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 to Service Begin the Implementation of Its Regulatory Plan	)))))	**Case No. ER-2006-0314**

INITIAL POST-HEARING BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

INTRODUCTION

On February 1, 2006[1], the Kansas City Power & Light Company (KCPL) filed with the Commission an application and tariff sheets designed to implement a general electric rate increase of approximately 11.5% for service it provides to its Missouri customers. In an order issued March 29, the Commission established November 15 as the deadline for initial post-hearing briefs.

KCPL has tried every avenue it can think of to try to increase its revenue requirement – even if they run afoul of the Regulatory Plan. The Regulatory Plan was put in place to address the issues that arise because of KCPL's construction program. It is clear that there are issues. It is equally clear that the Regulatory Plan was expressly designed and agreed to address those issues. It was designed to keep KCPL on an even keel while the construction goes forward. Yet KCPL continues to push for even more concessions.

When adults play board games with children, they sometimes change the rules a bit to account for the fact that the children have a disadvantage because the adults have greater experience, knowledge and maturity. The purpose is not to insure that the children will win or to

[1] All dates refer to calendar year 2006 unless otherwise noted.

make it probable that the children will win, but simply to allow them an even chance despite the disadvantage they start with. The rules changes are subtle, because if the rules change too much, the whole game has changed. A typical example is allowing the children an extra turn, or maybe even two extra turns if that's what it takes to give the children a fair chance. But some children will not be satisfied with having an extra turn or two and thus a fair chance of winning. Some children, even if they agreed up front that getting an extra turn would make the game fair, will demand more concessions as the game goes on. They don't want the game to be fair – they want it tilted in their favor so they have a better-than-even chance of winning. They will want more extra turns, or ask to move six spaces after rolling a two.

A very similar situation is unfolding in this case. The game here is a very serious one, and the outcome will determine how much ratepayers – already under siege from rising gasoline prices, steadily increasing health care costs, and the like – will have to pay for electricity. On the other side of the board are KCPL shareholders seeking to maximize their returns. The Commission sets the rules and determines how the game is played. Most importantly, the players (stakeholders) have recognized that KCPL faces a disadvantage because it is embarking on a period of significant construction expense. The stakeholders, **including KCPL**, have already changed the rules to account for this disadvantage. The new rules of the regulatory regime as it applies to KCPL are in the Regulatory Plan[2] and those rules cede a huge advantage to KCPL. Pursuant to the terms of the Regulatory Plan, once the Commission determines what rates will be just and reasonable for KCPL's customers using traditional regulatory methods, KCPL gets to add tens of millions of dollars in the form of additional amortizations. Returning

[2] The Regulatory Plan, as that term is used in this brief and as generally used in the lexicon of this case, refers to the Stipulation and Agreement as amended in Case No. EO-2005-0329. It has been made a part of the record in this case as Exhibit 143.

to the board game analogy, this amounts to a whole bunch of free turns for KCPL, and the stakeholders agreed to them because of KCPL's construction projects.

But despite having worked long and hard to get to this agreement with stakeholders, despite having told the Commission that these rule changes were enough to make the regulatory regime fair in light of the constructions projects, KCPL now is telling the Commission they are not enough. KCPL is pursuing three separate issues that constitute additional rule changes to tilt the field to KCPL's advantage. These proposals violate the spirit and the letter of the Regulatory Plan. First, KCPL proposes to include off-system sales revenues at a such a low level that it has a 75% chance of achieving a higher level. Second, KCPL proposes to allocate these revenues between Missouri and Kansas using a brand new method that it just invented for this case. Third, KCPL proposes a 50 basis point adder to an already inflated estimate of its cost of equity. This adder is specifically designed to address construction risk – the exact risk the Regulatory Plan already addresses.

Under any reasonable outcome of this case, KCPL will get tens of millions of dollars of additional cash from ratepayers through the amortizations. KCPL uses such phrases as "non-cash items" (Transcript, p. 60) to disparage the money it will receive through the additional amortizations and contrast it with so-called "real cash earnings." (*ibid*.) Such descriptions are misleading. KCPL will get real cash in the amount of the additional amortizations, and ratepayers will have to find a way to come up with that cash despite all the other rising costs they are facing. KCPL simply wants to extend the extraordinary run of overearnings it has enjoyed over the last twenty years through its upcoming construction period. It is telling the Commission that belt-tightening is just for ratepayers; shareholders are supposed to be kept fat and sassy.

Why didn't KCPL tell the Commission this when KCPL was presenting the Regulatory Plan and asking the Commission to approve it? Nowhere in the transcript of that proceeding does KCPL tell the Commission that the Regulatory Plan was just the beginning of the rule changes that KCPL wanted. Could it be that KCPL sought – and received – a huge concession on rule changes from ratepayer representatives, all the while planning to ask the Commission for more at the first opportunity? We will never know if the stakeholders would have agreed to the Regulatory Plan if they knew KCPL viewed it as just the first notch, and intended to keep ratcheting up its advantages beginning with the very first case under the Regulatory Plan. The Commission should reject all three of these new proposals.

This brief primarily addresses issues raised and supported by the testimony of Public Counsel witnesses, and it focuses on information elicited at the evidentiary hearing. Discussion of evidence in prefiled testimony is necessarily included to establish the context of the evidence adduced at hearing.

A number of significant issues appear to have been resolved, such as class cost of service/rate design and much of the regulatory plan amortizations issue. Those issues will not be addressed in this brief. In the unlikely event that the settlements of those issues are not finalized, or if the Commission does not approve those settlements, Public Counsel will supplement this brief as necessary.

ISSUES

Revenue Requirement

Incentive Compensation:
What amount, if any, of incentive compensation should be included in rates?

The Staff has proposed to exclude only those incentive compensation awards that are clearly geared toward incentivizing behavior that benefits shareholders rather than ratepayers.

Staff has included the majority of incentive compensation in its calculation of revenue requirement, and Public Counsel supports Staff's adjustment.

Staff is excluding: A) a portion of three incentive compensation plans that are tied to financial goals that benefit only shareholders (Executive Plan, ValueLink, and Rewards Plan); and B) discretionary awards paid without the goals for achieving the award clearly defined. Overall, Staff is allowing about 65% of the incentive compensation paid out by KCPL (Tr. 173). The rationale behind Staff's disallowance of the portion of the incentive compensation plans tied to financial goals was provided by Staff witness Harris:

> Staff's driving positions in this case is that it's unfair to hold captive Missouri ratepayers to an EPS and to an incentive plan that's funded based solely on unregulated operations that have nothing to do with providing electric service to Missouri. (Tr. 181).

The Commission has historically disallowed the expenses in incentive compensation programs to the extent they are not clearly tied to specific goals, and achieving those goals benefits ratepayers. In Case Nos. EC-87-114 and EC-87-115, the 1987 Union Electric Company complaint case, the Commission held: "At a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan."[3] The Commission reaffirmed this policy as recently as 2004. In the 2004 Missouri Gas Energy rate case, the Commission held:

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such

[3] The Staff of the Missouri Public Service Commission, Complainant, vs. Union Electric Company, Respondent (EC-87-114) and Douglas M. Brooks, Public Counsel for the State of Missouri, Complainant, vs. Union Electric Company, Respondent (EC-87-115). 29 Mo.P.S.C. (N.S.) 313 (December 21, 1987).

> as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.[4]

The Commission should follow this long-standing policy in this case, and adopt Staff's incentive compensation adjustment.

Surface Transportation Board Litigation:
Should the deferred expenses associated with the Surface Transportation Board rail rate complaint case that were incurred through June 30, 2006, be included in rate base?

On October 12, 2005, KCPL filed a rate complaint case with the Surface Transportation Board ("STB") against Union Pacific Railroad ("UP"). KCPL's complaint alleges that UP's charges to transport coal from Wyoming's Powder River Basin to KCPL's Montrose plant in Missouri are excessive. As explained by Public Counsel witness Smith:

> In the STB rate complaint case identified above, KCPL charged that UP's rates for the movement of coal from the Powder River Basin (PRB) to KCPL's Montrose Generating Station were unreasonably high. KCPL believes that the rates charged by UP exceeded 180% of the variable cost and was greater than the "stand-alone cost" to provide such service. (Exhibit 210, Smith Direct, p. 18)

Public Counsel commends KCPL for bringing this action, because it has the potential to achieve refunds and rate reductions that will benefit KCPL's ratepayers. If KCPL proves that the rates charged by UP exceeded 180% of the variable cost and were greater than the stand-alone cost to provide such service, the STB will prescribe a rate consistent with the greater of 180% of the

---

[4] In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service (GR-2004-0209). 235 P.U.R.4th 507, 2004 Mo. PSC LEXIS 1446, 67-68 (Mo. PSC 2004)

variable cost or the stand-alone cost to provide such service." If KCPL proceeds with the rate complaint against UP and prevails, KCPL will reflect any rate prescriptions in its subsequent cost of service calculations.

But Public Counsel does not agree with the way KCPL seeks to recover in this case the costs of the STB litigation. KCPL should not be permitted to recover – in this case – any of the estimated Missouri jurisdictional expense for the STB litigation. KCPL's costs associated with the STB rail case complaint should not be charged to customers in the current KCPL rate case because there are no benefits reflected in the current case. This does not mean that there can be no recovery of such costs during a future period when such costs can be appropriately matched with the benefits that KCPL indicates its STB rail case complaint could produce. Furthermore, most of the expenses KCPL seeks to recover are estimates of what it will spend in the future, not actual expenses that have already been incurred. The estimated future expenses do not meet the "known and measurable" standard, and in this case are not even very good estimates. Public Counsel witness Smith noted that:

> on February 27, 2006, the STB interrupted KCPL's procedural schedule and instituted a rulemaking proceeding. A final decision in that STB rulemaking proceeding is expected in October 2006, according to KCPL's response to OPC DR 5014(f). That KCPL response explains further that the STB plans to issue a new procedural schedule in the KCPL complaint case against UP after the STB issues a final decision in the rulemaking proceeding. Given these developments, it is doubtful that KCPL would incur the levels of cost that it had previously estimated for the STB complaint case through September 30, 2006. (Exhibit 210, Smith Direct, p. 22).

If the Commission decides to allow the actual STB litigation costs incurred during the test period in this case, those costs should be spread over a five-year period. Such a recovery period is appropriate for two reasons: (1) such costs are not annually recurring expenditures, and

(2) if KCPL is able to achieve a favorable outcome in the STB case, such an outcome would likely have benefits for more than one year. (Exhibit 210, Smith Direct, p. 24).

During the evidentiary hearing in this case, KCPL witness Blunk recognized that Public Counsel's position on this issue would not preclude KCPL from recovering costs of the STB litigation in future cases. (Transcript, p. 366). Mr. Blunk noted that KCPL does not expect to receive any refunds or freight cost savings until 2010 or later. (Transcript, p. 367). KCPL is required pursuant to the Regulatory Plan to file at least one more rate case before Iatan 2 goes on line in 2010, and it is very likely that there will be at least two rate cases filed before 2010. Mr. Blunk conceded that the estimates of future expenses that KCPL seeks to recover are likely to be inaccurate, because KCPL is "not sure yet what the new evidentiary … requirements are going to be under [the STB's] new rules." (Transcript, p. 368). Mr. Blunk also testified that the most significant expenses associated with the STB litigation case expenses are the ones that are most affected by the uncertainty over the STB's yet-to-be-implemented new rules. (*ibid*.)

Because any benefits of the STB litigation will accrue to customers so far in the future, an because there will be other rate cases in which the costs can be recovered, the Commission should adopt the position advocated by Public Counsel witness Smith and not allow any STB litigation expense in rates in this case. If the Commission does allow STB litigation expenses, only actual expenses – not estimates – should be allowed, and the recovery should be spread over a five-year period.

SO2 Premiums:
How should SO2 premiums related to lower-sulfur coal be recorded for book and ratemaking purposes?
What parameters does the Commission-approved Stipulation & Agreement in Case No. EO-2005-0329 impose on the treatment of SO2 premiums in this case?

The Regulatory Plan addresses SO2 premiums at pages 9-10:

> KCPL currently purchases coal from vendors under contracts that indicate nominal sulfur content. To the extent that coal supplied has a lower sulfur content than specified in the contract, KCPL may pay a premium over the contract price. The opportunity to burn coal with lower sulfur content is both advantageous to the environment and reduces the number of SO2 emission allowances that must be used. To the extent that KCPL pays premiums for lower sulfur coal up until January 1, 2007, it will determine the portion of such premiums that apply to retail sales and will record the proportionate cost of such premiums in Account 254. **But in no event will the charges to the Missouri jurisdictional portion of Account 254 for these premiums exceed $400,000 annually.** The portion of premiums applicable to retail will be determined monthly based on the system-wide percentage of MWh's from coal generation used for retail sales versus wholesale sales as computed by the hourly energy costing model. This system-wide percentage will be applied to premiums invoiced during the same period. (emphasis added)

Neither Staff witness Hyneman nor KCPL witness Blunk could provide a credible explanation that squared the phrase "but in no event" with their interpretation of what this section of the Regulatory Plan requires. Both of these witnesses essentially read it out of that section entirely; that is, their reading of the section would be the same whether that phrase was in or out. (Transcript, p. 379, pp. 384-385) A fundamental provision of statutory construction that is equally applicable here is that every phrase shall be deemed to have meaning. The phrase "but in no event" only has meaning if it prevents something from happening. In this case, it prevents KCPL from charging more than $400,000 annually to the Missouri jurisdictional portion of Account 254 for SO2 premiums. The reference to January 1, 2007 that Staff and KCPL contend eviscerates the phrase "but in no event" comes in the preceding sentence, and does not apply to the sentence noted in bold above.

The Commission should recognize the natural, everyday meaning of the phrase "but in no event," and determine that the sentence "But in no event will the charges to the Missouri jurisdictional portion of Account 254 for these premiums exceed $400,000 annually" means exactly what it says.

Rate Case Expense:
Should rate case expense be normalized or deferred and amortized? If the latter, then what is the appropriate amortization period for the deferred rate case expense?
Should the costs deferred for future amortization be included in rate base?

Public Counsel's issue with respect to rate case expense has to do with the question of whether this expense should be normalized or deferred and amortized. Rate case expense should be normalized. Normalization is the ratemaking practice that incorporates a level of expense into the revenue requirement for an activity that does not happen every year (or experiences significant fluctuations from year to year); rate case expense is a classic example of the type of expense that is usually normalized. Normalization does not result in any specific treatment on the financial records of the utility. In contrast, amortization requires special treatment or recognition on the financial records of the utility. An amortization results in the deferral of recognition of expenses on the income statement contrary to what Generally Accepted Accounting Principles normally require.

It appeared that Staff was changing its long-standing approach of normalizing rate case expense and adopting amortization in this case. In the executive summary of the direct testimony of Staff witness Harris (Exhibit 116), Mr. Harris stated that he amortized rate case expense. At the evidentiary hearing, Mr. Harris explained that this was simply a drafting error, and not a change in Staff's position:

> In putting together my executive summary, which is the last thing I did, I inadvertently put in the word amortize instead of normalize, but it's always been the Staff's position, as it has been for as long as I'm aware of, as long as I've been with the Commission at least, that rate case expense has always been normalized. (Transcript, p. 310).

So Staff and Public Counsel propose to treat rate case expense in the same way the Commission has always treated it: as a recurring expense that should be normalized and included in rates.

KCPL proposes to treat rate case expense as an extraordinary item and defer and amortize it in this case.

The Commission has addressed this issue in the past. One of the clearest explanations of the reason rate case expense should be normalized can be found in the Report and Order in a 1983 Missouri Cities Water rate case:

> the purpose of using a test year is to construct a reasonably expected level of revenues, expenses and investment during the future period for which the rates to be determined herein will be in effect. **Rate case expenses are not extraordinary expenses which should be amortized, but are ordinary expenses which should be included in a Company's cost of service at a reasonable level calculated upon historic data, adjusted if necessary for known and measurable changes.** The Commission finds and concludes that the reasonable level of rate case expenses which should be included in the Company's cost of service in this case is $52,000, as proposed by the Staff. To provide for the recovery of past rate case expenses, as proposed by the Company, could constitute retroactive ratemaking, which is prohibited by State ex rel. Utilities Consumer Council of Missouri v. Public Service Commission of Missouri, 585 S.W.2d 41, 59 (Mo. en banc 1979). See also Re: Martigney Creek Sewer Company, Mo. PSC Case No. SR-83-166 (Report and Order issued March 4, 1983).[5] [emphasis added]

Thus, not only did the Commission conclude that rate case expense should be normalized from an accounting point of view, but it also concluded that recovery of specific rate case expense could violate the prohibition against single issue ratemaking. In a Missouri Gas Energy rate case in 1998, the Commission adopted Public Counsel's proposal to normalize rate case expense over a two year period:

> OPC proposed the actual amount of rate case expense prudently incurred for this rate case is the most appropriate amount to include as the rate case expense. OPC performed a full audit on MGE's rate case expenses. OPC also recommended normalizing the actual amount of expenses for a two-year period, which OPC believes reflects the cycle of rate case occurrences.

---

[5] Case Nos. WM-82-147, WM-82-192, WR-83-14 and SR-83-15, In the matter of the joint application of Missouri Cities Water Company and the City of Northmoor, Missouri, for authority authorizing Missouri Cities Water Company to sell, transfer and convey to the City of Northmoor the water distribution system and related property serving residents within the City of Northmoor, 26 Mo. P.S.C. (N.S.) 1, at 18

…

> The Commission finds that there is competent and substantial evidence to support OPC's position on the rate case expense and its position is just and reasonable.[6]

The Commission should adopt the position of Staff and Public Counsel and normalize rate case expense, not amortize it.

Regulatory Plan Additional Amortizations:
What risk factor should be used in calculating the Regulatory Plan additional amortizations for off-balance sheet purchased power agreements?

KCPL witness Trippensee discussed the rationale of the Regulatory Plan amortizations in this True-up Rebuttal testimony:

> The Regulatory Plan Amortization is premised on providing adequate cash flows to the KCPL during the period of time covered by the Regulatory Plan approved by the Commission in Case No. EO-2005-0329. The parties to that case crafted a measurement of cash flow that gave consideration to methods and criteria used by S&P at that point in time in measuring cash flow and determining credit ratings based in part on the results of their cash flow calculations. However, the Stipulation and Agreement and the Commission's Report & Order in case No. EO-2005-0329 clearly does not anticipate that this Commission defer its regulatory authority to S&P to set just and reasonable rates.

Public Counsel recommends the Commission use a 10% risk factor in determining the debt equivalent for purposes of the Additional Regulatory Amortization calculation. Staff witness Traxler acknowledged that there is nothing in the Regulatory Plan that requires the use of a specific discount rate or a specific risk factor. (Transcript, pp. 1185-1186).

Staff's position on the off-balance sheet obligations is inconsistent. With respect to the risk factor adjustment, Staff originally proposed to use a 30% factor. Upon learning that Standard and Poor's used a 50% factor, Staff adopted that factor. But Staff does not follow

[6] Case Nos. GR-98-140, GT-98-237, Re Missouri Gas Energy, 188 P.U.R.4th 30, at 43.

Standard and Poor's lead on the discount rate. Both Staff and Public Counsel support the use of a 6.1% discount rate, despite the fact that Standard and Poor's uses a 10% rate.

The 10% risk factor that Public Counsel supports is certainly adequate to address the risk that KCPL actually faces with respect to its off-balance sheet obligations. It is ludicrous to suggest that KCPL faces a 50-50 chance of default on these obligations – yet that is exactly what the 50% risk factor comprehends. Furthermore, there is no evidence in the case that the risk is anything like that significant. The Commission should not abdicate its ratemaking role to Standard and Poor's. The Commission should only adopt a 50% risk factor if it believes that there is a 50% chance of default on these obligations; it should not adopt it simply because Standard and Poor's does.

Off-system Sales:[7]
What level of off-system sales margin should be included in determining KCPL's cost of service?
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?

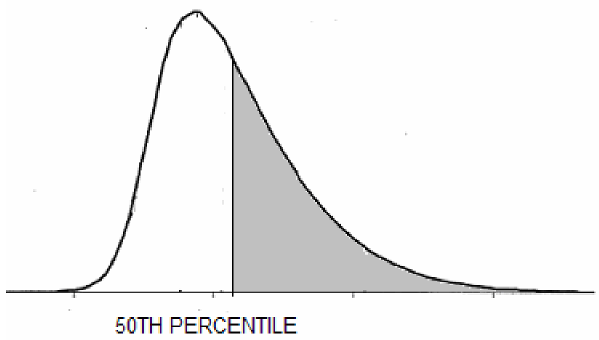
As noted in the Introduction section of this brief, the off-system sales margin issue is one of the areas in which KCPL is seeking to change the rules of the regulatory regime in its favor. It is doing so in two different ways. First, it wants the Commission to include a very low level of total company off-system sales margins in the ratemaking calculation. Second, it wants to assign an unreasonably large amount of those margins to Kansas.[8] These two changes each have the effect of under-recognizing revenues that KCPL will receive in the period in which the rates

[7] This brief will address three sub-issues under the Off-System Sales issue. Each of these sub-issues is set out under a separate heading.
[8] This second proposal is addressed under the next sub-issue: *How should the off-system sales margin be allocated to the Missouri retail, Kansas retail and FERC wholesale jurisdictions?* The real issue has to do with the split between Missouri and Kansas; the FERC piece is relatively small.

established in this case will be in effect, and thus inflating the amount of revenue that will be needed from Missouri retail ratepayers.

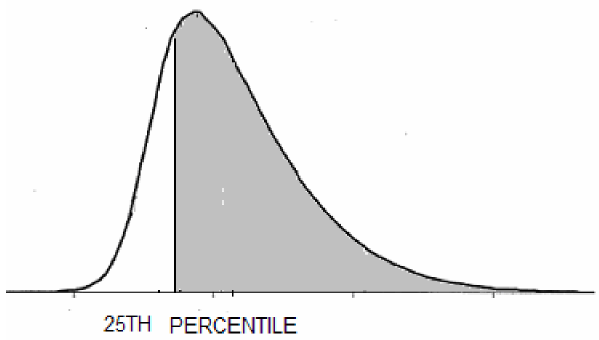
The Commission should recognize these changes for what they are: attempts to undermine the Regulatory Plan and to achieve additional returns for shareholders at the expense of ratepayers.

The first KCPL proposal is to set the rates going forward on an unrealistically low estimate of future off-system sales revenues. KCPL witness Schnitzer prepared a probability analysis of the revenues KCPL can be expected to achieve in the off-system sales market. Because we cannot know what the future will bring, Mr. Schnitzer did some modeling and predicted a number of possible future outcomes for KCPL's off-system sales revenues. Each of these possibilities is depicted as a point on a graph. The higher up the point is, the more likely it is to happen. The farther to the right the point is, the more money KCPL makes. So the points to the far right are very low, meaning that they are possible but not at all likely to happen. But if one of those particular futures actually did come about, KCPL would make a huge amount of money on off-system sales. There are points on the left that are also very low, meaning that these too are possible but unlikely, and if one of those futures came about, KCPL would make very little money on off-system sales. The graph is a fairly typical bell-shaped curve (a big hump in the middle, with both the beginning and end tapering off to zero). The curve below is taken (with the HC material deleted) from Highly Confidential Schedule MMS-5 to KCPL witness Schnitzer's direct testimony (Exhibit 30HC). The horizontal axis shows the dollar amount of revenue KCPL will receive from off-system sales, and the vertical axis shows the probability of achieving that outcome.



The line between the shaded portion on the right and the unshaded portion on the left illustrates the 50th percentile. At that point, the shaded part and the unshaded part are exactly equal in area, so KCPL is just as likely to get more revenues as it to get less revenues than the revenues shown on the horizontal axis.[9] This is the point at which Public Counsel proposes the Commission set off-system sales revenues for rate-making purposes. While the odds of any one particular point being exactly right are vanishingly slim, at this point – and **only** at this point – the Commission has equal chances of being too high or two low. KCPL proposes setting the off-system sales revenues level at the 25th percentile, as shown below.

[9] Because the bell curve is not perfectly symmetrical (it tapers more gradually to the right), the 50th percentile is not at the exact highest point, but shifted a little to the right.



If the Commission sets the level of off-system sales at the 25th percentile, KCPL is **three times more likely to get more revenues** than it is to get less. That is, if Mr. Schnitzer's modeling predicted 100 possible future outcomes, in 75 of those KCPL would make more money on off-system sales than the Commission allowed for in rates. It would make less money in only 25 of the possible outcomes. In the second graph shown above, the shaded area (in which KCPL gets more off-system sales revenue than the amount the Commission used to set rates) is three times the size of the unshaded area. If that turns out to be the case – and it is **three times** more likely than not to be the case – then KCPL "would achieve a higher rate of return and also higher cash flow." (Transcript, p. 825).

This higher rate of return flows to shareholders as additional earnings. (Transcript, p. 752). This proposal is not only patently unfair, but it violates the Regulatory Plan. KCPL witness Giles, once the regulatory law judge forced him to answer, admitted that KCPL has proposed no mechanism that would allow any of those earnings to flow back to ratepayers. (Transcript, p. 752). The Regulatory Plan[10] provides that:

[10] The last sentence in the cited portion was added in the Signatory Parties' Response to Order Directing Filing filed November 13, 2006 in EO-2005-0329. (Exhibit 148).

> 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. KCPL agrees that all of its off-system energy and capacity sales revenue will continue to be used to establish Missouri jurisdictional rates as long as the related investments and expenses are considered in the determination of Missouri jurisdictional rates. (emphasis added).

KCPL argues that the only reason it wants to set the level of off-system sales revenues so low is to reduce its risk. If that were the case, KCPL could have proposed a mechanism that would reduce the risk without giving KCPL a 75% chance of receiving a windfall. Public Counsel witness Ryan Kind stated:

> If KCPL was only interested in lowering the amount of downside risk that it faced from participating in the off-system sales market, it would either have (1) a sharing mechanism or (2) some other method of passing through to ratepayers the positive or negative fluctuations in off-system sales margins from the level of margins reflected in its revenue requirement. For example, KCPL could have requested that the Commission include only the low level of off-system sales margins associated with the 25 percent point on the probability distribution for off-system sales margins **in conjunction with** proposing some method to credit ratepayers with the amount of off-system sales margins that exceed this level. Since KCPL did not propose any method to credit ratepayers for the amount of margins that exceed the low level that it proposes to reflect in the revenue requirement, the Company is seeking to decrease its downside risk by 50% **while also** setting up a situation where it will likely reap a huge windfall for its shareholders since there is a 75% probability that the actual level of off-system sales would exceed the 25 percent level that was reflected in revenue requirement. (Exhibit 204, Kind Rebuttal, p. 9; emphasis in original).

In conclusion, setting the off-system sales revenue at the 50th percentile is fair to shareholders and fair to ratepayers. Any other point on the curve favors one group over the other. Most of the parties to Case No. EO-2005-0329, as well as the Commission, recognized the need to tilt the board in shareholders' favor, and did so with the amortizations in the Regulatory

Plan. At the time, KCPL professed it to be enough. The Commission should not allow KCPL to continue to change the rules of the game so drastically in favor of its shareholders.

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

This is the second subissue under the heading of Off-system Sales, and it is the second area related to off-system sales where KCPL is attempting to change the rules of the game so that its shareholders have much better chances of winning. KCPL has invented a new allocator, used for the first time ever in this case, that allocates more of the profit from off-system sales to Kansas than the allocator KCPL has always used in the past or the allocator Staff proposes in this case. (Transcript, pp. 642-643). Not coincidentally, KCPL has settled the rate case that it filed in Kansas at the same time as the instant case was filed in Missouri. The Kansas settlement is a "black box" settlement, and there is no way to look at the settlement and determine the level of off-system sales revenues that are built into KCPL's Kansas rates going forward. (Transcript, pp. 643-645). Assuming the Kansas Corporation Commission approves the settlement – and there is nothing in the record to indicate that it might not approve it – then KCPL's Kansas rates will be as agreed. Thus any amount of off-system sales profit that KCPL can convince this Commission to allocate to Kansas does not benefit Kansas ratepayers, but only benefits KCPL shareholders. Allocating a million dollars of profits to the Kansas jurisdiction will not change Kansas rates one penny, but it will enrich KCPL shareholders by the full million dollars (less any applicable taxes).

KCPL has never proposed this allocator in any previous rate case. (Transcript, p. 640). KCPL is unaware of an unused energy allocator ever having been proposed by any party in any jurisdiction. (Transcript, pp. 661-662). KCPL witness Frerking alone came up with the idea of using this allocator, and he alone developed it. (Transcript, pp 660-661). It has not been discussed in any textbook or learned treatise. (Transcript, p. 662).

Public Counsel witness Smith discussed the unused energy allocator and pointed out two significant flaws:

> The change proposed by KCPL in the jurisdictional allocation of off-system sales revenues presents at least two fundamental problems:
>
> (1) It results in an unreasonable and substantially lower amount of off-system sales margin being allocated to the Missouri retail jurisdiction than would result from the continued use of an Energy allocator. Staff's Reconcilement of Off-System Sales Margin workpaper quantifies the amount of difference … [as a very significant dollar amount]. The difference would be even greater if OPC's proposed total system off-system sales margin was used. This results from the 10.15% difference between (a) KCPL's new Unused Energy Allocator, which produces a Missouri retail jurisdictional allocation of only 46.97%, and (b) KCPL's Energy allocator which would produce a Missouri retail jurisdictional allocation of 57.12%.
>
> (2) It creates a potential inconsistency in the allocation of off-system sales margin between the jurisdictions. If the Missouri retail jurisdictional allocation is based on an Energy allocator, consistent with prior practice, as recommended by Staff, but no corresponding change is made to the Kansas retail jurisdictional allocation in KCPL's currently pending Kansas rate case, the use of inconsistent jurisdictional allocations between the two states and the FERC share of a jurisdictional allocation could result in jurisdictional allocations for off-system sales margins that do not add up to 100%. (Exhibit 211HC, Smith Rebuttal, p. 5; HC information removed)

KCPL's unused energy allocator is inappropriate to use in this case (or any other) because, even if one could accurately ascertain an unused energy measure (something which KCPL's allocator does not accomplish), it does not follow that such unused energy is proportionate to the fixed and variable costs of the generation used to make the off-system sales. In summary, KCPL's computed unused energy metric is a fiction, and the resulting allocation is both arbitrary and flawed.

Off-system Sales:
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?

Regardless of whether or not a sharing or a tracking mechanism may be appropriate under some circumstances, there is insufficient evidence in this case to establish one. Public Counsel in the direct testimony of witness Smith, expressed its willingness to consider such a mechanism:

> Q. Is OPC willing to consider an alternative treatment of off-system sales margins that would provide specific consideration for the potential for a large variation in the level of off system sales margin that KCPL could realize during the rate effective period?
>
> A. Yes.

Nonetheless, KCPL did not respond to this testimony in either its rebuttal or surrebuttal testimony. KCPL witness Giles acknowledged that KCPL did not make any specific proposal in this case. (Transcript, P. 771). In fact, Mr Giles, by the time the evidentiary hearing came around, had apparently forgotten that Public Counsel witness Smith – in his direct testimony – invited KCPL to propose some sort of a mechanism:

> Q. Did he not, at page 11 [of Exhibit 210, Smith Direct], say, "OPC is willing to consider an alternative mechanism by which KCPL would establish a regulatory liability or asset account and record its actual achieved off-system sales margin during the rate-effective period in excess of or below [a certain point] in such account"? And I didn't -- I substituted "a certain level" from that quote so as not to reveal highly confidential information.
> A. Yes, I recall that and --
> Q. And did you respond directly to that in either your direct or surrebuttal testimony?
> A. I believe that was in his surrebuttal.
> Q. That was in his direct testimony --
> A. In his direct testimony?
> Q. -- filed on August 8th. Did you respond to that in your rebuttal or surrebuttal?
> A. The manner I responded to that was to become more detailed and specific in my surrebuttal on what this adjustment really meant in terms of ROE

> and risk. **I did not respond specifically to his alternative.** [emphasis added] (Transcript, pp. 817-818).

Of course, Public Counsel witness Smith did not propose an alternative, but rather suggested that Public Counsel would be willing to consider something if KCPL proposed it. KCPL had a different strategy in this case, and never managed to put a proposal before the parties.

During cross-examination of Public Counsel witness Smith, KCPL repeatedly tried to ascribe proposals to him, referring to them as "your mechanism." (Transcript, pp. 471-474). As Public Counsel pointed out:

> We tried to get KCPL to bite on this issue and they refused to, and despite having two subsequent rounds of testimony, to say, yeah, we like this mechanism. Now here we are in the hearing room and they're trying to get something about this mechanism in the record when they didn't put it in their testimony. So I think it's an important point as to whether or not this mechanism is actually on the table, whether Public Counsel is affirmatively proposing it and whether KCPL ever proposed it. (Transcript, pp.473-474).

When KCPL belated tried to outline some proposals in redirect examination, it was much too late for other parties to be able to formulate a response to those sketchy proposals. KCPL even objected to a question asking how Public Counsel witness Smith would respond to those proposals:

> RECROSS-EXAMINATION BY MR. MILLS:
>
> Q. With respect to the -- the additional description you gave on redirect to Mr. Riggins about how one of your proposals would work, what do you think Mr. Smith, Public Counsel's witness, would say in response to that description?
>
> MR. RIGGINS: Object. Calls for speculation.
>
> MR. MILLS: I agree, and that's my point. I'll withdraw the question.
>
> JUDGE PRIDGIN: Thank you.
>
> MR. MILLS: We'll never know what Mr. Smith might have said. (Transcript, p. 833).

Furthermore, Public Counsel witness Smith testified that any sort of a tracking or sharing mechanism would substantially reduce KCPL's risk. (Transcript, p. 478). Mr. Smith is a certified rate of return analyst and a member of the Society of Utility Financial Analysts, so he is definitely qualified to testify on ROE issues. (Transcript, p. 481-482). KCPL witness Giles, despite offering testimony on ROE adjustments, is not qualified as a financial analyst. In fact, he testified that he was "definitely" not a certified rate of return analyst. (Transcript, pp. 812-813). There is no evidence in the record that would allow the Commission to adjust return on equity in conjunction with establishing a tracking or sharing mechanism.

Despite KCPL's efforts to establish a record after any party had a meaningful opportunity to respond, there is woefully insufficient evidence on the record for the Commission to order a sharing or tracking mechanism for off-system sales in this case. The Commission should not adopt any such mechanism.

Cost of Capital:
What is the appropriate capital structure?

As of September 30, 2006, KCPL's capital structure consisted of 53.69 percent equity, 1.53 percent preferred stock, and 44.79 percent long-term debt. (Exhibit 153, Barnes True-up Direct, p. 2). Public Counsel concurs with this capital structure.

Cost of Capital:
What is the appropriate return on common equity (ROE)?

The Commission might be tempted to grant KCPL an inflated ROE because of KCPL's repeated claims of increased risk from its construction program. As noted in the Introduction section of this brief, this is one of the areas in which KCPL seeks additional "rule changes" in its favor on top of the Regulatory Plan. KCPL sought input from stakeholders, and took up a year of their time, to develop a Regulatory Plan to address its construction risk. The ink is barely dry on that plan, and KCPL is seeking in this case to significantly increase the advantage it got through the Regulatory Plan. The Commission should not fall for this ploy. KCPL urged the Commission to approve the Regulatory Plan, the Commission did so, and nothing in the record in this case indicates that the plan will be inadequate to address KCPL's risk. KCPL does not need yet another free spin to have a fair chance in this case.

The appropriate return on equity (ROE) is 9.9%. The ROE recommendations of Public Counsel, Staff and the Department of Energy are all consistent, with KCPL's recommendation an extreme outlier.

KCPL witness Hadaway premises his criticism of the DCF model on the fact that analysts' projections are currently inaccurate – "pessimistic" is the term he uses to describe them. (Hadaway Direct, Exhibit 33, p.6). At the evidentiary hearing, Dr. Hadaway testified that, even though they are inaccurate now, they were accurate a few years ago. (Transcript, pp. 1245, 1247). Yet in his direct testimony, Dr. Hadaway cited a 2003 article that stated that analysts were optimistic. (Exhibit 33, p. 30). The fact of the matter is that analysts are neither optimistic nor pessimistic. Their projections, as long as one looks at a large enough sample, will be neutral. At any given time, some may be high and others low, but the overall picture from analysts forecasts will be neutral. Yet Dr. Hadaway uses this argument to support inclusion of Gross Domestic Product (GDP) forecasts in his DCF results. However, he provides no empirical basis for doing so. He offered no analysis that shows investors rely on GDP forecasts in determining their required cost of capital for electric utilities.

Public Counsel witness Baudino carefully and fully explained the problems associated with Dr. Hadaway's use of GDP in his DCF calculation:

> Dr. Hadaway included long-term GDP growth in the calculation of his recommended long-term growth rate. It is inappropriate to include long-term

> GDP growth of 6.60% in the expected long-term growth rate for electric utilities. Dr. Hadaway presented no evidence that investors base their current growth rate assumptions for electric utility companies on the historical growth in GDP (6.60%). Interestingly, this projection is substantially greater than any of the electric utility dividend and earnings growth projections used by both Dr. Hadaway and myself. This suggests that the GDP growth rate is an outlier and should be rejected, rather than included in a DCF analysis specific to a group of electric utilities.
>
> I believe that a more reasonable assumption is that investors will use the information specific to electric utilities in forming their growth rate expectations. I would agree that GDP growth is a factor that may directly and/or indirectly affect forecasted growth rates for electric utilities. However, it is the earnings and dividend growth forecasts for the individual companies that should be used in the DCF analysis. There is no good reason to believe that today's investors expect earnings and dividend growth for electric utilities to equal the historical growth rate in GDP. Indeed, all of the growth forecasts specific to electric utilities indicate otherwise. Including GDP growth has the effect of inflating Dr. Hadaway's final results. (Exhibit 202, Baudino Rebuttal, p. 3).

Dr. Hadaway's analysis also suffers from the fact that he chose not to include dividend growth in his traditional Discounted Cash Flow calculation. Had he done so, the results of his traditional DCF calculation would probably have been even lower. (Transcript, p. 1247). There are many other significant flaws in Dr. Hadaway's analysis. CAPM results are overstated at this time due to betas that are too high. (Exhibit 201, Baudino Direct, p. 26) Value Line's current market return is greatly overstated. (*ibid*).

Dr. Hadaway indiscriminately ascribes risks that might be facing other electric utility companies to KCPL. To the extent that other utilities in the witnesses' comparable groups face greater risks than KCPL, KCPL's ROE will be overstated in their DCF analyses. For example, Dr. Hadaway acknowledges that KCPL is in better shape with respect to other utilities in terms of risks associated with hurricanes. (Transcript, pp. 1252-1253).

The Commission should adopt the 9.9% ROE proposed by Public Counsel witness Baudino. Mr. Baudino has a great deal of experience, and performed the most "neutral" DCF calculation offered n this case. Staff witness Barnes used very few comparable companies, and this casts a shadow over his DCF calculation. KCPL witness Hadaway performed a reasonable traditional DCF calculation, but the ROE he recommends bears no relation to that DCF result.

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

The ROE calculation of Public Counsel witness Baudino accurately calculates KCPL's cost of equity. Mr. Baudino used a comparison group of companies with bond ratings similar to KCPL. Since similar bond ratings are used, no additional adjustment for additional risk is required. (Baudino Direct, Exhibit 201, p. 15). Mr. Baudino used analyst forecasts in his DCF model, which influence investor expectations with regard to their required ROE. Mr. Baudino relied on a broad range of dividend and earnings growth forecasts. There is no need to make further adjustments to it for risk or company performance. The ROE calculation of KCPL witness Hadaway is so inflated that it certainly is unnecessary to make upward adjustments to it. In short, while there may, in some other case under some other circumstances, be a need to make adjustments to an ROE calculation based on the DCF model, there is absolutely no call for such adjustments in this case.

Respectfully submitted,
Office of the Public Counsel

/s/ Lewis R. Mills, Jr.
By:______________________________

Lewis R. Mills, Jr. (#35275)
Public Counsel
P O Box 2230
Jefferson City, MO 65102
(573) 751-1304
(573) 751-5562 FAX
lewis.mills@ded.mo.gov

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to all parties this 17th day of November 2006.

/s/ Lewis R. Mills, Jr.

____