Exhibit No.:	
Issue:	Cost-of-Debt Synergies
Witness:	Michael W. Cline
Type of Exhibit:	Supplemental Direct Testimony
Sponsoring Party:	Great Plains Energy Incorporated and Kansas City Power & Light Company
Case No.:	EM-2007-0374
Date Testimony Prepared:	August 8, 2007

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: EM-2007-0374

SUPPLEMENTAL DIRECT TESTIMONY PURSUANT TO THE SCHEDULING ORDER

OF

MICHAEL W. CLINE

ON BEHALF OF

GREAT PLAINS ENERGY INCORPORATED

AND

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
August 2007

" [redacted] **" Designates "Highly Confidential" Information Has Been Removed.**
Certain Schedules Attached To This Testimony Designated ("HC") Have Been Removed
Pursuant to 4 CSR 240-2.135

SUPPLEMENTAL DIRECT TESTIMONY

PURSUANT TO THE SCHEDULING ORDER

OF

MICHAEL W. CLINE

CASE NO. EM-2007-0374

1 **Q: Are you the same Michael W. Cline who submitted direct testimony in this**
2 **proceeding?**
3 A: Yes, I am.
4 **Q: What is the purpose of your testimony?**
5 A: My testimony is divided into four sections. In Section 1, I will articulate the overall
6 objective of Great Plains Energy ("Great Plains Energy") with respect to managing the
7 existing debt of Aquila ("Aquila") following Great Plains Energy's acquisition of Aquila.
8 In Section 2, I will describe the debt portfolio that Great Plains Energy expects to inherit
9 with the Aquila acquisition. In Section 3, I will discuss the strategy for managing that
10 portfolio that best meets Great Plains Energy's overall objectives and the regulatory relief
11 essential to the strategy's success. Finally, in Section 4, I will summarize the key
12 elements from the preceding three sections.

1

2 **SECTION 1 – GREAT PLAINS ENERGY'S OVERALL OBJECTIVES IN MANAGING**
3 **AQUILA'S DEBT PORTFOLIO**

4

5 **Q: What are Great Plains Energy's overall objectives in planning for actions to be**
6 **taken with respect to Aquila's existing debt following the closing of the transaction?**

7 A: The direct testimonies provided by Terry Bassham, William H. Downey, and me in this
8 proceeding articulated the importance and the benefits of achieving and maintaining an
9 investment-grade rating for Aquila as a result of this transaction. Maintaining Great
10 Plains Energy's current investment-grade status is essential as well. These are the key
11 objectives upon which we are focused as we plan to manage Aquila's debt portfolio post-
12 closing of the merger.

13

14 **SECTION 2 – AQUILA'S DEBT PORTFOLIO INHERITED BY GREAT PLAINS**
15 **ENERGY**

16

17 **Q: What is the "starting point," i.e., what debt is expected to be on Aquila's books at**
18 **the time the transaction is closed?**

19 A: Schedule MWC-6 (HC) lists the debt that Great Plains Energy expects to be on Aquila's
20 balance sheet at the time of closing. This debt includes the following: (1) 15 issues of
21 senior notes, medium term notes, first mortgage bonds, and tax-exempt pollution control
22 bonds totaling ** [redacted] **; and (2) Short-term debt outstanding on Aquila's Iatan
23 revolving credit facility of approximately $102 million.

1 **Q: Is this portfolio the same as what Great Plains Energy had initially assumed in**
2 **quantifying the interest synergies disclosed when the transaction was announced?**
3 A: No.
4 **Q: What accounts for the difference?**
5 A: As anticipated, in June Aquila utilized cash on hand and a portion of the proceeds from
6 its sale of its Kansas Electric properties to retire a number of their debt issues. The actual
7 debt retired, however, was different than originally assumed. In all, Aquila called four
8 issues totaling $344.0 million, with a weighted average coupon rate of 7.90%,and plan to
9 call approximately $2 million additional in August of 2007. The four issues retired are
10 the last four listed in the table entitled "Bonds Previously Tendered, Matured, or
11 Converting" in Schedule MWC-6 (HC). The two largest issues retired as part of this
12 activity, $287.5 million of 7.875% Retail QUIBs due in March 2032 and $51.5 million of
13 8.00% Senior Notes due in March 2023, had been assumed to still be outstanding at
14 closing when interest synergies were originally calculated.
15 **Q: Why did Aquila retire different debt than what had been assumed?**
16 A: The approach a firm takes in managing a portfolio of liabilities ("liability management")
17 depends on its objectives. A firm may decide to retire different debt issues if its goal is to
18 reduce interest expense on the income statement going forward than it might if the focus
19 were on minimizing the near-term volatility in reported results. A firm could also choose
20 to make maximum dollar reduction of debt the top priority for credit reasons, or focus
21 only on those issues that could be refinanced at lower rates based on current borrowing
22 cost or the opportunity cost of available cash.

1 In this situation, Aquila's liability management objectives in 2007 were originally
2 projected to focus more upon retiring their higher-cost debt issues in order to reduce
3 interest expense going forward. As the strategy actually developed, however, Aquila
4 adopted an approach that used its available cash to target issues that were callable either
5 at par (face value) or at a small premium. This enabled Aquila to maximize the amount
6 of debt reduction on their balance sheet, achieve some degree of interest expense savings
7 going forward, minimize the income statement "hit" that would result from retiring
8 higher-premium issues, and obtain positive refinancing economics since the all-in cost,
9 including call premiums, of the retired debt was higher than the rate Aquila could earn by
10 investing the cash at money market rates.
11 The rating agencies have reinforced Aquila's approach through their rating
12 changes on Aquila since the company's announcement of this strategy. Standard &
13 Poor's ("S&P") upgraded Aquila's senior unsecured rating one notch, from B to B+, on
14 May 15, 2007, while Moody's upgraded the senior unsecured rating two notches from B2
15 to Ba3 on June 22, 2007. Note that, despite these upgrades, Aquila's senior unsecured
16 rating remains four notches below the lowest investment-grade level of BBB- at S&P and
17 three notches below the Baa3 investment-grade threshold at Moody's.
18 **Q:** ** **
19 A: **
20
21
22
23 **

1 **Q: Will any other debt mature or convert prior to closing?**

2 A: Yes. As shown in the table entitled "Bonds Previously Tendered, Matured, or
3 Converting" in MWC-6 (HC), the remaining $2.6 million of Aquila's Premium Income
4 Equity Security (PIES) will convert to common stock in September 2007.

5 **Q: Will the debt issues anticipated to remain on Aquila's balance sheet at the time of**
6 **closing still be able to be retired?**

7 A: Yes. Aquila has a number of issues representing over 90% of its outstanding debt that
8 could be fully retired at a "make-whole" price. The method for determining the make-
9 whole price, when applicable, is outlined in the prospectus for each security. The balance
10 of Aquila's debt without a "make-whole" provision can be repurchased in the market
11 through a tender offer. While there is no certainty as to the amount of any particular
12 issue that existing holders would make available in response to a tender offer, it should be
13 possible to structure the terms of the offer in a manner that would be sufficiently
14 attractive to ensure a significant degree of investor participation.

15 **Q: Do you expect there to be material changes in any terms of the existing Aquila debt**
16 **following its acquisition by Great Plains Energy?**

17 **A:** Yes. As described in my direct testimony in this proceeding, Great Plains Energy expects
18 that Moody's and Standard & Poor's would upgrade Aquila's credit rating to Baa2 and
19 BBB, respectively, within a relatively short period following closing. These actions
20 would result in an immediate coupon rate reduction in two of Aquila's senior note issues:
21 (1) For the $500 million issue with a maturity of July 2012, a reduction from 14.875% to
22 11.875%; and (2) For the **[redacted]** issue with a maturity of February 2011, a
23 reduction from 9.95% to 7.95%. The prospectus supplements for these securities, which

1 include a description of the coupon reductions, are attached as Schedule MWC-7 and

2 MWC-8 for the $500 million and ** ** million issues, respectively.

3

4 **SECTION 3 – POTENTIAL STRATEGIES FOR MANAGEMENT OF AQUILA'S DEBT**

5 **PORTFOLIO**

6

7 **Q: What is the purpose of this section of your testimony?**

8 A: I will discuss the strategy developed by Great Plains Energy to manage Aquila's debt

9 portfolio in a manner that achieves the objectives outlined in Section 1 and the regulatory

10 elements critical to the success of the approach.

11 **Q: What alternative has Great Plains Energy identified with respect to managing the**

12 **existing Aquila debt that achieves the objectives you outlined in Section 1?**

13 A: Schedule MWC-9 (HC) reflects a *pro forma* 2008-12 model of this strategy prepared by

14 Credit Suisse, Great Plains Energy's advisor on the merger transaction. This strategy

15 involves the following key elements: (1) The issuance by Great Plains Energy of a

16 ** ** hybrid debt security with an assumed coupon rate of ** **;

17 (2) Contribution of the proceeds of the hybrid issuance from Great Plains Energy to

18 Aquila as capital; and (3) **

19

20

21

22

23

1 [redacted]

2 [redacted]**

3 **Q: What are the implications of this strategy for the credit profiles of Aquila and Great**

4 **Plains Energy?**

5 A: In order to address this question, it's important to first revisit how S&P is expected to
6 view the business risk of Aquila and Great Plains Energy post-merger. As discussed in
7 my direct testimony, in January 2007 Great Plains Energy engaged S&P to conduct an
8 analysis of the proposed Aquila merger through S&P's Ratings Evaluation Service
9 ("RES"). A copy of S&P's analysis is attached as Schedule MWC-4 (HC) (This schedule
10 was attached to my initial direct testimony. I attach it again here for convenience.). In
11 that analysis S&P stated (using "Asteroid" to refer to Aquila and "GXP" to refer to Great
12 Plains Energy) that "Asteroid's business risk profile is currently satisfactory ('6') on
13 Standard & Poor's 10-point scale," and "Post-merger, GXP's consolidated business
14 profile would be revised to a '6' from a '7'." S&P assigns a business risk score to an
15 entity on a scale of 1-10, with '1' representing the lowest risk and '10' the highest.
16 Accordingly, S&P's view is that the acquisition of Aquila will lower Great Plains
17 Energy's overall business risk.

18 The business risk profile is then used to establish the guidelines for the financial
19 metrics that correspond generally to a given credit rating. S&P published its financial
20 guidelines for utility and power company credit ratings in June 2004. Their report is
21 attached as Schedule MWC-1 (This schedule was attached to my initial direct testimony.
22 I attach it again here for convenience.).

1 Compared to S&P's financial guidelines contained in Schedule MWC-1, the *pro forma* FFO-to-Debt ratios reflected in Schedule MWC-9 (HC) are in the middle third of the range for the "BBB" rating category, for a company with a business risk of '6', throughout the three-year period of the analysis. The Debt-to-Capitalization and FFO Interest coverage ratios, the two other most important metrics from S&P's perspective, are both stronger than indicated by the range for the BBB rating category. These credit metrics appear sufficiently strong to maintain an investment-grade rating for Aquila and Great Plains Energy over the period.

Also supporting this assessment is the fact that this ** [redacted] ** is consistent with the approach that Great Plains Energy discussed with both S&P and Moody's prior to announcement of the merger. A copy of Great Plains Energy's January 2007 presentation to Moody's and S&P to facilitate both Moody's Ratings Assessment Service ("RAS") analysis and S&P's RES analysis is attached as Schedule MWC-11 (HC). The February 2007 update given by Great Plains Energy to the agencies just prior to announcement of the merger is attached as Schedule MWC-12 (HC). As referenced earlier, the S&P RES report is attached as Schedule MWC-4 (HC). The Moody's RAS report is attached as Schedule MWC-5 (HC) (This schedule was attached to my initial direct testimony. I attach it again here for convenience.).

Q: Briefly describe hybrid debt and its significance in this strategy.

A: Hybrid debt is a financing instrument that is treated like debt for accounting and tax purposes but contains certain equity-like features that result in the attribution of "equity credit" from the rating agencies in the calculation of credit metrics. The degree of equity

1 credit granted by the agencies depends on the terms and structure of the each particular
2 issue. Moody's assigns a given hybrid debt instrument to one of five "baskets," each
3 with a different level of equity credit (from Basket A, treated as 0% equity / 100% debt,
4 to Basket E, treated as 100% equity / 0% debt, adjusting in 25% increments). S&P, on
5 the other hand, attributes equity credit based on assigning the security to one of three
6 categories: (1) "Low" (0% equity / 100% debt); (2) "Intermediate" (50% equity / 50%
7 debt); or (3) "High" (100% equity / 0% debt). With the issuance of a heavy volume of
8 hybrid securities over the past two years, the structuring attributes required to attain a
9 given level of equity credit have become well-understood by issuers.

10 Great Plains Energy plans to issue a security that will receive 50% equity credit
11 from both agencies, i.e., "Basket C" at Moody's and "Intermediate" at S&P. The
12 significance of this in terms of the strategy is that, although Great Plains Energy's
13 balance sheet following issuance will reflect ** ** of debt, for purposes of
14 calculating credit ratios at the Great Plains Energy level, the rating agencies will assume
15 debt of ** ** and equity of ** **. From a rating agency
16 standpoint, Aquila's total debt will decline by nearly ** ** and, at the
17 consolidated Great Plains Energy level, net total debt will decline by nearly **
18 ** (** ** reduction at Aquila, less ** ** of new Great
19 Plains Energy debt attributed to the hybrid).

20 Q: **Why is Great Plains Energy leaving Aquila's $500 million Senior Notes issue**
21 **outstanding?**

22 A: This issue, shown on Schedules MWC-6 (HC) and MWC-10 (HC), matures in July 2012
23 and has a current coupon of 14.875%. As discussed earlier, Great Plains Energy expects

1 this coupon to decline to 11.875% upon the closing of Great Plains Energy's acquisition
2 of Aquila, based upon S&P's and Moody's actions to upgrade Aquila to investment-
3 grade.

4 In order to retire this security, Aquila would be required to utilize the "make-
5 whole call." This provision is described in the "Redemption" section of Schedule MWC-
6 7 and establishes the basis for calculating the price which Aquila would need to pay to
7 retire the security. As shown on Schedule MWC-10 (HC), the estimated "make-whole"
8 price, expressed as a percentage of the par amount, is 124.14. Stated another way, Aquila
9 would have to pay $1,241.40 for every $1,000 of outstanding debt, which would result in
10 a total redemption cost of $620.7 million. As a result, redemption of this one issue would
11 utilize essentially all of the cash Aquila expects to have available to complete this
12 refinancing. At the Great Plains Energy consolidated level, this would result in a net debt
13 reduction from a rating agency perspective of only ** ** ($500 million
14 retired at Aquila, less ** ** of Great Plains Energy debt attributed to the
15 hybrid), compared to ** ** as previously discussed for the target strategy.

16 **Q: Could Great Plains Energy just issue a larger hybrid to fund the take-out of the**
17 **$500 million Senior Notes?**

18 A: No. S&P's current guidelines call for hybrid securities to comprise no more than 15% of
19 a firm's total capitalization. The *pro forma* capitalization of Great Plains Energy
20 following the acquisition of Aquila is estimated at approximately ** **, as
21 shown in Schedule MWC-9 (HC). The absolute limit on hybrids for Great Plains Energy
22 would therefore be ** **. As Great Plains Energy expects to execute a
23 hybrid issue of ** ** in 2007, the ** ** expected to be

1 completed as part of this debt reduction strategy for Aquila will lead to total hybrids
2 outstanding of about ** ** at Great Plains Energy, or about ** ** of *pro*
3 *forma* total capitalization. Great Plains Energy views this as sufficiently close to S&P's
4 stated threshold to preclude additional hybrid issuance beyond this level.

5 **Q: What are the key regulatory elements to this debt reduction strategy?**

6 A: There are three items Great Plains Energy views as key regulatory elements of our debt
7 reduction strategy in order to achieve our credit objectives: (1) Recovery in rates of
8 actual interest costs on any Aquila debt remaining after execution of the strategy; (2)
9 Recovery in rates of amortized debt retirement costs reflected in interest expense going
10 forward; and (3) The availability of an Additional Amortizations mechanism for Aquila,
11 as outlined in my direct testimony.

12 **Q: For regulatory purposes, Aquila currently recovers interest costs of approximately**
13 **7%. Why does Great Plains Energy believe that full cost recovery is warranted?**

14 A: Great Plains Energy is acquiring all of Aquila's debt through the merger. Recovery of
15 actual interest costs going forward is key for Great Plains Energy to facilitate the short
16 and long-term term benefits of the transaction.

17 The $500 million senior note matures in July 2012. As discussed in Section 2,
18 Great Plains Energy's financial strength is expected to result in an immediate lessening of
19 Aquila's interest burden on this issue in the form of a 300 basis point coupon reduction,
20 which represents $15 million in reduced pre-tax interest expense annually over the life of
21 the issue. Even with this reduction triggered by Great Plains Energy, however, the actual
22 annual pre-tax interest cost will be $24.4 million per year higher than the 7% currently
23 allowed in rates. Going forward, Aquila customers will derive considerable long-term

1 benefits from Aquila achieving and maintaining investment-grade status as a result of this
2 transaction. Interest costs will be significantly lower as a direct result of Great Plains
3 Energy's actions and will ultimately reflect Aquila's true financing costs to the entity
4 following continued de-leveraging to improve Aquila's financial prospects. Therefore,
5 Great Plains Energy believes that actual interest cost is an appropriate cost for Aquila's
6 customers to bear in the short-run in order to achieve the long-term objective of financial
7 stability and rates that reflect actual cost of service.

8 The recovery of actual interest costs is necessary to achieving Great Plains
9 Energy's credit objectives in the merger transaction. Both the S&P RES analysis
10 (Schedule MWC-4 (HC)) and Moody's RAS analysis (Schedule MWC-5 (HC))
11 emphasized the importance of Great Plains Energy's ability to recover actual interest
12 costs as a key consideration in the investment-grade outcomes indicated by both
13 agencies.

14 Q: **What are the debt retirement costs to which you refer and how would such costs be**
15 **accounted for?**

16 A: Excluding the $500 million Senior Notes, Aquila will be able to retire between **█
17 █** of the target portfolio under the "make-whole" provisions in the respective
18 individual securities, as discussed in Section 2. The remaining securities do not have
19 make-whole provisions and, as such, Aquila intends to retire those bonds through a
20 tender offer whereby Aquila will endeavor to establish a sufficiently attractive price to
21 induce current holders to sell all, or a significant portion, of their bonds back to the
22 company. Regardless of whether the debt is retired using a make-whole provision or a
23 tender offer, Aquila will pay a premium above the par value of the bonds in order to do

1 so. Schedule MWC-10 (HC) reflects Credit Suisse's estimate of the prices Aquila will
2 pay to retire the debt and the resulting repurchase premium, which totals **
3 **. These amounts will be deferred and amortized as a component of interest
4 expense.
5 **Q: Why does Great Plains Energy believe that rate relief for these costs is warranted?**
6 **A:** These costs are necessary to complete the debt reduction needed to achieve an
7 investment-grade rating for Aquila. Because ** ** of the target portfolio matures
8 before ** **, this represents a largely short-term cost borne by customers in
9 exchange for the long-term benefits concomitant with investment-grade status, as
10 discussed previously.
11 **Q: Under the assumption of full cost recovery of interest, both on remaining debt and**
12 **based on the amortization of debt refinancing costs, what is the projected impact of**
13 **this strategy on customer rates?**
14 A: Schedule MWC-9 (HC) reflects the impact of this strategy on projected Aquila customer
15 rates. While the Additional Amortizations mechanism is assumed to be available to
16 Aquila if needed to support credit metrics, Great Plains Energy's proposed debt reduction
17 strategy results in sufficient cash flow so that the mechanism is not assumed to be
18 invoked during the analysis period.
19 **Q: Since the strategy you have outlined appears to support an investment-grade rating**
20 **without an assumed Additional Amortizations mechanism being triggered, is such a**
21 **mechanism still needed?**
22 A: Yes. The reasons for such a mechanism, as stated in my direct testimony, are unaffected
23 by the results of this or any single strategy. The rating agencies consider the availability

1 of the Additional Amortizations mechanism to be an important sign of regulatory support
2 for credit quality and a vital means of risk mitigation for bondholders.
3 **Q: Please summarize the regulatory relief related to this strategy that is either**
4 **requested now or will be requested by Aquila in future rate cases.**
5 A: Great Plains Energy reiterates the request outlined in the direct testimony of Terry
6 Bassham in this proceeding, that once Aquila achieves the financial metrics necessary to
7 support an investment-grade rating, the Commission authorize Aquila to use the
8 Additional Amortizations mechanism in the same manner and on the same terms and
9 conditions as implemented by the Commission with respect to KCPL in Case No. ER-
10 2006-0314.
11 Aquila will ask, in future rate cases, that all actual interest costs be recovered in
12 rates. This will include both the actual coupon rate on all outstanding debt, including that
13 remaining subsequent to the execution of this de-leveraging strategy, as well as the effect
14 on interest costs from the amortization of debt retirement costs resulting from this
15 strategy.
16
17 **SECTION 4 -- SUMMARY**
18
19 **Q: Please summarize your testimony.**
20 A: Achieving and maintaining an investment-grade rating for Aquila while maintaining
21 Great Plains Energy's current investment-grade rating is a key objective. Great Plains
22 Energy's post-closing execution strategy related to existing debt at Aquila is, in turn, a
23 key element to the attainment of that objective. Great Plains Energy has outlined a

1 strategy of refinancing nearly all of Aquila's outstanding individual debt securities using
2 a combination of holding company hybrid debt and cash. The debt reduction at Aquila
3 that will result from this plan is designed to accomplish the aforementioned credit
4 objectives and foster long-term financial stability at a company that has not enjoyed
5 investment-grade status since 2002.

6 The strategy proposed by Great Plains Energy is reasonable, responsible, and
7 sound. While there are short-term costs involved with the strategy, the overall
8 restructuring plan, in light of other synergies that will be realized and the benefits of
9 investment-grade status to customers, demonstrate that the merger's benefits outweigh
10 the costs, that the merger is not detrimental to the public interest, and that the plan to
11 execute the merger should be approved by the Commission.

12 **Q: Does that conclude your testimony?**

13 A: Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of Great Plains Energy Incorporated, Kansas City Power & Light Company, and Aquila, Inc. for Approval of the Merger of Aquila, Inc. with a Subsidiary of Great Plains Energy Incorporated and for Other Requester Relief	)	**Case No. EM-2007-0374**

AFFIDAVIT OF MICHAEL W. CLINE

STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

Michael W. Cline, being first duly sworn on his oath, states:

1. My name is Michael W. Cline. I work in Kansas City, Missouri, and I am employed by Kansas City Power & Light Company as Treasurer and Chief Risk Officer.

2. Attached hereto and made a part hereof for all purposes is my Supplemental Direct Testimony on behalf of Great Plains Energy Incorporated and Kansas City Power & Light Company consisting of fifteen (15) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Michael W Cline
Michael W. Cline

Subscribed and sworn before me this 8th day of August 2007.

Nicole A. Wehry
Notary Public

My commission expires: Feb 4 2011

" NOTARY SEAL "
Nicole A. Wehry, Notary Public
Jackson County, State of Missouri
My Commission Expires 2/4/2011
Commission Number 07391200