. Staff also compared
18 functional averages, which included using a two (2) and a three (3) year average to determine if
19 there were fluctuations with each functional area. The Staff also compared each of the costs by
20 year and averages for maintenance to the 2010 test year. Staff reviewed the data as detailed
21 above to establish a maintenance level that will result in an annual and normalized level of the
22 Company's future maintenance costs. Based on the review of non-labor maintenance costs, Staff
23 concluded that the 2010 test year maintenance balances reflect a proper expense level for the

1 future. Since the amounts of non-labor maintenance costs are already reflected in the test year
2 levels included in the revenue requirement calculation, no further adjustment was necessary.

3 *Staff Expert/Witness: Patricia Gaskins*

4 **H. Outside Services and Rate Case Expense**

5 Outside services are amounts paid to consultants and non-Veolia Kansas City employees
6 hired by the Company to perform specific tasks and functions. Rate case expenses are costs
7 incurred by the Company in preparation and performance of its filing for rate relief.

8 Staff utilized Company records and responses to data requests to determine the correct
9 amount of rate case expense for inclusion in rates. The Staff took into consideration the amounts
10 from both Outside Services and Regulatory Expense accounts, as the Company determined they
11 were incurred for the current rate case. Staff has included in this case, based upon invoices
12 provided by Veolia Kansas City, reasonable and prudent expenses incurred during the 2010 test
13 year through the March 31, 2011 update period. The invoices reviewed dealt not only with costs
14 associated with the current rate case proceedings, Case No. HR-2011-0241, but also the
15 Company's Class Cost of Service Report that the Commission ordered the Company to complete
16 in Case No. HR-2008-0300. However, Staff was provided with only face sheets for the invoices
17 from Bryan Case, its rate case legal consultant. Since Staff was not provided detailed invoices
18 for these face sheets, these legal costs from Bryan Cave have been disallowed from rate
19 recovery.

20 Rate case expenses typically are end-loaded—that is, the Company incurs costs to
21 process the rate case towards the end of the process with activities such the production of
22 testimony, participation in the settlement conferences and the hearing process including the
23 production of briefs. As the Company incurs additional rate case costs for this case, Staff will

1 include actual costs deemed to be reasonable and prudent to develop an amount of on-going rate
2 case expense level that it will recommend for recovery in rates.

3 Staff has determined that the Company should be allowed to recover its prudently
4 incurred and verified Rate Case expenses at an on-going and recurring level. (Accounting
5 Adjustments E-71.2)

6 *Staff Expert/Witness: Sean Furey*

7 **I. Missouri Public Service Commission Assessment Expense**

8 The PSC assessment is an amount levied on every regulated utility for the recapture of
9 expenses incurred by the Commission for providing the regulation of public utilities under its
10 jurisdiction. Staff annualized the Commission Assessment to reflect the latest assessment
11 available for the current fiscal year. The Staff updated the test year Commission Assessment to
12 the current fiscal year 2012 amount based on records from the Commission. (Accounting
13 Adjustment E-78)

14 *Staff Expert/Witness: Sean Furey*

15 **J. Insurance**

16 Insurance expense is the cost of protection obtained from third parties by utilities against
17 the risk of financial loss associated with unanticipated events or occurrences. Utilities, like non
18 regulated entities, routinely incur insurance expense in order to minimize their liability
19 associated with unanticipated losses. Likewise, certain forms of insurance reduce ratepayer's
20 exposure to risk. Premiums for insurance are normally pre-paid by utilities; i.e., payment is
21 made by the utility to the insurance vendor in advance of the policy going into effect. Insurance
22 payments are normally treated as prepayments, with the amount of the premium being booked as
23 an asset and amortized to expense ratably over the life of the period. The Staff included in rate

1 base the unamortized balance of the prepaid insurance account (either the period-ending balance
2 or a 13-month average balance), with an annualized level of insurance expense included in rates.
3 Staff expert Sean Furey has addressed the unamortized balance of the prepaid insurance in rate
4 base in the Prepayments section of this Report.

5 During the audit, Staff reviewed the Company's insurance policies for the following
6 forms of insurance; General Liability, Forward and Historic Pollution Legal Liability, Storage
7 Tank Liability, Worker's Compensation, and Automobile and Property Insurance. Staff looked at
8 coverage dates from 2008 through 2011. Based on the information provided by the Company,
9 the Staff calculated an annualized insurance amount by using the insurance premiums that will
10 be in effect through 2011, which the Company provided in the insurance policies. While
11 reviewing Company documents, Staff became aware that Veolia Kansas City does not allocate
12 insurance costs to Veolia Missouri, the non regulated affiliate of Veolia Kansas City. Staff's
13 insurance annualization excludes Veolia Missouri's share of the insurance premiums.
14 (Accounting Adjustments E-53.1, E-72.1, and E-73.1)

15 *Staff Expert/Witness: Patricia Gaskins*

16 **K. Miscellaneous Non-Recurring Expenses**

17 During the 2010 test year, two non-recurring events impacted Veolia Kansas City's
18 operating expenses.

19 In February 2010, Veolia Kansas City received a Responsible Party Notification Letter
20 from the Kansas Department of Health and Environment (KDHE). KDHE identified Veolia
21 Kansas City as a potentially responsible party in connection with an environmental investigation.
22 As a result of the investigation, Veolia Kansas City may be held responsible for a portion of the
23 remediation costs. The Company made an adjustment in its direct filing to remove the estimated

1 accrued costs of remediation from expense. Staff made the same adjustment, as reflected on
2 Schedule 10 of its Accounting Schedules, Adjustment E-30.

3 In July 2008, Missouri Gas Energy (MGE) notified Veolia Kansas City of an issue with
4 MGE's gas meter that resulted in an alleged under-billing of Veolia Kansas City's natural gas
5 service for the period of 2003-2008. Veolia Kansas City is currently disputing the costs MGE
6 has identified as a result of the meter issue. Consequently, the Company did not seek recovery
7 of these costs in its direct filing for this rate case. Staff did not include any of these costs in
8 its case.

9 *Staff Expert/Witness: Karen Lyons*

10 **L. Property Taxes**

11 Each year, the jurisdictional taxing authority bills Veolia Energy Kansas City, Inc. for the
12 Company's property. Tax bills for the year are based (assessed) on the property that Veolia
13 Energy Kansas City, Inc. owns exclusively on January 1 of that calendar year. The property taxes
14 assessed on January 1 of each year are typically not due to the taxing authorities until
15 December 31 of that same year.

16 Since the update period for this case is June 30, 2011, Staff determined the annualized
17 property taxes based on the property that the Company had in-service on January 1, 2011. Staff
18 used the relationship of 2010 property taxes (paid December 31, 2010) to January 1, 2010. This
19 ratio property taxes, based on actual 2010 property tax payments was applied to January 1, 2011
20 plant balance, provides the amount of annualized property taxes the Staff expects the Company
21 to pay for 2011.

22 For this rate case, Staff obtained from the Company the total amount of taxable property
23 owned on January 1, 2011, and then applied it to the tax rate assessed to the Company in 2010.

1 The Staff calculated the property tax rate assessed in 2010 by dividing the total amount of
2 property tax paid by the Company by the total cost of the taxable property owned on January 1,
3 2009. Staff believes that the level of property tax expense arrived at in this manner is the best
4 available information, since it relies on the January 1, 2011 balance of the Company's property,
5 and uses the most recent, known tax rate (2010), without attempting to estimate any change in
6 the rate of taxation for 2011 that is not known as of the update period June 30, 2011. Staff's
7 approach is consistent with that taken in previous cases in which the Commission has ruled
8 favorably toward, including KCPL's 2006 rate case. In its Report and Order issued in Case No.
9 ER-2006-0314, the Commission states the following:

10 Staff recommends that the Commission calculate property tax expense
11 by multiplying the January 1, 2006 plant-in-service balance by the ratio of
12 the January 1, 2005 plant-in-service balance to the amount of property
13 taxes paid in 2005...the Commission finds that the competent and
14 substantial evidence supports the Staff's position, and finds this issue in
15 favor of Staff.

16 Based on the methodology addressed earlier, Staff's adjustments include an annualized
17 amount for property taxes. Adjustments E-89 and E-90 reflect the annualized levels.

18 *Staff Expert/Witness: Sean Furey*

19 **VII. INCOME TAXES**

20 Staff calculated the revenue requirement in this case for income taxes using two
21 components for the income statement and one component for the rate base.

22 **A. Income Taxes in the Income Statement**

23 **1. Interest Expense Deduction**

24 Staff calculated the interest expense deduction using a method it has used since the early
25 1980's called "interest synchronization." Staff first utilized this methodology, and the

1 Commission adopted such, in KCPL's 1980 electric rate case, Case No. ER-80-48. Staff
2 has consistently used, and the Commission has consistently adopted, this approach since that
3 early case.

4 This method identifies the interest expense amount utility customers pay in rates through
5 the rate of return calculation. The rate of return developed by Staff witness Zephania
6 Marevangepo includes a debt component. When applied to the recommended rate base, that debt
7 component provides the Company with an amount to pay interest on its debt service. Since this
8 is the amount customers are responsible for in rates, this interest expense is also used as the
9 income tax deduction to the calculated income tax expense amount for rate purposes.

10 The interest expense deduction is calculated by taking the weighted cost of debt
11 multiplied by the recommended rate base. This is the amount shown as a deduction on
12 Schedule 10 - Income Taxes of the revenue requirement model. This methodology assures that
13 the amount of interest expense used in the calculation of income tax expense, for ratemaking
14 purposes, equals the interest expense the ratepayer is required to provide the Company in rates.
15 Since the Staff's bases its recommended revenue requirement recommended in part on a rate of
16 return computation, the interest synchronization method allows an interest deduction consistent
17 with the rate of return computation that is applied to rate base.

18 *Staff Expert/Witness: Karen Lyons*

19 **2. Depreciation Expense Deduction for Income Taxes Purposes**

20 Staff used the amount of annualized book depreciation expense determined on a
21 straight-line basis as the deduction for depreciation for calculating income tax expense. The
22 amount identified in Schedule 10- Income Taxes as the "Add Back" for depreciation was also
23 used as the deduction for income tax purposes, found in Schedule 10- Income Taxes.

1 Staff used the "Add Back" amount for the depreciation deduction since the Company was
2 essentially treated as a "start-up" company after the 2005 purchase by Thermal North America.
3 After the sale of the Veolia Companies, Thermal North America treated the assets of the Veolia
4 Companies as a new company and as though they did not exist prior to acquisition. As such,
5 Veolia Kansas City no longer had any tax basis differences³⁰ that the Staff would normally need
6 to consider in the calculation of the depreciation deduction used in the income tax calculation.
7 Typically, any income tax deduction previously taken cannot be taken again, so the Staff
8 excludes those amounts from the tax basis of the property used in calculating the straight-line
9 depreciation deduction for ratemaking purposes. In addition, since the Company essentially
10 started over as a new company in 2005, all accumulated deferred income tax reserves were
11 reduced to zero and, consistent with this treatment, no basis differences existed for tax
12 depreciation. Staff has taken the annualized book depreciation expense that is calculated on a
13 straight line basis using the proposed rates recommended by Staff expert David Williams. Staff's
14 annualized depreciation amount is being used as the tax deduction for depreciation found on
15 Schedule 10, without reflecting any basis differences for prior years deductions. There is a
16 question as to whether there has been any basis differences at all based on prior tax treatment of
17 timing differences. Staff believes that to the extent that timing differences were identified by the
18 Company, the Company never took a current income tax deduction; in other words, those
19 deductions for the timing differences were very likely normalized. KCPL was one of two
20 utilities in the state that used normalization treatment of its timing differences. The
21 "normalization" method (which was not typically used in determining utility rates in this state in
22 the past) provided for a deferral of the deduction of the timing differences in the ratemaking

³⁰ "Basis differences" are amounts that had already been taken as a previous deduction.

1 process. While the companies were able to take the tax deductions of certain costs currently to
2 determine the amount of income taxes owed to the IRS, the normalization method did not reflect
3 those current deductions in the ratemaking process. Under normalization, the Company deferred
4 deductions and took them over the life of the assets. Generally, because of these deferred
5 deductions, income tax expense was higher for ratemaking purposes under the normalization
6 method than it would have been under the flow-through method.

7 Under the "flow-through" method, the Staff treated the tax timing differences for the tax
8 deductions consistent with the period used in calculating current income tax expense. This
9 treatment was commonly referred to as the "flow-through" method. Conversely, reflecting the
10 tax deduction for tax timing differences consistent with the period used for recognizing the cost
11 as an expense for financial reporting purposes is referred to as the "normalization" method.

12 Staff generally used the "flow-through" method of determining income tax expense for
13 ratemaking purposes. Staff used this method to give the customers the same deduction as the
14 Company took on its tax return. Taking the same capitalized overhead costs as a current
15 deduction for ratemaking purposes as those taken as a current deduction in the Company's
16 calculation of its income taxes ensured that the current utility customers received the tax benefit
17 for these deductions. (Accounting Schedule 10)

18 *Staff Expert/Witness: Karen Lyons*

19 **B. Income Taxes for Deferred Income Tax Expense**

20 Staff reflected an amount of deferred income expense based on a level calculated by the
21 Company. This amount was included in Schedule 11—Income Tax Calculation.

22 *Staff Expert/Witness: Karen Lyons*

1 **C. Income Taxes in the Rate Base**

2 **1. Accumulated Deferred Income Tax Reserves**

3 The Staff based its amount for accumulated deferred income tax reserve on the level of
4 reserves on Veolia Kansas City's books as of June 30, 2011. Staff was unable to determine what
5 the proper levels for accumulated deferred income taxes were for this case, because of the
6 manner the accumulated reserve was treated in the 2005 sale. After the 2005 sale closed, Veolia
7 Kansas City's deferred income tax reserve balance was reduced to zero, in effect the Company's
8 deferred income tax reserves started over.

9 Deferred income tax reserves result from providing normalization treatment for
10 tax timing differences. The tax timing difference for depreciation occurs because utilities
11 are allowed to use an accelerated method for depreciation for tax purposes rather than the
12 straight-line method used for financial reporting and ratemaking determination. Each year
13 utilities must maintain the proper identification of these tax timing differences and calculate the
14 proper levels of deferred income taxes on their books. Veolia Kansas City simply did not do this
15 and as such, the proper level of deferred income tax reserves is impossible to determine.

16 The significance of the deferred income tax reserves is that rate payers are required to
17 pay an amount for these deferrals up front to the Company prior to the point when the utility
18 must pay for those taxes to the Internal Revenue Service (IRS). As such, the Company has use
19 of these deferred income taxes before they are owed and paid to the IRS. In reality, the
20 Company is allowed a greater tax deduction for depreciation expense based on accelerated
21 depreciation methods than the depreciation tax deduction the utility customers are allowed for
22 rate setting purposes. Since the Company has use of this "interest free" money (the income tax
23 deferrals) customers are given the benefit of the deferred income tax reserves by treating those
24 amounts as an off-set to rate base.

1 What the seller of the Trigen properties did in the 2005 sale case was capture those
2 deferred income taxes as part of the transaction and, therefore, the deferred income taxes paid by
3 the customers were lost to them. The newly acquired Company customers "lost" the benefits of
4 the accumulated deferred income reserves that had accumulated over the years from Veolia
5 Kansas City's steam customers.

6 Further, the records of the deferred income tax reserves prior to the 2005 sale transaction
7 were not reliably maintained. Veolia Kansas City reported large positive and large negative
8 balances over a period of time from one year to the next. In the last case, Staff examined the
9 FERC Form 1's for the period 1997 to 2007, but was not convinced that the amounts reflected in
10 these annual reports were ever correct. As discussed in the section regarding plant investment,
11 Veolia Kansas City did not maintain property accounting records for much of the time it has
12 owned the steam system. In addition to plant, depreciation reserve, and depreciation expense all
13 being incorrect, it appears the deferred income tax reserve was also subject to inadequate or
14 improper accounting.

15 Since the new ownership, the Company has maintained a level of deferred income tax
16 reserves. An amount for these deferred taxes are shown on Schedule 2—Rate Base as an offset,
17 or subtraction from rate base.

18 As noted above in the section "Depreciation Expense Deduction," the Veolia Companies,
19 including Veolia Kansas City, were treated as though the companies were new start-up
20 companies. As such, all accumulated deferred income tax reserves were reduced to zero. Since
21 the deferred income tax reserves were "started over", Staff is consistently using the same
22 approach with the treatment of tax depreciation, discussed above, in that the newly acquired

1 company no longer had any basis differences, to the extent that those basis differences ever
2 existed. (Accounting Schedule 2)

3 *Staff Expert/Witness: Karen Lyons*

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

AFFIDAVIT OF DANIEL I. BECK

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Daniel I. Beck, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Daniel I. Beck
Daniel I. Beck

Subscribed and sworn to before me this 8th day of August, 2011.

Nikki Senn
Notary Public

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)
)
)

AFFIDAVIT OF KIM COX

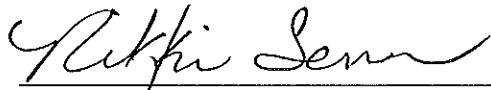
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Kim Cox, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

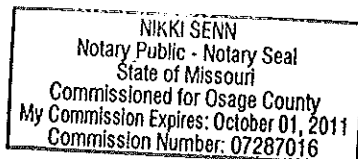


Kim Cox

Subscribed and sworn to before me this 8th day of August, 2011.



Notary Public



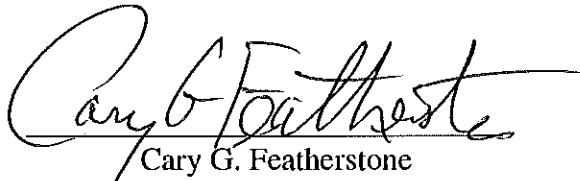
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)
)
)

AFFIDAVIT OF CARY G FEATHERSTONE

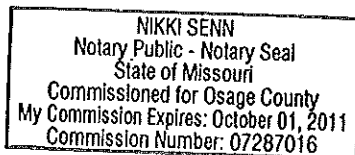
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Cary G Featherstone, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.


Cary G. Featherstone

Subscribed and sworn to before me this 8th day of August, 2011.


Nikki Senn
Notary Public



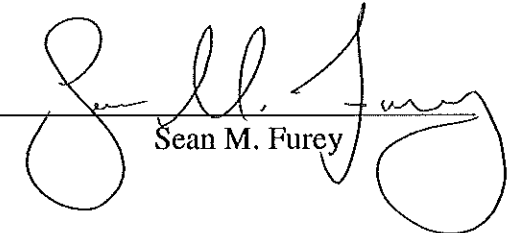
BEFORE THE PUBLIC SERVICE COMMISSION
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In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase)
Rates) File No. HR-2011-0241

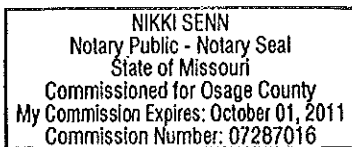
AFFIDAVIT OF SEAN M. FUREY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Sean M. Furey, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.


Sean M. Furey

Subscribed and sworn to before me this 8th day of August, 2011.




Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

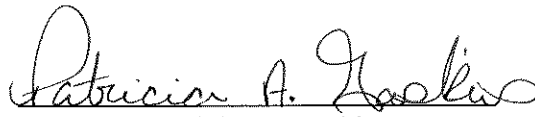
In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase)
Rates)
)
)

File No. HR-2011-0241

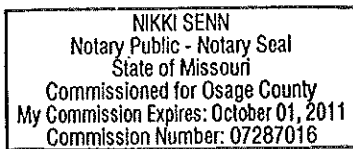
AFFIDAVIT OF PATRICIA A. GASKINS

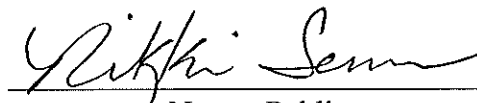
STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

Patricia A. Gaskins, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.


Patricia A. Gaskins

Subscribed and sworn to before me this 8th day of August, 2011.




Notary Public

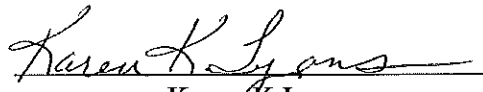
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

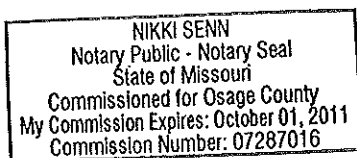
AFFIDAVIT OF KAREN K. LYONS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Karen K. Lyons, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.


Karen K Lyons

Subscribed and sworn to before me this 8th day of August, 2011.




Notary Public

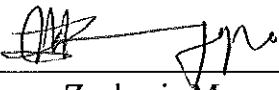
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

AFFIDAVIT OF ZEPHANIA MAREVANGEPO

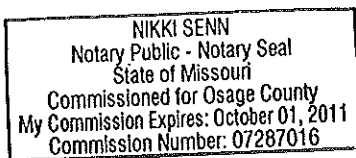
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

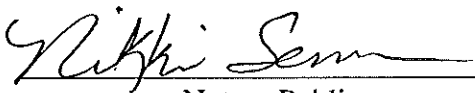
Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.



Zephania Marevangepo

Subscribed and sworn to before me this 8th day of August, 2011.





Notary Public

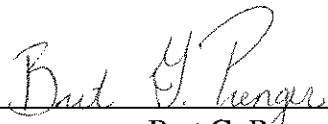
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

AFFIDAVIT OF BRET G. PRENGER

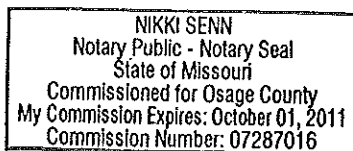
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Bret G. Prenger, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.



Bret G. Prenger

Subscribed and sworn to before me this 8th day of August, 2011.





Notary Public

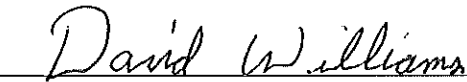
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

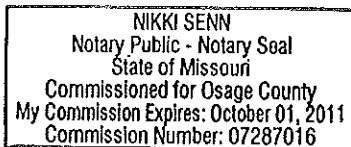
AFFIDAVIT OF DAVID WILLIAMS

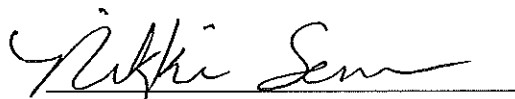
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Williams, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.


David Williams

Subscribed and sworn to before me this 8th day of August, 2011.




Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Veolia Energy Kansas City,)
Inc. for Authority to File Tariffs to Increase) File No. HR-2011-0241
Rates)

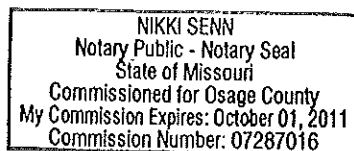
AFFIDAVIT OF SEOUNG JOUN WON

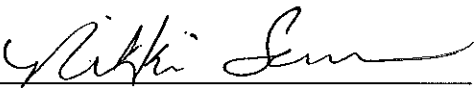
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Seoung Joun Won, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.


Seoung Joun Won

Subscribed and sworn to before me this 8th day of August, 2011.




Notary Public