

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

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)
Continue the Implementation of its Regulatory Plan.)

Case No. ER-2010-0355

REPLY BRIEF OF AARP

COME NOW AARP and hereby submits its Reply Brief, explaining opposition to certain arguments contained in the Initial Post-Hearing Brief of KCP&L (“KCPL Brief”) with regard to the two largest categories revenue requirement issues that remain contested in this rate case: a) issues relating to the prudence and reasonableness of costs relating to the Iatan 1 and 2 power plants, and b) determination of the proper return on common equity.

The positions on these issues constitute the most significant reason for the difference between KCPL’s true-up suggestion that it has a \$55.8 million annual revenue deficiency and the Public Service Commission’s Staff (“Staff”) true-up recommendation that the Commission find that the electric company has only a \$9.6 million annual revenue deficiency.¹ AARP supports Staff’s overall true-up recommendation for KCPL. Issues and arguments not addressed in AARP’s Reply Brief should not be considered acquiescence to the positions of KCPL or any other party.

¹ Rush True-Up Direct, p. 1; Featherstone True-Up Direct, p. 4.

Prudence and Reasonableness of Iatan 1 and 2 Plant Additions

The KCPL Brief analyzes and frames the issues relating to the Iatan 1 and 2 plant additions in a limited way—as “prudence” issues only.² While a prudence review is important, the Commission’s scope of review in this case is much broader, involving a standard that does not necessarily rely upon prudence. Missouri law requires that all of the costs related to the plant additions for these generation projects be proven by KCPL to be just and reasonable, stating specifically: “At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the . . . electrical corporation.”³ Since KCPL bears the burden of proof, any uncertainty regarding the evidence should be held against the electric company.⁴

With regard to prudence alone, KCPL’s own witness Kris Nielsen has admitted in rebuttal testimony that KCPL incurred imprudent expenditures in the construction of Iatan 2.⁵ Therefore, the question of imprudence with regard to the newer Iatan project is a matter of quantifying the imprudence; there should be no question about whether a serious doubt has been raised. Missouri law uses a reasonable person standard for reviewing prudence, but that is just one part of the overall “reasonableness” standard.⁶

The Commission should ignore references made in KCPL’s Brief to determinations made by the Kansas Corporation Commission (“KCC”) regarding these two power plants, because the statutory scheme relating to electric rates in Kansas,

² *Ibid.*, pp. 21-27.

³ Section 393.150.2, RSMo.

⁴ *State ex rel. GS Technologies Operating Co. v. PSC*, 116 S.W.3d 680, 693-94 (Mo.App. W.D. 2003).

⁵ KCPL Ex. 46.

⁶ See *Re Kansas City Power & Light Co.*, Case Nos. EO-85-185 and EO-85-224, Report And Order, 28 Mo.P.S.C.(N.S.) 228, 343; 75 P.U.R.4th 1 (April 23, 1986).

requires the KCC to make very specific findings of prudence that are different than Missouri's legal standards.⁷ Missouri law requires the Commission to more holistically review the evidence relating to the management of the project and the reasonableness of each cost.

Also important to these issues is the Stipulation and Agreement that KCPL entered into in the Regulatory Plan case, Case No. EO-2005-0329. Consumer parties relied upon the expectation that KCPL has would comply with section III.B.1.q. Cost Control Process for Construction Expenditures of that Stipulation and Agreement. Staff's testimony and its latest Construction Audit and Prudence Review are sufficiently persuasive to show that KCPL has not lived up to its responsibilities with regard to the Regulatory Plan, and that the Regulatory Plan has not necessarily lived up to its purported protections of consumers.⁸ It is now up to the Commission to adopt the disallowances and adjustments recommended by its Staff so that the Regulatory Plan operates as expected and to ensure that KCPL consumers do not unfairly pay for unreasonable latest cost overruns.

The latest 1 and 2 plant additions should not be placed into KCPL's approved rate base without deducting each of the disallowances recommended by the Staff, as summarized on page 11 of Staff's Brief, and as explained in detail on pages 23-77. Staff performed a thorough review of the prudence and reasonableness of these projects and made specific findings that are supported by clear and convincing evidence. Staff witnesses Cary Featherstone and Chuck Hyneman both have decades of experience reviewing electric utility plant costs, and despite the aspersions cast on

⁷ K.S.A. 66-128g.

⁸ Staff Brief, p. 6.

their qualifications in KCPL's Brief, are highly qualified as experts in determining prudence and reasonableness.⁹

The analyses that Staff witnesses make in testimony regarding the various unexplained and unsupported cost overruns experienced by these projects are similar to the Commission's determinations that disallowed certain costs relating to the Wolf Creek plant, nearly 25 years ago.¹⁰ It is notable that disallowances were made by the Commission in that past KCPL rate case because of unsupported cost overruns, and those disallowances were based upon a legal finding that reasonableness for those costs were lacking.

Return on Common Equity

AARP urges the Commission to adopt an allowed return on common equity ("ROE") in the revenue requirement ratemaking formula that falls within the Staff's recommended range of 8.5 to 9.5% (recommended midpoint of 9.0%), which is based upon the results of a Discounted Cash Flow ("DCF") analysis and a Capital Asset Pricing method ("CAPM").¹¹ KCPL's recommendation is an unreasonably high 10.75%, based upon the results of its witness' own flawed DCF analysis, plus a 25 basis point adder for its reputation for "reliability and customer service".¹²

⁹ Featherstone Direct; Hyneman Direct.

¹⁰ Re Kansas City Power & Light Co., Case Nos. EO-85-185 and EO-85-224, Report And Order, 28 Mo.P.S.C.(N.S.) 228, 343; 75 P.U.R.4th 1 (April 23, 1986).

¹¹ David Murray Direct.

¹² Samuel Hadaway Direct.

KCPL's Brief also invites the Commission to utilize a "zone of reasonableness" in making its determination on this issue.¹³ A "zone of reasonableness" approach attempts to base an ROE allowance on the determinations of other public utility commissions. Such an approach is flawed because it is backward-looking, circular in that it is based on regulatory *allowed* ROEs rather than *actual* market expectations for earnings, and does not even work as intended to keep Commission rulings in some sort of mainstream. The "zone of reasonableness" has (perhaps ironically) permitted KCPL to receive earnings awards in the past that far exceeded the vast majority of other similarly situated electric companies.¹⁴

KCPL describes the *double-digit ROEs* that it has been allowed by the Commission over the past five years as allowing it to "weather the storm" during a major construction project and "the worst economy since the Great Depression".¹⁵ AARP urges, before the Commission adopts yet another double-digit ROE, that it consider the impact that another double-digit ROE award would have on ordinary residential electric customers who are still reeling from the same struggling economy. Ordinary residential consumers are suffering from the recession *at least as much* as KCPL has suffered from the recession. It is only fair that the Commission consider treating consumers and shareholders evenhandedly by recognizing this economic reality.

Staff's arguments on this issue are the most convincing and rooted in the current market realities regarding what level of ROE would be "commensurate to the returns

¹³ *Ibid.*, pp. 145-146.

¹⁴ This Commission granted KCPL the highest return on equity in the nation for similar regulated electric companies the calendar year 2006 (11.25%), based in part on a "zone of reasonableness" analysis, *despite* the fact that KCPL's overall level of risk had been greatly reduced due to the Regulatory Plan adopted in Case No. EO-2005-0329.

¹⁵ KCPL Brief, p. 144.

realized from other businesses with similar risks”, as required by the controlling Supreme Court cases of Hope and Bluefield as the ultimate guide of the Commission’s decision in this matter.¹⁶ As Staff points out, the United States is still emerging from a severe recession, with a projected economic growth that is expected to be on the low side for the next few years. Economists generally expect the long-term GDP growth rate to be in the 4-5% range, approximately 2% of which is attributed to inflation. The Fed Funds rate, which affects short-term debt costs, is at an all-time low. Recent utility bond yields on investment-grade debt have dropped to levels not experienced in the last 40 years. In view of the well-known relationship between the cost of debt and the cost of equity, these facts imply that generally a fairly low cost of equity is expected.¹⁷

Setting ROEs in the double-digits would simply ignore economic reality. Growth is not robust, and is not expected to be robust in the near future. In understanding the primary reason for the gap between the different ROE recommendations in this case, the Commission needs primarily to examine the respective growth rate components chosen by the witnesses for use in their DCF analyses. Staff witness Murray used a growth rate of 4-5% in his DCF.¹⁸ On the other hand, KCPL witness Hadaway used a 6% growth rate in his analyses, based on his calculation of the expected growth in the Gross Domestic Product (GDP). Mr. Hadaway’s wildly optimistic view is unattainable, unsustainable, and simply unreasonable. In order to stretch up to a double-digit ROE for KCPL in this case, the Commission would have to accept just such an inflated growth rate.

¹⁶ Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

¹⁷ See Staff Brief, pp. 128-134.

In attempting to provide a fair estimation of a perpetual growth rate, Staff examined a variety of information, including (but not limited to) the expected long-term growth in electricity demand plus inflation, and the “Rule of Thumb”, which is a rough estimate of the current cost of equity calculated by adding a 3-4% risk premium to the cost of long-term debt. In this case, the “rule of thumb” suggests a cost of common equity in the range of 8.14%-9.71%.¹⁹ As Staff points out, the Congressional Budget Office (CBO) currently estimates long-term GDP growth to be approximately 4.5%.²⁰ However, Dr. Hadaway uses a unique, self-generated measure of GDP equaling 6% and this higher, manufactured number is ultimately what is necessary for him to recommend KCPL’s outlying ROE recommendation.

Finally, AARP objects to KCPL’s proposal to award the “high end” of its ROE range to reward “reliability and customer service”, for the same reasons laid out by Staff: “(1) Customers pay for all aspects of customer service they receive; the companies determine, dictate and control the level of service performance they will offer, and customers are subsequently billed for it; (2) neither company has stellar service and, in fact, both have demonstrated areas of service decline in recent history; (3) awarding the high-end of the ROE based on “customer satisfaction and reliability achievements” is a slippery slope.”²¹

¹⁸ David Murray Direct Testimony.

¹⁹ David Murray Surrebuttal Testimony.

²⁰ *Id.*, p. 15.

²¹ See Staff Brief, p. 140.

Conclusion

The evidence admitted into the record of this rate case clearly and convincingly supports the Staff's position regarding the prudence and reasonableness of costs relating to the Iatan 1 and 2 power plants, as well as Staff's 9.0% ROE recommendation. AARP respectfully requests that the Commission adopt those positions in its Report and Order, and thus ensure that KCPL's consumers will be paying rates for electricity that are just and reasonable.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to all parties of record on this 18th day of March 2011:

/s/ John B. Coffman
