**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

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| In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Service to Begin the Implementation of Its Regulatory Plan | ) ) ) ) ) | Case No. ER-2006-0314 |

# PREHEARING BRIEF OF UNITED STATES DEPARTMENT OF ENERGY/NATIONAL NUCLEAR SECUTIRY ADMINISTRATION (DOE/NNSA) AND STATEMENT OF POSITION


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**<u>DOE/NNSA'S PREHEARING BRIEF</u>**
**<u>AND STATEMENT OF POSITION</u>**

**<u>OFF-SYSTEM SALES</u>**

**<u>Issue:</u> What level of off-system sales margin should be included in determining KCPL's cost of service?**

An ongoing, normalized level of margins from non-firm off-system sales should be reflected as a credit within the Missouri jurisdictional cost of service. KCPL has undertaken a sophisticated modeling technique designed to estimate the range of possible margins from off-system sales to be achieved during the period that rates being established within this proceeding will be effect (i.e., most of 2007), and further, created a probabilistic distribution for such range of possible outcomes. However, KCPL has proposed that the off-system sales level to be credited within the Missouri jurisdictional cost of service be established at the 75th percentile of probability of occurrence. If KCPL's probabilistic analysis is to be employed, the $50^{th}$ percentile should be utilized as the "most likely" or "normalized" level of off-system sales to be credited to the cost of service. Within the prefiled direct testimony of witness Dittmer DOE/NNSA has proposed the inclusion of off-system sales margins as quantified at the $50^{th}$ percentile of probability of occurrence as predicted by KCPL's study as the "normalized, ongoing" level of off-system sales margins to be credited to the cost of service. (Dittmer prefiled Rebuttal p. 2 et seq., Dittmer prefiled Surrebuttal p. 3 et seq.)

However, DOE/NNSA reserves the right, based upon evidence that may yet be entered into the record, to again address the appropriate level of off-systems sales margins to be credited to the Missouri retail cost of service.

**Issue: How should the off-system sales margin be allocated to the Missouri retail, Kansas retail and FERC wholesale jurisdictions?**

DOE/NNSA proposes that the “total company” level of off-system sales margins (the topic of the first DOE/NNSA issue listed) be allocated to the Missouri retail jurisdiction on the basis of the “energy with losses” allocator as was employed to allocate the “cost” of facilitating such sales in this case, and which has been employed in every KCPL case , as well as, to DOE/NNSA’s knowledge, every Missouri electric utility rate proceeding in recent years. DOE/NNSA specifically opposes KCPL’s never-before-utilized “unused energy allocator” to assign non-firm energy sales margins to the Missouri jurisdiction. Nowhere in KCPL’s prefiled testimony does it demonstrate that any utility regulatory commission, state or federal has ever adopted such a proposal and in the 93 year history of the Missouri Public Service Commission has such a proposal ever been adopted. In support of its opposition to KCPL’s proposed “unused energy allocator,” DOE/NNSA notes that such allocator rewards low load factor customers/jurisdictions and punishes high load factor customers/jurisdictions – which is counterintuitive to cost causation principles. (Dittmer prefiled Rebuttal p. 2 et seq., Dittmer prefiled Surrebuttal p. 3 et seq.)

**Issue: What parameters does the Commission-approved Stipulation & Agreement in Case No. EO-2005-0329 impose on the treatment of off-system sales revenue in this case?**

Staff witness, Mr. Traxler in prefiled testimony states that the Stipulation & Agreement in Case No. EO-2005-0329, KCPL’s Experimental Regulatory Plan requires that off-system energy and capacity sales would continue to be treated “above the line” for ratemaking purposes. DOE/NNSA witness Dittmer agreed with Mr. Traxler commenting that this was an issue addressed in great detail in the Experimental Regulatory Plan and by the Commission Order on the Plan. (Dittmer prefiled Rebuttal p. 14)

The Stipulation & Agreement in Section III.B.1.j at page 57 states:.

**j. Off-System Sales**

KCPL agrees that off-system energy and capacity sales revenues and related costs will continue to be treated above the line for ratemaking purposes. KCPL specifically agrees not to propose any adjustment that would remove any portion of its off-system sales from its revenue requirement determination in any rate case, and KCPL agrees that it will not argue that these revenues and associated expenses should be excluded from the ratemaking process.

**<u>Issue:</u> Should KCPL's customers receive the benefit of all margins of off-system sales or should it be shared between customers and shareholders? Should a mechanism be adopted to ensure that the benefit is received by the appropriate party or parties? If so, what mechanism?**

As stated above off-system sales are to be treated as "above the line" which to DOE/NNSA means that all margins from off-system sales are to benefit KCPL's customers and none to benefit shareholders.

DOE/NNSA asserts that there are different methodologies available to the Commission for effectuating KCPL's commitment that all revenues from off-system sales would be treated "above the line" for ratemaking purposes but that at present KCPL has not offered any. (Dittmer prefiled Rebuttal p. 15)

Mr. Giles in prefiled testimony states that KCPL has agreed that it has no inherent right to earnings from the off-system sales market. (Giles, prefiled Rebuttal, p. 7, lines

18-22)

## ICE STORM COSTS

**<u>Issue:</u> What amount of the amortization of the costs associated with the 2002 ice storm should be included in rates?**

DOE/NNSA opposes KCPL' proposal to include within the Missouri jurisdictional cost of service amortization of ice storm costs incurred in 2002. In support of such position, DOE/NNSA argues that such costs have already been recovered with existing Missouri jurisdictional rates. Further, the scheduled expiration of the existing amortization coincides very closely with the expected implementation date for new rates being established within this proceeding. With the establishment of that date there will absolutely be no ice storm costs to recover. To allow such costs to continue in the future is unreasonable. (Dittmer prefiled Direct p. 19 et seq.)

## REGULATORY PLAN ADDITIONAL AMORTIZATIONS

**<u>Issue:</u> What amount of Regulatory Plan additional amortizations should be allowed to maintain KCPL's credit rating?**

At most, amounts calculated on test year values to achieve the minimum financial metrics agreed to by the parties in the 2005 Stipulation and Agreement. DOE/NNSA reserves the right to address this issue after the hearing. At this time DOE/NNSA takes the position that KCPL should not be allowed any "Regulatory Plan Additional Amortizations" until there is an actual and verifiable indication by Standard & Poor's to lower KCPL's debt rating. KCPL has not prefiled any testimony which supports this.

**<u>Issue:</u> Should a "gross up" for taxes be added to this amount? If so, what amount is appropriate?**

DOE/NNSA supports Staff's calculations as being made in accordance with the

Stipulation & Agreement in Case EO-2005-0329. DOE/NNSA reserves the right to address this issue further after the hearing in Brief.

**<u>Issue:</u> What risk factor should be used in calculating the Regulatory Plan additional amortizations for off-balance sheet purchased power agreements?**

The Commission, not being a party to the Stipulation & Agreement reached among some of the parties in Case EO-2005-0329, is free to determine the risk factors it believes are relevant, apply no risk factors at all or determine that no additional amortization should be allowed. NNSA/DOE not being a party to the Stipulation & Agreement reserves the right to argue that no additional amortization should be allowed and that rates should be set according to the cost of KCPL to serve its customers including an opportunity to earn a reasonable return on its equity. For the Commission to set KCPL's rates according to criteria that Standard & Poor's uses to determine its rating of KCPL's debt amounts to the Commission deferring to the judgment of Standard & Poor's in setting rates. The Commission would thereby avoiding the Commission's statutory obligation to use its best judgment in setting rates for KCPL's ratepayers that are just and reasonable and based on competent and substantial evidence based upon the record. Nowhere in Missouri law is Standard and Poor's allowed to set rates.

**<u>Issue:</u> Over what period of time should the Regulatory Plan additional amortizations be treated as an offset to rate base?**

Unamortized Regulatory Plan additional amortizations balance should be used as a rate base offset so long as any net unamortized balance exists. Once the entire balance has been amortized, only then should there no longer be a rate base offset. Ratepayers should receive the benefits of any Regulatory Plan additional amortizations as early as possible. The longer the delay in repaying ratepayers for revenues advanced to KCPL by way of additional amortization the greater the intergenerational subsidy and will result in unreasonable and unlawful rates.

**Issue: Should the capital structure be synchronized with the investment in Missouri jurisdictional electric operations?**

Yes.

**Sub-Issue: How should that be accomplished?**

DOE/NNSA endorses Staff's methodology.

**Issue: Should an amount be added to Missouri jurisdictional rate base to reflect additional investments related to Missouri jurisdictional electric operations?**

DOE/NNSA is unaware of any prefiled testimony by any party which supports any amount.

## COST OF CAPITAL

**Issue: What is the appropriate capital structure?**

The appropriate capital structure for KCPL is set out in Exhibit JRW 1 below from J. Randall Woolridge prefiled Direct Testimony:

**Capitalization Structure and Senior Capital Cost Rates[1]**

| Source of Capital | Capitalization Ratio | Cost Rate |
|---|---|---|
| Long-Term Debt | 44.67% | 6.16 % |
| Preferred Stock | 1.52% | 4.29% |
| Common Equity | 53.81% | |
| Cost of Capital | 100.0% | |

DOE/NNSA has agreed to the Company's proposed capital structure and debt cost rate. However, Mr. Woolridge in prefiled Testimony does note that the proposed capital structure contains more equity capital than found in the capital structures of electric utility companies and hence KCP&L is exposed to less financial risk.

**<u>Issue:</u> What is the appropriate return on common equity (ROE)?**

The appropriate return on common equity (ROE) is 9.0%. (Woolridge prefiled Direct p. 47, L 4)

The major area of disagreement between Mr. Hadaway and Mr. Woolridge is in the estimation of the equity cost rate for KCP&L. Mr. Hadaway's estimate is 11.5%, while Mr. Woolridge's is 9.0%.

Using Mr. Woolrigde's proposed ROE the Cost of Capital (in his prefiled schedule) would be:

**Exhibit_(JRW-1)**

**Kansas City Power & Light Company**
**Cost of Capital**

**As of September 30, 2006**

| Capital Source | Capitalization Ratio | Cost Rate | Weighted Cost Rate |
|---|---|---|---|
| Long-Term Debt | 44.67% | 6.16% | 2.75% |
| Preferred Stock | 1.52% | 4.29% | 0.07% |
| Common Equity | 53.81% | 9.00% | 4.84% |
| Total | 100.00% | | 7.66% |

Mr. Hadaway uses Discounted Cash Flow (DCF) and Risk Premium (RP) approaches to estimating an equity cost rate for KCP&L. Mr. Woolridge has employed a DCF and the Capital Asset Pricing Model (CAPM), which is a RP approach. The major difference in the results from the equity cost rate applications can be traced to three factors – the growth rate in the DCF models and the risk-free interest rate and the risk premiums in the RP/CAPM approaches.

<u>DCF Growth Rate</u> – Mr. Hadaway has rejected using analysts' Earnings per Share (EPS) forecasts for his DCF growth rate, and instead has incorporated a long-term Gross Domestic Product (GDP) growth rate of 6.60% into his DCF equity cost rate.

[1] Woolridge prefiled Direct p. 9, l. 9

He provides no justification for using this growth rate, which is well above the historic and projected growth of electric utility companies. Mr. Woolridge has used a DCF growth rate of 4.25%, which incorporates historic and projected measures of growth.

Risk-Free Interest Rate – in his prefiled testimony Mr. Hadaway has used various projected interest rates as base interest rates in his RP approaches, including a projected long-term Treasury yield of 5.70%. In his prefiled surrebuttal testimony, Mr. Woolridge indicates that the current long-term Treasury yield is only 4.76%, which is much closer to the 5.00% he uses as a risk-free interest rate.

Equity Risk Premium – Mr. Hadaway has used two sources for his equity risk premiums -- he uses a historical risk premium as computed by Ibbotson Associates, and he uses a risk premium from a study by Harris and Marston. Mr. Woolridge has highlighted the many problems with using historic returns such as the Ibbotson approach to measure an equity risk premium. In contrast, Mr. Woolridge has used not only the results of numerous academic studies (including Ibbotson and Harris and Marston), but also the results from leading investment banks and consulting firms as well as surveys of CFOs and financial forecasters. These later sources – investment banks, consulting firms, and CFOs - use the equity risk premium concept every day in making financing, investment, and valuation decisions. Their results, which reflect the level of the equity risk premium as it is applied in the real world of finance, indicate an equity risk premium in the 3-4 percent range and not in the Mr. Hadaway's 6-7 percent range. Hence, Mr. Hadaway's equity risk premium is not reflective of how the real world views the equity risk premium.

**Issue: Should ROE be adjusted either upwards or downwards to reflect increased or decreased risk or company performance? If so, what adjustment should be made?**

Mr. Hadaway arbitrarily adjusts his equity cost rate upwards by 50 basis points to reflect what he deems the risk associated with KCPL's investment plan. However, Mr., Hadaway makes no mention of the Stipulation and Agreement and therefore has totally ignored the Agreement in assessing the riskiness of KCP&L and therefore its effect on the cost of equity capital. In addition, Mr. Hadaway has made no adjustment to reflect the Company's lower degree of financial risk as indicated by its higher common equity ratio. Mr. Woolridge has rejected the 50 basis point adjustment, and indicated that, in his opinion, the elements of the Stipulation and Agreement may be worth as much as 30 basis points to KCP&L. See Woolridge prefiled Surrebuttal Testimony. P. 5.

## JURISDICTIONAL ALLOCATIONS:

**<u>Issue:</u> What is the appropriate method (4 CP vs. 12 CP) to use for allocating generation and transmission costs among jurisdictions?**

DOE/NNSA supports staff witness Erin Maloney's prefiled Direct Testimony in determining jurisdictional demand and energy allocators. With regard to demand allocation Ms. Maloney states on page 11 of her prefiled Direct Testimony that "The 4 CP methodology is appropriate for a utility, such as KCP&L, where the monthly peak demands during the non-summer months are significantly below the summer monthly peak demands. The lower demand in the non-summer months will have little or no influence on the capacity planning process and it would not be rational to consider all twelve monthly peaks in a jurisdictional allocation methodology when there are such significant statistical variations in the monthly seasonal peaks."

Ms. Maloney derived the following demand alloctors:

| | |
|---|---|
| **Missouri Retail** | **.5346** |
| **Kansas Retail** | **.4573** |
| **Wholesale** | **.0082** |

Ms. Maloney stated on page 13 of her prefiled Direct Testimony that the energy allocation factor for an individual jurisdiction is the ratio of the adjusted annual kilowatt-hour (kWh) usage in the particular jurisdiction to the total adjusted kWh usage in all jurisdictions. The sum of the energy allocation factors across jurisdictions equals one. Ms. Maloney derived the following energy allocators:

| | |
|---|---|
| **Missouri Retail** | **0.5668** |
| **Kansas Retail** | **0.4243** |
| **Wholesale** | **0.0089** |

## CLASS COST-OF-SERVICE

**Issue: On what basis should distribution costs be allocated to classes? Should the allocation of primary distribution costs include any customer-related component? What type of demand should be used to allocate the cost of distribution substations and distribution lines?**

DOE/NNSA relies upon KCPL's class cost of service filed in this case.

**Issue: On what basis should production capacity and transmission costs be allocated to classes?**

DOE/NNSA relies upon KCPL's class cost of service filed in this case.

**Issue: What is the appropriate method to use for allocating margins on off-system sales among Missouri retail customer classes? (MIEC)**

Mr. Price stated in his prefiled testimony that the allocation of off-system sales margin ( Price prefiled Surrebuttal Cross Surrebuttal pages 2-3) or profits should be based upon an energy plus losses allocator for both the jurisdictional and class cost of services. KCPL assigned system average energy costs on an energy plus losses basis but it allocated the margins or profits on a different and never used allocator based on load factors, its "unused energy" allocator. Not only has KCPL's load factor or "unused energy" allocator never been used anywhere, it would be incorrect and inconsistent to allocate system energy benefits or profits on a different basis that the energy costs incurred to produce the benefits.

Mr. Price states in his prefiled testimony that KCPL's cost of service should be used for realigning revenue deficiencies and surpluses except that it must be first corrected for the allocation of off-system sales to the Missouri jurisdiction and its classes of service ( Price prefiled Surrebuttal page 10 lines 7-11) and that off-system sales expenses and profits should be allocated to the Missouri jurisdiction and to its classes of service on an energy plus losses allocator (Price prefiled Surrebuttal page 2 lines 17-19).

Staff witnesses Maloney (prefiled Surrebuttal pages 6 and 7) and Pyatte (prefiled Surrebuttal page 3 lines 6-8), MIEC witness Brubaker(prefiled Direct page 29 lines 6-9) all agree that the correct allocator is the energy plus losses allocator**.**

**Issue: Do KCPL's computation of coincident peak demands and class peak demands properly recognize line losses?**

DOE/NNSA has not addressed this issue.

**Issue: To what extent, if any, are current rates for each customer class generating revenues that are greater or less than the cost of service for that customer class?**

In Schedule GCP-3, Page 1 of 3, Line 40, of DOE/NNSA of the Mr. Price's prefiled Surrebuttal Cross-Surrebuttal testimony of DOE/NNSA witness Gary Price quantifies the Total Revenue Adjustment that would be required to move all classes to the system average rate of return based on his proposed modification to KCPL's COSS. This Schedule is attached to this Brief as GCP-3. Also see Price prefiled Table 2A column c below on page 15.

**Issue: What is the appropriate basis for allocating Administrative and General Expense Account Numbers 920, 922, 923, 930.2, and 931 among Missouri retail customer classes?**

DOE/NNSA relies upon KCPL's class cost of service filed in this case.

**<u>Issue:</u> Should revenue adjustments among classes be implemented in order to better align class revenues to class cost-of-service? If so, what percentage increase or decrease should be assigned to each customer class?**

Mr. Gary C. Price stated in his prefiled testimony that KCPL should have relied upon its 9/30/2005 COSS results as corrected for the allocation of off-system sales to move the classes toward unity versus the system average. Mr. Price states that KCPL's proposal ( KCPL's T Rush prefiled Direct pages 4-6) to increase the classes' revenue responsibility across the board will exacerbate the present great revenue responsibility imbalance that presently exists among all classes rate of return indices.

Witness Price proposes to make rate changes that would move by 25% each rate class' contribution to system average return (See prefiled Surrebuttal Table 1B). Even if rate increase is zero or a decrease, the classes' contributions to the system average should be corrected as proposed (Price prefiled Direct pages 6-7 and prefiled Surrebuttal page 4-6).

For each of the four years, the revenue allocation proposal will first adjust present rates by increasing the deficient classes and decreasing the surplus classes as shown in Price prefiled Surrebuttal Cross-Surrebuttal Table 1B and then by adding to each class equally the across the board revenue change.

All parties agree ( Price prefiled Surrebuttal Cross-Surrebuttal page 7 Table 3A) that the residential class is under recovering by a substantial margin its allocated costs. All parties, except OPC, agree that the remaining classes (except street lights) are over recovering their allocated costs. OPC's cost of services produce inconsistent results and should not be relied upon to realign revenue deficiencies or surpluses. See also Gary C. Price prefiled Surrebuttal Cross-Surrebuttal Tables 1B and Table 2B. Table 1B, below, which shows how relative rates of return should be adjusted over four rate filings to accomplish unity rates of returns for all classes by the end of the fourth filing.

[redacted]

Schedule GCP-3, Page 1 of 3, Line 4, quantifies the Total Revenue Adjustment that would be required to move all classes to the system average rate of return based on DOE/NNSA's proposed modification to KCPL's COSS. DOE/NNSA's proposal is to adjust the present rates for each class in a manner that would either increase or decease revenues as shown in Table 2B, below, shows the revenue change for each class required to reach a unity rate of return in this filing and also shows the revenue change needed to accomplish DOE/NNSA's gradualism approach in this case.

[redacted]

**<u>Issue:</u> Should class revenue adjustments be implemented even if no increase or decrease in revenue requirement is granted?**

Yes. KCPL wants to postpone (KCPL's T Rush prefiled Direct pages 4-6) for ten years (until after the end of the regulatory plan) the re-alignment of classes' revenues (Price prefiled Direct page 4 lines 7-9). Witness Price disagrees and proposed a 4 year phase in plan starting with this case because the discrepancy among classes is so large that doing all at once may provide increases to some classes much larger than the system average. His proposal will ameliorate impact of class increases. Mr. Price's plan could be adjusted annually or concurrent with KCPL's filings during the regulatory plan. In Price's prefiled Rebuttal testimony he expresses his opinion that class revenue adjustments should be implemented even if there is no increase in revenue requirements. (Price prefiled Rebuttal pp 5-6)

**<u>Issue:</u> Should revenue adjustments be phased-in over multiple years?**

Yes. See Gary Price prefiled Testimony and Table 1B above**.** In Price's prefiled rebuttal testimony he recommends that adjustments be phased in over four years commencing with this rate case. (Price prefiled Rebuttal p. 4)

**<u>Issue:</u> Should revenue adjustments among the non-residential classes be applied uniformly or non-uniformly?**

Uniformly after making alignment adjustment. (See Price prefiled Surrebuttal Cross-Surrebuttal p. 5, Table 2B and p. 11 Table 4)

**<u>Issue:</u> How should any increase in the revenue requirement be implemented?**

Price prefiled Surrebuttal Cross-Surrebuttal testimony Table 1B p. 4 (shown above) represents the four 25% changes that would gradually move all classes to unity rate of return.

## <u>RATE DESIGN</u>

**<u>Issue:</u> Should a comprehensive analysis of KCPL's class cost-of-service issues and rate design be conducted after the conclusion of the regulatory plan and the in-service date of Iatan 2? Should the cost-basis of general service all-electric rates be included in this analysis?**

No. Annual or concurrent with KCPL's filings cost of service analysis as KCPL goes through the regulatory plan. (See Gary Price's prefiled Surrebuttal Cross-Surrebuttal testimony pp 5 & 6).

**<u>Issue:</u> Should KCPL's proposed changes to the General Service customer charge be implemented?**

DOE/NNSA has taken no position on this Issue at this time but reserves the right to address this after the hearing in brief.

## CLARIFICATION

**Clarification: DOE/NNSA makes the following clarification to the Reconciliation filed by Staff on 10/11/2006 at 9:18:22 AM.**

DOE/NNSA accepts Staffs Revenue Requirement less the specific items adjusting Staff's Revenue Requirement as set out on Lines 91 through 93 of the Reconciliation. See below.

| | | |
|---|---|---|
| | Department of Energy - Difference from **Staff** Position (Corrected) | |
| 91 | DOE - Off System Sales Margin | (5,163,054) |
| 92 | DOE - Return on Equity - 9.00 % | (4,185,335) |
| 93 | DOE - Eliminate Amortization of Ice Storm AAO | (2,661,169) |
| 94 | DOE Revenue Requirement - Prior to Regulatory Plan Amortization | **(46,550,002)** |
| 95 | DOE - Amortization – DOE will require strict proof of Amortization if any | |

Further, DOE/NNSA draws the Commission's attention to its position on the Commission allowing Additional Amortization as set out in the section entitled Regulatory Plan Amortizations beginning on page 5 above. **The Commission will have to determine that there is competent and substantial testimony supporting the granting of any additional amortization in this case.**


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