MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. EO-2009-0439, Kansas City Power & Light Company

FROM: David Murray, Financial Analysis Department

/s/ David Murray 12/04/09 — Project Coordinator / Date

/s/ Steven Dottheim 12/04/09 — Staff Counsel's Office / Date

SUBJECT: Staff's Recommendation Regarding Kansas City Power & Light Company's Application and First Amended Application for Approval to Update the Investment Guidelines, Add an Investment Manager and Enter Into a New Agreement with the Existing Investment Manager for the Kansas City Power & Light Company Nuclear Decommissioning Trust Fund

DATE: December 4, 2009

Kansas City Power & Light Company Application

On June 10, 2009, Kansas City Power & Light Company (KCPL or Company), filed an Application with the Missouri Public Service Commission (Commission) requesting the Commission: A.) authorize KCPL to adopt revised KCPL Wolf Creek Nuclear Decommissioning Trust Investment Guidelines attached as Appendix A (Investment Guidelines); B.) authorize KCPL to retain Duff & Phelps Investment Management Co. to manage the equity asset class of the Trust Fund assets; C.) authorize KCPL to retain Columbia Management Advisors, LLC to manage the fixed income asset class of the Trust Fund assets; D.) authorize KCPL to execute the proposed Investment Management Agreement with Columbia Management Advisors, LLC, which incorporates the updated Investment Guidelines; E.) authorize KCPL to execute the proposed Investment Advisory Agreement with Duff & Phelps Investment Management Co., which incorporates the updated Investment Guidelines; and F.) grant such other relief as may be deemed necessary and appropriate and which is not inconsistent with the Application. In response, the Commission established Case No. EO-2009-0439 and directed the Staff to file a recommendation or a status report on August 14, 2009. Staff requested and the Commission granted additional time for Staff to file its recommendation on August 31, 2009. On August 31, 2009, Staff filed a status report indicating that Staff was pursuing additional discovery from KCPL and that it anticipated that it could file a recommendation within two weeks of receiving responses to this additional discovery. Staff received responses to this discovery and communicated to KCPL certain concerns Staff had about KCPL's lack of recent and more detailed analysis in support of KCPL's Application, specifically its proposed change in asset allocation for its nuclear decommissioning trust fund. Staff requested KCPL file a supplement to its Application providing additional information on the anticipated savings to ratepayers if the Commission were to approve KCPL's Application. KCPL filed its First Amended Application on November 10, 2009. The Commission ordered Staff to file its recommendation no later than December 4, 2009.

Background

The KCPL Wolf Creek Nuclear Decommissioning Trust Fund (Fund) was established in 1986 for purposes of collecting and investing funds so as to accumulate in an external trust fund the estimated cost of decommissioning Wolf Creek at the end of its operating license, which now expires in 2045.[1] KCPL's current asset allocation is fairly conservative with a maximum 45 percent equity asset allocation and the remaining 55 percent allocated to fixed-income and cash investments. Due to lack of sufficient documentation, Staff and KCPL have been unable to determine the exact dates in which KCPL started to target an equity asset allocation of 45 percent, but this equity asset allocation proportion was authorized by KCPL on March 31, 2004 by letter to Banc of America Capital Management, current owner of Columbia Management Advisors, LLC (Columbia Management). It is Staff's understanding that from August 1993 through around March 2004, KCPL's maximum allocation of funds to the equity asset class was 40 percent. Prior to 1993, it is Staff's understanding that the Fund was invested entirely in fixed-income securities. Consequently, comparing the performance of the Fund since inception using the current strategy would not be useful for purposes of evaluating KCPL's proposal in this case because of the lack of continuity in the asset allocation of the Fund.

KCPL's current investment manager, Columbia Management, actively manages all assets of the Fund. Columbia Management has managed the Fund since July 20, 1990. However, there have been several name changes of the investment management firm as a result of various acquisitions and mergers over this time, but the Fund has been managed under the same Investment Management Agreement for this period. Staff is not aware if the personnel managing the Fund has changed over this period.

KCPL has changed its investment advisor one time since the inception of the Fund. In both cases each investment manager managed all of the assets of the Fund.

KCPL filed its Application pursuant to 4 CSR 240-2.060 and 4 CSR 240-20.070 with the latter regulation governing the specific requirements for Decommissioning Trust Funds for Missouri regulated electric utilities. Subsection 20.070(4) (E) 3. provides specific guidance on the maximum amount of equity allowed in the Fund. The maximum amount of equity securities is not to exceed sixty-five percent (65%) of the trust fund's book value. Under the proposed change in investment guidelines, KCPL will not exceed this requirement. However, KCPL is requesting permission to allocate 15 percent of the Fund to international equities. The aforementioned rule does not identify any specific restrictions on the classes of equities allowed under the 65 percent limitation.

[1] The Nuclear Regulatory Commission in November 2008 extended Wolf Creek's operating license 20-years to 2045.

Additionally, no specific guidance is provided by the rule for the review of a request to change an investment manager.

KCPL Wolf Creek Nuclear Decommissioning Trust Investment Guidelines

KCPL is proposing to change its current targeted asset allocation strategy of 55 percent high quality debt (above investment grade) and 45 percent equity (domestic equity that is benchmarked against the S&P 500) to 65 percent equity, which includes a variety of domestic equity asset classes as well as an allocation of 15 percent to international equities, consisting of developed and emerging markets (see Attachment B of Appendix A attached to the Application). Although KCPL's proposed change in the Fund's asset allocation includes a higher allocation to equity in the portfolio and the introduction of small capitalization equities and international equities (which entails more risk, especially when evaluated as individual portfolios), Staff believes KCPL's Fund has the ability to incur additional risk in order to achieve a better return considering that the recent license extension of Wolf Creek extends the time-horizon of the Fund by an additional 20-years to 2045. If a portfolio has long time horizon with very low liquidity needs in the near term, then the portfolio generally has a higher tolerance for risk.

Paragraph 9 of KCPL's Application indicates the following regarding its request:

> KCP&L believes it is in the best interest of the Trust Fund to diversify management of the Trust Fund assets. After conducting significant research and due diligence, KCP&L seeks to split management of the Trust Fund among two managers, with responsibility allocated according to their strengths and specialties.

Although in conjunction with its original application KCPL had performed some research to support its requested change to its Investment Guidelines, Staff believed KCPL needed to update this research to consider recent capital market activity and any impact this may have on expected returns going forward. Considering that the strategic asset allocation tends to be the most important factor in explaining long-term expected returns and the variation of these returns, any significant changes in capital markets should cause one to reevaluate an existing or a proposed asset allocation. KCPL supplemented its Application with expected risk and return information that demonstrates why its proposed asset allocation change would not be detrimental to the public interest. In fact, KCPL believes that this change may save ratepayers approximately $2.4 million annually through 2044 with the possibility of a total savings of approximately $80 million.

Although Staff believes the expected returns KCPL used to compare its current asset allocation to its proposed asset allocation are optimistic, Staff agrees that KCPL's Fund has the ability to incur more risk in order to achieve a higher return. Even assuming lower return expectations, there should still be a savings to ratepayers if the extra risk incurred by the portfolio is rewarded with the higher returns that one would expect to accept this additional risk. While year-to-year volatility should increase, as long as the probability of achieving the ending value needed to decommission the nuclear plant are good, then this additional risk will result in a net benefit to ratepayers.

First, although Staff does not have actual professional experience in portfolio management, Staff is familiar with capital market issues and expectations through its experience in analyzing costs of capital and analyzing finance applications. Staff also has gained additional knowledge about portfolio management through David Murray's pursuit of the Chartered Financial Analyst ("CFA") designation. Mr. Murray has not passed Level III of the CFA Program, which is the level that primarily focuses on the practice of portfolio management. Although Mr. Murray has this knowledge and experience, Mr. Murray's professional duties do not include developing capital market expectations for purposes of determining appropriate strategic asset allocations. Consequently, for purposes of evaluating KCPL's proposed asset allocation in this case, Staff chose to rely on capital market expectations the Missouri State Employee Retirement System ("MOSERs") uses for its asset allocation decisions.

KCPL's proposed asset allocation strategy should not be measured against the past performance of the Fund because of changes in asset allocation strategies since the inception of the Fund. However, for informational purposes, Staff reviewed recent Fund performance data KCPL filed in EFIS. The overall performance of the Fund since inception (8/31/1986) through June 30, 2009, has been an average annualized return of 6.10 percent after taxes and fees. For purposes of comparison, the AmerenUE Decommissioning Trust Fund for the Callaway Plant has averaged annualized returns of 6.79 percent after taxes and fees since inception (8/31/1985) through June 30, 2009. Because each decommissioning trust fund has different inception dates and both have operated under various asset allocations, a simple comparison of the performance of the funds alone would be misleading. For example, AmerenUE's Decommissioning Trust Fund has been more heavily invested in domestic equities (65% maximum compared to KCPL's maximum of 40% before March 2004 and then 45%), since the early 1990s. Consequently, this higher return did not necessarily come without a higher amount of risk. However, because this period includes the dramatic capital market activity starting in the fall of 2008, a general observation of the differences in performance of the two funds shows that even after consideration of this volatility, the AmerenUE Decommissioning Trust Fund still has achieved better returns than KCPL's Fund. This is especially interesting considering the fact that the KCPL Fund outperformed the AmerenUE Decommissioning Trust Fund by 2.23 percent (2.57% - 0.34%) for the ten years ended June 30, 2009.

Risk tolerance should be viewed in terms of the willingness and ability to incur risk. The willingness to incur risk should be determined based on those who are depending on the proceeds from the Fund. Although KCPL depends on the Fund to pay for decommissioning of Wolf Creek, it would seem that the fiduciary responsibility of the Fund should be directed to ratepayers because in all likelihood, KCPL would seek additional ratepayer funds to cover any shortfall in funds available to decommission Wolf Creek. Unfortunately, Staff has no way of directly measuring ratepayers' willingness to incur the risk of a shortfall in funding necessary to decommission Wolf Creek. The guideline Staff will use to measure this willingness is the maximum 65 percent equity allocation contained in Missouri's regulations. Staff believes that the Fund has an above-average ability to incur risk given the Fund's remaining time-horizon of 35 years and minimal liquidity needs (taxes and fees).

The obvious challenge in analyzing KCPL's proposal is not knowing how the proposed asset allocation will perform in the future compared to its current asset allocation. In its First Amended Application, KCPL provided its best estimate of the anticipated savings to ratepayers if the Fund invests according to the new proposed asset allocation strategy. Staff appreciates KCPL's much improved supplemental analysis to support its Application. However, Staff tested this supplemental analysis for reasonableness to determine if different assumptions would cause Staff to arrive at a different conclusion than KCPL.

KCPL developed its return expectations using the "building block" method using historical earned return information provided in the Ibbotson SBBI *2009 Classic Yearbook.* Using this methodology, KCPL developed the expected returns for the various asset classes in its proposed asset allocation. If historical returns were not available for the specified asset classes in the proposed asset allocation, then KCPL used an asset class that it considered to be a proxy for the proposed asset class or classes. KCPL developed the following expected returns: Large Company Stocks – 10.5 percent, Small Company Stocks – 15.2 percent, International Stocks – 11.5 percent and Corporate Bonds – 4.2 percent. This resulted in an overall expected portfolio return of 8.8 percent. Using these same inputs based on KCPL's current asset allocation results in an overall expected portfolio return of 7.0 percent.

While it is desirable for the Fund to achieve higher returns in order to minimize the amount of contributions required from ratepayers, it is also important to evaluate the additional risk that will be incurred to allow for the possibility to achieve those returns. This additional risk causes a higher probability that the expected return will not be achieved, which if this occurs in the case of the Fund, this would possibly result in the Company requesting additional ratepayer funds to make up for the shortfall, which would reduce, eliminate or even reverse any projected savings.

The Company chose the Sharpe ratio to evaluate whether the higher expected returns justify taking on the additional risk expected from the proposed asset allocation. KCPL accurately defines the Sharpe ratio in Paragraph 14 of its First Amended Application and Staff agrees that based on KCPL's analysis, the Sharpe ratio does show that the increased expected return does not come at the expense of a higher proportion of risk per unit of return. A higher Sharpe ratio is usually achieved by adding investments to a portfolio that have low correlations with the assets in the current portfolio. This is precisely why most investment professionals advise investors to add at least small amounts of riskier assets to a portfolio because they improve long-term return potential without the stand-alone risk.

Although Staff agrees with the mechanics of KCPL's analysis, Staff did not believe it was prudent to rely exclusively on KCPL's assumptions in its analysis to determine if its proposed asset allocation strategy may require a lower overall contribution to the Fund. Consequently, Staff performed the same type of analysis KCPL performed using different assumptions on expected returns and standard deviations for the asset classes. Because Staff does not have professional experience with developing capital market expectations for the proposed asset classes, Staff relied on capital market expectations provided to MOSERs from its investment consultant, Summit Strategies Group. Although these expectations are for the next ten years, it is Staff's understanding that MOSERs uses these expectations for purposes of making its asset allocation decisions.

The expected returns used by MOSERs are much lower than those used by KCPL in its analysis. Also, of considerable interest is the fact that the expected returns used by MOSERs indicates that small stock returns are expected to lag that of large stock returns. The expected returns for the same or similar asset classes are as follows: Large Company Stocks – 8.50 percent, Small Company Stocks – 7.25 percent, International Stocks – 10.25 percent (this does not include emerging markets, which according to KCPL's proposed asset allocation will make up 3.0 percent of total assets), and Core Bonds – 4.00 percent. This resulted in an overall expected portfolio return of 7.1 percent. Using these same inputs based on KCPL's current asset allocation results in an overall expected portfolio return of 6.0 percent.

Staff's analysis assumed the same diversification benefits as those used in KCPL's analysis (correlation coefficients), but Staff used the standard deviations used by MOSERs. Although the expected returns from both the proposed and current asset allocation are much lower than those assumed by KCPL, the proposed asset allocation also showed a higher Sharpe ratio in Staff's analysis (0.25 for the proposed portfolio compared to 0.22 for the current portfolio). Consequently, based on the Sharpe ratio, KCPL's proposed asset allocation strategy should not incur unacceptable risks. However, just as with KCPL's analysis, Staff's analysis is sensitive to the assumptions made. For example, historical correlation coefficients between domestic stocks and international stocks will likely narrow as the world's economy continues to become more integrated.

Although Staff believes KCPL's proposal should be based on forward-looking expectations, an example of a period in which KCPL's proposed asset allocation would not have been worth the extra risk incurred is the period from January 1, 1988 (the earliest date in which data was available for the Morgan Stanley Capital International Emerging Markets Index) through June 30, 2009. Staff's analysis of this data showed that KCPL's proposed asset allocation strategy would have increased the average annualized return by only 0.02% compared to its existing strategy. According to Staff's calculation of the Sharpe ratio for this period, this small incremental additional return would not have been worth the additional risk incurred. Of course, it should also be recognized that during this period, long-term corporate bonds had an average annual return of 8.8 percent and long-term government bonds had an average annual return of 10.0 percent. This seems like a very unlikely scenario going forward considering the current low domestic interest rate environment.

Retention of Asset Managers

KCPL is requesting approval to retain Columbia Management as its fixed-income investment manager. It is not clear to Staff if KCPL is required to request Commission approval to continue to use Columbia Management as its asset manager for its fixed-income asset class because KCPL already uses Columbia Management for this asset category. KCPL is proposing that Columbia Management be retained to only manage the fixed-income assets rather than the entire portfolio. Staff reviewed the information KCPL relied upon to make the decision to keep Columbia Management as its fixed income manager.

Columbia Management has been actively managing the fixed income assets of the Fund since July 20, 1990. Columbia Management's achieved return on the fixed income assets after taxes has been 4.6% since July 1, 1998. This compares to a benchmark return of 4.6% over the same period, which according to the Fund's August 13, 1993 Investment Policy Statement was the Shearson Lehman Brothers Municipal Bond Index which was renamed the Barclays Capital indices, effective November 3, 2008. According to Columbia Management's current agreement with KCPL, it is currently charging a fee of 21 basis points of assets under management for its services. Appendix A of the Investment Management Agreement with Columbia Management indicates that KCPL will be charged an annual asset-based fee of 21 basis points on all assets managed by Columbia Management subject to the Investment Management Agreement.

Duff and Phelps Investment Management Co. (D&P) will charge KCPL a fee of no more than 10 basis points on all assets managed in the equity account. Schedule A, Part II attached to the Investment Advisory Agreement with D&P provides the detailed fee schedule that will be charged for the management of the equities in the trust. KCPL was previously charged 21 basis points by Columbia Management for its management of the equity class, which was actively managed.

The aggregate fees that will be incurred to manage the Fund will be less under the proposed arrangement (approximately 14 basis points if KCPL maintains its proposed targeted asset allocation of 65% equity and 35% fixed-income), which is to be expected considering that the equity class will no longer be actively managed.

Recommended Conditions

Staff recommends approval of KCPL's Application subject to the following conditions:

1. That subsequent to KCPL's execution of the changes proposed under its Application and First Amended Application, KCPL or its trustee shall amend / revise on a going forward basis future quarterly Nuclear Decommissioning Trust Fund Performance Reports to include sub-accounts for each investment manager with performance data for each proposed asset class beginning with the establishment of the sub-account.

2. That the amended / revised future quarterly Nuclear Decommissioning Trust Fund Reports shall include performance data for the Performance Benchmarks identified in Attachment C of the KCP&L Wolf Creek Nuclear Decommissioning Trust Investment Guidelines.

3. That in addition to the aggregate "since inception" performance data of the Nuclear Decommissioning Trust Fund, the amended / revised quarterly Nuclear Decommissioning Trust Fund Reports shall disaggregate performance of the Nuclear Decommissioning Trust Fund to show performance from the execution date of the changes proposed under this Application to the most recent reporting period.

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 Update the Investment Guidelines, Add an Investment Manager and Enter Into a New Agreement with the Existing Investment Manager for the Kansas City Power & Light Company Nuclear Decommissioning Trust Fund	)))))	Case No. EO-2009-0439

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Murray, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.

David Murray

DAVID MURRAY

Subscribed and sworn to before me this 4th day of December, 2009.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public