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UTILITY SERVICES - AUDITING

SURREBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

KANSAS CITY POWER & LIGHT COMPANY

CASE NO. ER-2014-0370

Jefferson City, Missouri
June 2015

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1 KCPL Witness Klote

2 Q. At page 34 of his rebuttal testimony Mr. Klote states that you made the
3 following statement in the Staff's Cost of Service Report "Staff has found numerous and
4 significant noncompliance with the Affiliate Transactions Rule on the part of KCPL over a
5 long period of time." Did you make that statement in the Staff Report?

6 A. Yes. As I noted in the Staff's Cost of Service Report in this case, "the Staff
7 performed a review of KCPL's affiliate transactions and corporate allocations as a part of its
8 rate case audit. This review was performed in conjunction with Staff's current review in
9 File No. EO-2014-0189." Mr. Klote is one of KCPL's main participants in File No.
10 EO-2014-0189 ("KCPL's CAM Case"), which concerns KCPL's request for Commission
11 approval of its Cost Allocation Manual, or CAM. Mr. Klote is very well aware of KCPL's
12 long history of noncompliance with the Commission's Affiliate Transactions Rule.

13 Q. Does Mr. Klote's testimony indicate to you that he expected Staff to list each
14 and every past KCPL violation of the Affiliate Transactions Rule in its Cost of Service Report
15 in this rate case?

16 A. Yes. At page 34 of his rebuttal testimony Mr. Klote states that "[t]he only
17 Staff allegation of KCP&L non-compliance with the Affiliate Transactions rule that can be
18 found in the Staff's Cost of Service Report (on page 15, lines 13-16) relates to Allconnect."
19 However, as stated in the Staff's Cost of Service Report, the review of KCPL's corporate
20 allocations and affiliate transactions in this rate case was done "in conjunction with" the
21 Staff's review in KCPL's CAM Case.

22 In supporting its relatively moderate corporate allocations/affiliate transactions cost-
23 of-service adjustments, the Staff did not find it necessary to recite, in detail, each and every
24 instance of KCPL's past poor performance in complying with the Commission's Affiliate

1 Transactions Rule. The Staff particularly did not find it necessary to list and describe each
2 and every KCPL Affiliate Transactions Rule violation that has no impact KCPL's cost of
3 service in this rate case.

4 Q. What are some of the major past KCPL Affiliate Transactions Rule failures?

5 A. KCPL violated the Commission's Affiliate Transactions Rule when it failed to
6 report a significant affiliate transaction with its then affiliate Great Plains Power (GPP).
7 Failing to report a significant, approximately \$2 million dollar purchase from an affiliate is
8 not just an oversight by KCPL. This action indicates a lack of concern with adherence to the
9 Affiliate Transactions Rule by KCPL management. Failure to report to the Commission,
10 as required, a significant affiliate transaction also reveals a lack of policies, procedures and
11 internal controls being in place to prevent such a significant rule violation. While this
12 significant Affiliate Transactions Rule violation may have occurred a few years ago,
13 KCPL has made no changes in its CAM and its affiliate transactions policies and procedures
14 to prevent such a significant violation of the Affiliate Transactions Rule from recurring in
15 the future.

16 If KCPL had made such changes, this GPP issue would not be an issue in this rate
17 case. It is an issue because the continued lack of affiliate transactions policies and procedures
18 have caused significant ratepayer harm through higher costs being reflected in KCPL's cost of
19 service regulated accounts. The very costs KCPL is seeking to pass on to its customers in this
20 case. The Staff's adjustments in this case are designed only to reduce the extent of this
21 ratepayer harm. Staff does not have the resources necessary to quantify and remove all the
22 inappropriate costs in KCPL's books and records that are the result of KCPL's lack of
23 effective internal controls and policies and procedures to protect its customers.

1 In its Report and Order in Case No. ER-2010-0355 the Commission found that KCPL
2 significantly overstated the value of the Crossroads Energy Center ("Crossroads") it acquired
3 from Aquila, Inc. in the acquisition of Aquila Inc.'s Missouri electric properties (now named
4 Kansas City Power & Light – Greater Missouri Operations, or "GMO").

5 KCPL failed to apply Paragraph (2)(A)1 of the Affiliate Transactions Rule to the
6 Crossroads Energy Center. This part of the Affiliate Transactions Rule required KCPL to
7 record this asset at the lower of the fair market price ("FMP") of the asset or KCPL's fully
8 distributed cost ("FDC") to KCPL to provide the good or service to itself. As with the GPP
9 affiliate transactions rule issue, recording a non-regulated asset from an affiliate at an amount
10 that significantly exceeded the fair market price of that asset represents, not a management
11 oversight, but a significant lack of concern about affiliate transactions in general and a lack of
12 in-place internal controls and policies and procedures designed to protect regulated utility
13 customers from affiliate abuses.

14 **Crossroads Affiliate Transaction**

15 Q. Please further describe the Crossroads affiliate transactions issue.

16 A. KCPL management's handling of the Crossroads issue is possibly the
17 most serious violation of the Commission's Affiliate Transactions Rule since the Rule was
18 adopted in 2001. Schedule CRH-s1 to this testimony is a memorandum prepared by
19 Mr. Klote that describes Crossroads and the long history of how Aquila, KCPL and GMO
20 accounted for the transfers of this asset from Aquila's nonregulated merchant operations to
21 KCPL's nonregulated operations and finally to GMO's regulated plant in service accounts and
22 rate base.

1 Crossroads is a power plant formerly owned by a GMO affiliate which was, at one
2 time, a merchant company investment that was transferred to GMO's regulated operations.
3 On August 31, 2008, Crossroads was moved from GMO's business unit non-regulated
4 (NREG), where it was recorded after the acquisition of Aquila, Inc. by Great Plains Energy on
5 July 14, 2008, to GMO's regulated books and records. GMO is the regulated business unit
6 which previously served the territory known as Missouri Public Service ("MPS").

7 On September 5, 2008, after KCPL completed the acquisition of GMO, GMO filed a
8 rate case including the Crossroads in GMO's rate base at net book value. The transfer was
9 not reported in KCPL's CAM, which is in conflict with the requirements of the Affiliate
10 Transactions Rule.

11 Further the Affiliate Transactions Rule was not followed regarding this asset in that
12 KCPL apparently failed to do any serious analysis to determine the fair market price of the
13 Crossroads Energy Center as required by the Affiliate Transactions Rule when it attempted to
14 include this asset in GMO's rate base at the original cost when Crossroads was constructed by
15 Aquila, Inc. as a non-regulated merchant asset. KCPL simply recorded the purchase at
16 Aquila's original cost, and not even on the fair market price of Crossroads that KCPL
17 attributed to the asset when it purchased Crossroads from Aquila in July 2008.

18 Great Plains and Aquila publically disclosed an objective "fair market valuation" of
19 \$51.6 million for Crossroads in February to May 2007. Great Plains and Aquila released this
20 valuation to the public on at least three occasions from May 2007 to August 2007 in joint
21 proxy statements and amendments Great Plains and Aquila filed with the Securities and
22 Exchange Commission ("SEC"). That "fair market valuation" was Great Plains' estimate that
23 it would receive \$51.6 million in proceeds from the sale of Crossroads to an unrelated party in

1 the then current market place. The following is a quote from the Great Plains and Aquila joint
2 proxy statement and amendments:

3 D - The pro forma adjustment represents the adjustment of the
4 estimated fair value of certain Adjusted Aquila non-regulated
5 tangible assets and reduction of depreciation expense associated
6 with the decreased fair value. The adjustment was determined
7 based on Great Plains Energy's estimates of fair value based on
8 estimates of proceeds from sale of units to an unrelated party of
9 similar capacity in the current market place. The preliminary
10 internal analysis indicated a fair value estimate of Aquila's non-
11 regulated Crossroads power generating facility of
12 approximately \$51.6 million. This analysis is significantly
13 affected by assumptions regarding the current market for sales
14 of units of similar capacity. The \$66.3 million adjustment
15 reflects the difference between the fair value of the combustion
16 turbines at \$51.6 million and the \$117.9 million book value of
17 the facility at March 31, 2007.

18
19 Great Plains Energy management believes this to be an
20 appropriate estimate of the fair value of the facility. The
21 adjusted value will be depreciated over the estimated remaining
22 useful lives of the underlying assets and could be materially
23 affected by changes in fair value prior to the closing of the
24 merger. An additional change in the fair value of the facility of
25 \$15 million would result in an additional change to annual
26 depreciation expense of approximately \$0.5 million.

27
28 [Great Plains Energy & Aquila Joint Proxy
29 Statement/Prospectus the SEC on May 8, 2007, page 175]

30 Aquila, the owner of Crossroads in 2007, also stated that the "fair market value" of
31 Crossroads was \$51.6 million since it was party to the Joint Proxy Statement/Prospectus filed
32 with the SEC in May 2007.

33 Q. Did both Aquila and KCPL attempt to sell Crossroads on the open market?

34 A. Yes. However, neither Aquila nor KCPL found any willing buyers. That fact
35 alone is a strong indication that the price Aquila and KCPL were willing to sell Crossroads
36 (presumably a price below its cost) was above the actual fair market price of Crossroads.

1 The market determined the price or value of Crossroads and the market determined that the
2 fair market price was significantly below the cost of the asset that KCPL management sought
3 to include in GMO's rate base. This is what the Staff found and presented to the Commission
4 in a subsequent rate case.

5 Q. How did the Commission rule on this issue?

6 A. Just as found by the Staff, the Commission ruled that KCPL had
7 significantly overstated the fair market value of the Crossroads asset on its books. KCPL
8 sought to value Crossroads at an amount exceeding \$100 million while the Commission found
9 the fair market price of Crossroads to be \$61.8, for a difference of approximately \$38 million.
10 The Commission noted in paragraphs 26 and 275 of its Report and Order in File No.
11 ER-2010-0356:

12 26. Recognizing that Crossroads was transferred from a
13 non-regulated affiliate to the Missouri regulated operations, the
14 Commission's affiliate transaction rule is implicated. The
15 affiliate transaction rule, as it applies to the immediate issue,
16 provides that the purchase of —goods or services— from an
17 affiliate shall be —the lesser of: (a) fair market price; or (b) the
18 fully distributed cost.
19

20 275. Considering the depressed market as exhibited by the sale
21 of similar turbines to Ameren, and the valuation of these assets
22 reported to the SEC by GPE, the Commission finds that
23 \$61.8 million is an accurate reflection of the fair market value
24 of Crossroads as required by the affiliate transaction rule as of
25 July 14, 2008.

26 **Great Plains Power ("GPP") Affiliate Transaction**

27 Q. Beginning at page 34 and continuing on to page 35 of his rebuttal testimony
28 Mr. Klote discusses the affiliate transaction between KCPL and its former affiliate GPP.
29 Mr. Klote states that the GPP issue was "fully examined" by the Commission in past rate
30 proceedings. Is that a correct statement?

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1 A. No. KCPL and specifically KCPL witness Darrin Ives took specific actions to
2 limit the examination of the GPP issue by the Commission in Case No. ER-2010-0355.

3 Q. Please explain.

4 A. The Staff first filed its Iatan Construction Audit Report on December 31, 2009.
5 In this report the Staff reported its findings and conclusions about KCPL's violation of the
6 Affiliate Transactions Rule and the imprudence of charging the GPP costs to the
7 Iatan Construction Project. In Case No. ER-2010-0355, I filed direct testimony sponsoring
8 many of the Staff's Iatan construction audit adjustments including the GPP adjustments.
9 While many KCPL witnesses filed rebuttal and surrebuttal testimony responding to my direct
10 testimony and the specific Staff's construction audit adjustments, Mr. Ives did not. In fact, no
11 KCPL witness filed rebuttal or surrebuttal testimony expressing any disagreement with the
12 Staff's GPP adjustment. I was convinced at the time that KCPL had accepted the Staff's GPP
13 issue and it was no longer an issue in the rate case. It was not until February 28, 2011 when
14 KCPL witness Ives filed True-Up Rebuttal testimony that KCPL addressed the GPP issue for
15 the first time since the Staff's December 2009 Audit Report. Thus, due to the actions of
16 KCPL, the Staff did not have the opportunity to file any responsive testimony because there
17 was no provision for surrebuttal testimony. The specific actions taken by KCPL did not allow
18 for a full and open discussion of the GPP issue before the Commission in that rate case, which
19 is the exact opposite of the situation which Mr. Klote describes in his rebuttal testimony.

20 Q. Please provide a brief summary of this affiliate transaction.

21 A. GPP was a subsidiary of KLT, Inc., which is a wholly owned subsidiary of
22 Great Plains. GPP sold to KCPL, at cost, certain assets (environmental permitting and
23 engineering surveys) on its books at the time of its dissolution. KCPL asserted that Iatan 2
24 would benefit from the assets acquired from GPP. KCPL's CAM did not report this asset

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1 transfer, identify the transfer cost basis, or reflect any market value evaluation required to
2 determine whether the transfer was made at the lower of fully distributed cost or fair market
3 price as specified in 4 CSR 240-20.015(2)(A)1.

4 In response to Staff Data Request No. 844 in Case No. ER-2009-0089, KCPL stated
5 that: "No reports were filed on this transaction. This was an error and should have been
6 reported." Also in this response KCPL said that had it not acquired the assets from GPP, it
7 would have to purchase the same or similar services at the same or potentially higher costs
8 and that KCPL believed that the price paid to GPP based on GPP's costs was the lower of
9 fully distributed cost or fair market price.

10 However, the requirements of the Affiliate Transactions Rule for determining fair
11 market price is much greater than simply relying on what a utility "thinks" the fair market
12 price may be. A fair market price is determined in the market at or near the time of the
13 transaction. The market at the time KCPL purchased these so-called GPP assets consisted of
14 only two entities, KCPL and GPP. There was no other willing buyer for these assets and
15 without KCPL's interest; the assets would have been worthless to GPP, which was in the
16 process of liquidation. In this situation KCPL had total control over the amount it would pay
17 its affiliate GPP. Nonetheless, KCPL decided to subsidize GPP by reimbursing GPP for its
18 full cost of the assets when the value of the assets in the open market was likely zero.

19 The issue here is not only whether or not the price KCPL paid its affiliate GPP was the
20 lower of KCPL's cost to acquire the assets or the fair market price of the assets. Another big
21 issue is that KCPL failed to report the transaction. By failing to report the transaction, the
22 Staff and other potentially interested parties were prevented from timely auditing the
23 transaction to determine at what price, if any, KCPL should have acquired these assets and if
24 these assets did in fact provide a benefit to KCPL in its construction of the Iatan 2 coal unit.

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1 The bottom line on the GPP issue is that KCPL's internal controls failed to report a
2 major affiliate transaction as required and KCPL failed to obtain the fair market price of the
3 assets at the time of the transaction, which is also required by the Affiliate Transactions Rule.
4 The Staff does not believe these issues would have taken place if KCPL had the type of
5 controls in effect at the time of the purchase of assets from its now defunct affiliate GPP.
6 While the GPP and Crossroads issues did take place several years ago, the Staff is aware of no
7 substantive changes made by KCPL to its CAM to prevent similar transactions from recurring
8 in the future. KCPL is still operating under the same CAM and the same affiliate transaction
9 processes and procedures that it was operating under when it failed to report the GPP
10 transaction and when it recorded the Crossroads asset on GMO's books and records at an
11 amount over \$100 million, significantly exceeding its fair market value.

12 Q. Did the Staff, KCPL and the Commission all agree that KCPL was in violation
13 of the Commission's Affiliate Transactions Rule when KCPL purchased the assets
14 (site surveys) from its defunct affiliate, GPP, and failed to report to the Commission?

15 A. Yes. The Staff presented evidence to the Commission of KCPL's failure to
16 report this material violation and, in its Report and Order in Case No. ER-2010-0355, the
17 Commission noted that even KCPL agrees "they were in error" for not reporting the
18 transaction to the Staff and the Commission:

19 169. The Companies agree that they were in error for not
20 reporting the transaction in the annual affiliate transaction
21 report. . . .

22 Q. What specific requirements of the rule did KCPL violate for failing to report
23 the GPP affiliate transaction?

24 A. In just the one act of failing to report the GPP affiliate transaction, KCPL
25 violated the following requirements of the Commission's Affiliate Transactions Rule:

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1 *KCPL violated Paragraph (2)(D), which prohibited KCPL from
2 engaging in any affiliate transaction which is not in compliance with
3 the rule unless KCPL sought and obtained a variance from the rule.

4 *KCPL violated paragraph (3)(D) which required KCPL to use a
5 commission-approved CAM which sets forth cost allocation, market
6 valuation and internal cost methods.

7 *KCPL violated paragraph (4)(B)2 which requires KCPL to provide to
8 the Staff and OPC on, or before March 15 of the succeeding year a full
9 and complete list of all goods and services provided to or received from
10 affiliated entities.

11 *KCPL violated paragraph (4)(B)3 which requires KCPL to provide to
12 the Staff and OPC on, or before March 15 of the succeeding year a full
13 and complete list of all contracts entered with affiliated entities.

14 *KCPL violated paragraph (4)(B)5 which requires KCPL to provide to
15 the Staff and OPC on, or before March 15 of the succeeding year the
16 amount of all affiliated transactions by affiliated entity and account
17 charged.

18 *KCPL violated paragraph (4)(B)6 which requires KCPL to provide to
19 the Staff and OPC on, or before March 15 of the succeeding year the
20 basis used to record each type of affiliate transaction, such as the fair
21 market price of assets acquired from GPP or KCPL's costs of acquiring
22 the assets for itself.

23 *KCPL violated paragraph (4)(C)1 which requires KCPL to maintain
24 information identifying the basis used to record the GPP affiliate
25 transaction.

26 *KCPL violated paragraph (4)(C)2 which requires KCPL to maintain
27 books of accounts and supporting records in sufficient detail to permit
28 verification of compliance with the rule.

29 Q. While the Commission agreed with the Staff that KCPL violated the Affiliate
30 Transactions Rule for not reporting the purchase of assets from its affiliate GPP, did the
31 Commission accept the Staff's adjustment to exclude the costs of these assets from the
32 Iatan Construction Project?

33 A. No. The Commission ruled at paragraph 164 of its ER-2010-0355 Report and
34 Order that as it relates to KCPL's affiliate transaction with GPP "*Staff has not raised a serious*
35 *doubt as to the prudence of these costs that can overcome the presumption of prudence*

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1 *afforded to KCP&L. Based upon a prudence analysis, the affiliate transactions were prudent*
2 *when looking at the circumstances known by KCP&L at the time the decision was made."*

3 Because the Commission ruled that the Staff did not meet its burden of raising a serious doubt
4 about the prudence of these expenditures it had to accept KCPL's position that the "assets"
5 purchased in the affiliate transaction with GPP were necessary for the construction of the
6 Iatan 2 construction project, which the Commission recited in paragraphs 165, 166 and 167 of
7 its Report and Order.

8 Q. At page 34 of his rebuttal testimony Mr. Klote states that in the Commission's
9 ER-2010-0355 Report and Order the "Commission rejected the disallowance proposed
10 by Staff, finding that "it would have been of no value to complete a market review of what
11 it would cost to do an environmental permitting and engineering study at the time of
12 the purchase of the GPP work as the study was being purchased at cost." Is this
13 statement accurate?

14 A. No. Mr. Klote is misreading the Commission's Report and Order. As
15 I explained above, the Commission rejected the Staff's proposed disallowance to the Iatan 2
16 coal plant for the GPP costs because the "*Staff has not raised a serious doubt as to the*
17 *prudence of these costs that can overcome the presumption of prudence afforded to KCP&L.*
18 *Based upon a prudence analysis, the affiliate transactions were prudent when looking at the*
19 *circumstances known by KCP&L at the time the decision was made."*

20 The Commission did not reject Staff's proposed disallowance because of KCPL's
21 failure to comply with the 4 CSR 240-20.015(2)(A). This was clearly stated by the
22 Commission at paragraph 168 of the Report and Order that the Commission was not
23 addressing the Staff's proposed disallowance but KCPL's actions as it relates to Paragraph
24 (2)(A) of the rule:

1 168. As far as the affiliate transaction rule (4 CSR 240-20.015(2)(A),
2 the rule requires that the compensation to GPP be the lower of the fair
3 market price or the cost to provide the services for itself. In this case, it
4 would have been of no value to complete a market review of what it
5 would cost to do an environmental permitting and engineering study at
6 the time of purchase of the GPP work as the study was being purchased
7 at cost.

8 Q. Did the Commission state that KCPL was not in violation of the rule when it
9 did not seek to find out what the current market value of the previously-completed
10 engineering surveys acquired by GPP?

11 A. No, it did not. However, I do not believe this is correct. The Commission was
12 clear and it said it would have been "of no value" for KCPL to determine the fair market price
13 of the site surveys when it decided how much to pay to GPP for these surveys because KCPL
14 was purchasing the surveys at cost. The statement of "no value" is found in KCPL's briefs in
15 that rate case. As I noted above, KCPL's not addressing the GPP issue until the very last
16 possible opportunity restricted a full and open discussion of the GPP issue. To me, it is very
17 clear why KCPL did not want this full and open discussion and chose to operate in the manner
18 it did

19 Q. Do you understand the rationale in paragraph 167 of the Report and Order why
20 the determination of the fair market price of the assets purchased from KCPL's GPP affiliate
21 would be of no value to KCPL in the application of Paragraph (2)(A) of the rule?

22 A. No, I don't. KCPL was in a position that it considered the purchase of what it
23 considered to be something of value from a company that was going out of business and
24 liquidating its assets – GPP. GPP was in the process of dissolution. As discussed above, the
25 items that KCPL considered to have value – engineering studies on the land that it was
26 considering to build Iatan 2 had no value to any other entity except KCPL. GPP's only option

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1 in this transaction was to sell KCPL these items at whatever dollar amount KCPL would be
2 willing to pay for these items. Otherwise GPP would get nothing for these assets. KCPL had
3 GPP, its affiliate, over the barrel on this transaction and could have paid significantly less to
4 GPP to acquire the rights to these assets.

5 It is unreasonable to believe that GPP would have demanded that KCPL had to pay it
6 dollar-for-dollar what it, GPP, paid for these items. Actually, since KCPL was GPP, both
7 entities had the same management; KCPL was negotiating with itself to determine the amount
8 to pay GPP. If KCPL treated GPP as a non-affiliated entity and conducted this transaction in
9 the open market (which are the conditions the Rule is intended to impose on affiliate
10 transactions) and in a prudent manner, then KCPL would have paid GPP much less than
11 GPP's cost to acquire the assets. To any entity, other than possibly KCPL, these GPP assets
12 were worthless. They had no value.

13 However, regardless of whether or not the Commission ruled that the determination of
14 a fair market price to compare with KCPL's cost of acquiring the asset itself was of no value
15 that still does not relieve KCPL of complying with Paragraph (2)(A) of the rule. If KCPL
16 believed that it did not need to find out what the current market value of the GPP work was,
17 and did not need to comply with Paragraph (2)(A) of the rule, it was required to seek a
18 variance in accordance with Paragraph (10)(A)(2) which allows KCPL to engage in an
19 affiliate transaction not in compliance with Paragraph (2)(A) when to KCPL's "best
20 knowledge and belief" compliance with Paragraph (2)(A) would not be in the best interests of
21 its regulated customers and it notifies the Commission and the OPC within ten days of the
22 non-complying affiliate transaction.

23 Q. Did KCPL seek a variance for its GPP affiliate transaction?

24 A. No.

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1 Q. How is Mr. Klote's reading of the Commission Report and Order, that KCPL
2 did not violate Paragraph (2) (A) of the rule fundamentally wrong?

3 A. According to Mr. Klote's understanding, KCPL is free to not comply with
4 Paragraph (2)(A) of the rule whenever it believes that complying with the rule "would be of
5 no value." Clearly this is not the ruling of the Commission at paragraph 168 of its Report and
6 Order in Case No. ER-2010-0355. Such action is noncompliant with the affiliate transaction
7 rule and actually defeats the purpose of the rule.

8 Q. Do you believe that if the Commission was faced with this same affiliate
9 transaction today that its decision could very well be different?

10 A. Yes. I am not an attorney but there is a fairly recent Missouri Supreme Court
11 Opinion that I will make note of its existence. In *Office of Public Counsel v. Missouri Public*
12 *Serv. Comm'n*, 409 S.W.3d 371 (Mo.banc 2013; reh.denied; Op. Mod. Sept.10, 2013),
13 attached as Schedule CRH-s2, the Missouri Supreme Court provided to the Commission
14 guidance on the application of the presumption of prudence to affiliate transactions:

15 Further, the presumption of prudence is not even a creature of
16 statute or of PSC regulations or rules. It was created by PSC
17 case law. It cannot be applied inconsistently with the PSC's
18 governing statutes and rules. As discussed above, the
19 application of a presumption of prudence to a transaction with
20 an affiliated company is inconsistent with the PSC's statutory
21 and regulatory obligations to review affiliate transactions.
22 Accordingly, the presumption of prudence is inapplicable to
23 affiliate transactions. 409 S.W.3d at 379.

24 Q. In the Missouri Supreme Court Opinion relevant to the Commission's decision
25 on KCPL's GPP affiliate transaction in Case No. ER-2010-0355?

26 A. Yes, as noted above, the Commission used the "presumption of prudence" as a
27 basis for its decision on the GPP affiliate transaction. The Commission stated "*Staff has not*
28 *raised a serious doubt as to the prudence of these costs that can overcome the presumption of*

1 | *prudence afforded to KCP&L. Based upon a prudence analysis, the affiliate transactions*
2 | *were prudent when looking at the circumstances known by KCP&L at the time the decision*
3 | *was made." The Commission Order in Case No. ER-2010-0355 was issued on April 12, 2011*
4 | *more than two years before the opinion in *Office of Public Counsel v. Missouri Public Serv.**
5 | *Comm'n, 409 S.W.3d 371 (Mo.banc 2013; reh.denied; Op. Mod. Sept.10, 2013).*

6 | Q. Are the GPP and Crossroads affiliate transaction violations, as well as other
7 | KCPL affiliate transaction rule violations described more fully in your rebuttal testimony in
8 | the concurrent KCPL CAM case, File No. EO-2014-0189?

9 | A. Yes, they are.

10 | **Staff's Corporate Allocations/Affiliate Transactions Rate Case Adjustments**

11 | Q. Briefly summarize the Staff's corporate allocations and affiliate transaction
12 | adjustments you are sponsoring in this case.

13 | A. In its direct testimony in this case Staff proposed five corporate allocation
14 | and affiliate transactions adjustments, referred to as Staff Adjustment 1 through Staff
15 | Adjustment 5 in this testimony. A brief summary of these adjustments are:

16 | Staff Adjustment 1 removes test year expenses charged to KCPL's
17 | regulated accounts using the Corporate ("Corp") Massachusetts
18 | Factor and adds back to test year expenses the charges that would
19 | have been made using KCPL's newly-adopted 2015 General
20 | Allocator. This adjustment is not contested by KCPL.

21 | Staff Adjustment 2 removes test year expenses charged to KCPL's
22 | regulated accounts using the "Utility" Massachusetts Factor and adds
23 | back (in the same manner as Staff Adjustment 1) to test year expenses
24 | the charges that would have been made using the 2015 General
25 | Allocator. This adjustment is contested by KCPL.

26 | Staff Adjustment 3 restates KCPL's proposed adjustment CS-117
27 | using the General Allocator as opposed to the Corp Mass Factor
28 | allocation percentages used in KCPL adjustment CS-117. KCPL's
29 | adjustment CS-117 is designed to allocate the benefits of common use
30 | plant in service among the entities that benefit from this plant. This
31 | adjustment is not contested by KCPL.

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1 Staff Adjustment 4 removes the impact of KCPL's transactions with
2 Allconnect. The Staff has a number of serious concerns with KCPL's
3 business association with Allconnect, which Staff witness Lisa
4 Kremer briefly notes in her section of the Staff Cost of Service
5 Report. The Staff filed on December 19, 2014 a Report of Staff's
6 Investigation respecting the Allconnect Direct Transfer Service
7 Agreement in File No. EO-2014-306. On May 20, 2015 Staff filed a
8 formal complaint with the Commission in File No. EC-2015-0309.
9 This adjustment is contested by KCPL.

10 Staff Adjustment 5 is referred to as Staff's consolidated corporate
11 allocations adjustment. This adjustment is designed to accomplish
12 three objectives. The adjustment reduces KCPL's overhead expenses
13 by \$750,000 on a total company basis and is designed to reduce the
14 level of risk that KCPL's customers will be significantly harmed
15 through inappropriate cost allocations such as employee
16 compensation and benefits, excessive expense report costs, and
17 KCPL's noncompliance with the Commission's Affiliate Transactions
18 Rule. This adjustment is contested by KCPL.

19 Q. Mr. Klote testifies that KCPL is in agreement with Staff Adjustment 1 and 3
20 listed above, but takes issue with Staff adjustments 2, 4, and 5. Is that correct?

21 A. Yes.

22 Q. What is KCPL witness Klote's response to the Staff's Adjustment 1 which
23 substitutes the Corp Mass Formula with the 2015 General Allocator?

24 A. Mr. Klote begins his discussion of all of these adjustments at page 26 of his
25 rebuttal testimony where he lists as "Item 10. Affiliate Transactions item a. Corporate General
26 Allocator." At pages 26 and 27 Mr. Klote explains that KCPL agrees with Staff
27 Adjustment 1, which is based upon replacement of KCPL's prior Corporate
28 Massachusetts Formula allocation factor with use of a "General Allocator" allocation factor
29 ("2015 General Allocator"). KCPL's adoption of the new General Allocator as of January 1,
30 2015 is a result of KCPL, Staff and OPC's discussions in KCPL's current CAM case, File No.
31 EO-2014-0189.

32 Q. KCPL's use of a General Allocator is pursuant to a tentative understanding
33 between the Staff and KCPL in File No. EO-2014-0189. Is that correct?

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1 A. Yes. While Staff and KCPL have agreed to the use of a General Allocator in a
2 general sense, the Staff has not agreed to any specificity in the design of a General Allocator.

3 Q. What is the difference between a Massachusetts Formula type of allocation
4 factor and the General Allocator now used by KCPL to allocate costs charged to Operating
5 Unit 10105?

6 A. The basic type of Massachusetts Formula allocation factor is an allocation
7 factor that is used by utilities primarily to allocate residual corporate overhead costs. Residual
8 corporate overhead costs are costs that are not directly charged to a specific corporate entity
9 and cannot be reasonably allocated using a more specific cost-causative allocation factor.
10 A good example of this type of costs is the portion of utility officer compensation and benefits
11 that have not been directly charged to a specific corporate entity.

12 The original design of the Massachusetts formula was based on the ratio of direct
13 labor, capital investment and gross revenue of each affiliate to total direct labor, capital
14 investment and gross revenue of all entities in the corporate umbrella. The unmodified
15 Massachusetts formula is derived from *Midwestern Gas Transmission Co. v. Federal Power*
16 *Com.*, 32 FPC 993 (1964). Different utilities use different variations of the three basic
17 components of the Formula. See Schedule CRH-s3, Staff Response to Commission Request
18 in Case No. GR-2009-0355, for a more complete general description of the Massachusetts
19 formula.

20 The General Allocator is different from the Massachusetts Formula allocator in that it
21 does not attempt to allocate costs based on the relative size of the entities. This focus on the
22 relative size of the entities under the allocation is the basis of the Massachusetts Formula.
23 The use of a General Allocator is appropriate, and the use of a Massachusetts Formula
24 allocator is not appropriate, when residual corporate overhead costs are being allocated among

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1 entities that are not basic utility companies that have material levels of revenues, plant and
2 payroll. The General Allocator is simply a ratio allocates cost to entities based on the total
3 direct charges and allocated costs (using cost causative allocation factors, such as square feet
4 for lease expense) assigned to a particular entity as the numerator. The denominator is total
5 allocable costs in the relevant cost pools. Basically, the philosophy underlying the use of the
6 General Allocator is that the allocation of residual corporate overhead costs should follow the
7 level of direct charges and other allocated costs assigned to a specific entity.

8 Q. Does the Staff believe that KCPL has appropriately calculated the General
9 Allocator?

10 A. No. I learned of KCPL's January 1, 2015 adoption of a General Allocator
11 when I reviewed KCPL's response issued February 26, 2015 update (reflecting January 2015
12 data) to Staff Data Request No.14. In that data request response, KCPL advised that it is
13 currently allocating costs formerly allocated under the Corporate Massachusetts Formula
14 under the new General Allocator:

15 Attached are the indirect corporate allocation factors used for
16 January 2015. In January, the Corporate Massachusetts
17 Formula, used to allocate general and corporate type costs, was
18 replaced with the General Allocator. The remaining indirect
19 factors did not change from December.

20 Q. Does KCPL's new January 2015 General Allocator allocate any residual
21 corporate overhead costs of KCPL's affiliated company Transource Energy LLC
22 ("Transource")?

23 A. No. The following chart showing allocation percentages for residual corporate
24 overhead costs by KCPL to itself and its affiliates was received in response to Staff Data
25 Request No. 14, as a monthly update to that data request. The chart below shows that KCPL,

1 in 2015, has determined not to allocate any residual corporate overhead costs to Transource,
2 even as Transource plays a bigger and bigger role in Great Plains' company operations. This
3 result can only be the result of an error in KCPL's calculation of the General Allocator:
4

Data Request 14	CORP	
	MASS FORMULA	GENERAL ALLOCATOR
	Dec-14	Jan-15
GREAT PLAINS ENERGY	0.75%	0.49%
TRANSOURCE	0.06%	0.00%
PARNT	0.00%	0.10%
KLT	0.00%	0.00%
KCPL SOLAR INC	0.00%	0.04%
KC RECEIVABLES COMPANY	0.00%	0.50%
GMO RECEIVABLES COMPANY	0.00%	0.26%
GMO-MPS	21.09%	23.80%
GMO-L&P	8.13%	8.47%
KCPL	69.97%	66.34%
Total	100.00%	100.00%

5
6 Q. Did you address the fact that Great Plains and KCPL are focusing more on the
7 nonregulated operations of Transource in your sections of the Staff's Cost of Service Report?

8 A. Yes. As I noted at page 157 of the Staff's Cost of Service Report, KCPL is
9 continually increasing its focus on nonregulated activities:

10 KCPL and Great Plains seem to have an ever increasing
11 focus on nonregulated operations. An example of this
12 focus is KCPL and Great Plains' formation of
13 Transource Energy, LLC as a joint venture with AEP to
14 pursue competitive transmission projects. KCPL and
15 Great Plains have more recently entered the
16 nonregulated solar energy business with KCPL Solar,
17 Inc. As KCPL and Great Plains noted in their March
18 2015 Investor Presentation, the companies are
19 continually seeking other growth opportunities such as
20 selective future initiatives that will leverage KCPL's
21 core strengths.

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1 Q. Does Mr. Klote admit that KCPL has increased its focus on nonregulated
2 operations?

3 A. Yes. At page 40 of his rebuttal testimony, Mr. Klote admits that KCPL's
4 endeavors into KCP&L Solar, Inc. and Transource demonstrate KCPL's increased emphasis
5 on non-regulated operations. Mr. Klote's conclusion is supported by KCPL's June 1, 2015
6 Form 8-K filing with the SEC where it filed its Great Plains June 2015 Investor Presentation
7 (see Schedule CRH-s4).

8 At page 7 of this presentation KCPL included under the label "Strengthening Great
9 Plains Energy for the Long Term" four discrete areas where KCPL is "Focused on
10 Execution". These areas are Regulatory, Operations, Transmission and Financial. KCPL
11 described its focus on the Transmission area as "pursue competitive transmission projects
12 through Transource Energy LLC joint venture." This June 2015 Investor Presentation spends
13 considerable time on Transource and shows that Transource is a significant part of Great
14 Plains and KCPL's operations.

15 It is KCPL's position that, despite Transource being one of its four primary areas of
16 focus, none of Great Plains or KCPL's residual corporate overhead costs should be allocated
17 to Transource. This just does not make sense and it clear that KCPL is inappropriately
18 allocating costs under its 2015 General Allocator. As noted, Transource was allocated at least
19 some level of expenses in 2014 using KCPL's Corporate Mass allocation factor.

20 Q. Does it make any sense at all that an increased emphasis on the non-regulated
21 operations of Transource, which KCPL admits, can result in lower amount corporate overhead
22 costs from being allocated to Transource?

23 A. It makes no sense at all. This is, in part, why the Staff is proposing Staff
24 Adjustment 5, its consolidated corporate overhead and affiliate transaction adjustment. This

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1 adjustment is not only designed to protect KCPL's customers from excessive, imprudent and
2 inappropriately-allocated KCPL management charges to regulated operations, as will be
3 described below, but also to protect KCPL's regulated customers from an under allocation of
4 corporate overhead charges to non-regulated operations, such as Transource.

5 Q. What is Mr. Klote's response to the Staff's Adjustment 2 which substitutes
6 KCPL's "Utility" Massachusetts Formula allocation factor with the 2015 General Allocator?

7 A. At pages 29 through 31 of his rebuttal testimony Mr. Klote describes why, in
8 his opinion, the "Utility" Massachusetts Formula is the appropriate factor for allocating costs
9 in KCPL's Operating Unit 10106 that are only, in Mr. Klote's view "applicable" to
10 Great Plains' two utility operating utilities – KCPL and GMO. Mr. Klote's reasoning is that
11 there are certain costs incurred by Great Plains that only benefit KCPL and GMO and no
12 other Great Plains entities. Mr. Klote describes KCPL Operating Unit 10106, which he
13 claims houses only costs that are common only to KCPL and GMO, and should be allocated
14 only to KCPL and GMO.

15 Mr. Klote distinguishes between KCPL Operating Unit 10106 which is allocated using
16 KCPL's "Utility" Massachusetts Formula (or "Utility Mass Formula") (net plant, revenues and
17 payroll) and KCPL Operating Unit 10105, which, because these costs benefit all of
18 Great Plains' entities, is allocated to all Great Plains entities.

19 Q. Do you believe the use of KCPL's "Utility" Mass Formula allocation factor can
20 be appropriate for costs incurred solely for the benefit of KCPL and GMO?

21 A. Yes. The Staff is not opposed to the use of the Utility Mass Formula for costs
22 that benefit "only" KCPL and GMO. Costs that are incurred solely for the benefit of the
23 operating utilities can be appropriately allocated using a generic utility Massachusetts
24 Formula factor similar to the factor used by KCPL in the test year in this case.

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1 The Massachusetts Formula allocation factor used by KPCL is calculated using the
2 relative net plant in service, utility revenues and payroll expense. This factor is only
3 appropriate to use among a group of utilities that have significant dollar amounts of the
4 components of the allocation factor, such as plant, revenues and payroll. The basis of the
5 factor, which are plant, revenue and payroll, all have to be directly related to regulated
6 operations and all of the costs to be allocated using this factor have to be incurred solely for
7 the regulated operations of the utilities.

8 Q. If you believe the use of KCPL's Utility Mass Formula allocation factor may
9 be appropriately used for costs incurred solely for the benefit of KCPL and GMO in the test
10 year, why did you substitute the 2015 General Allocator for the Utility Mass Formula in
11 Staff's Adjustment 2?

12 A. In my review of KCPL's test year books and records I found that there was
13 no consistency in how KCPL applied its allocation methodologies. For this reason,
14 I determined that, for purposes of this rate case, all the dollars in KCPL's cost pools that are
15 subject to general allocation should all be allocated using one single allocation factor, the
16 2015 General Allocator.

17 During the course of Staff's audit of KCPL's cost allocations and affiliate transactions,
18 numerous examples were found where KCPL personnel recorded costs in Operating Unit
19 10106 (KCPL and GMO) when the costs actually were incurred to provide benefits to all
20 Great Plains entities, not just KCPL and GMO and should have been recorded in KCPL
21 Operating Unit 10105.

22 Q. Does Mr. Klote's rebuttal testimony concerning this issue contain inaccurate
23 statements concerning the "Utility" Massachusetts Formula allocation factor used to allocate
24 costs charged to Operating Unit 10106?

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1 A. Yes. The statement made by Mr. Klote at page 30 of his rebuttal testimony
2 that "...the Utility Massachusetts Formula only houses costs that are applicable to the
3 operating utilities of the Company" is not accurate. Also, the statement also at page 30
4 "...costs charged to this operating unit do not benefit all entities under the GPE corporate
5 umbrella, but instead only benefit the operating utilities" is also not accurate. Finally, the
6 statement made by Mr. Klote at page 30 that "costs in the Utility Mass operating unit are
7 distinguishable from common costs charged to Corporate Mass operating unit by the very fact
8 that they benefit only the utilities" is not accurate.

9 Q. Has KCPL admitted that it has significant problems in how it applied the
10 "Utility" Massachusetts Formula to costs in Operating Unit 10106 in the test year?

11 A. Yes. Staff issued a number of data requests to KCPL seeking an explanation
12 why KCPL used the "Utility" Massachusetts Formula to allocate certain KCPL and Great
13 Plains officers' expenses. In response to each and every one of these data requests KCPL
14 admitted that it has been "inconsistent" in use of the Utility Massachusetts Formula for cost
15 charged to Operating Unit 10106 and the costs identified should have been charged to
16 Operating Unit 10105.

17 Q. Please describe these data requests and KCPL's response.

18 A. The following are Staff questions and KCPL's response in Staff Data Request
19 Nos. 559, 564, 565, 566 and 567. KCPL's responses indicate that KCPL has little or no
20 internal controls over the process of allocating corporate overhead costs, particularly the costs
21 charged to KCPL and GMO only using the Utility Mass Formula. Based on the Staff's audit,
22 including KCPL's responses to the following data requests, the Staff finds that there is a
23 serious deficiency on the part of KCPL in its corporate cost allocations and affiliate
24 transaction recordings of costs that needs to be corrected immediately.

Staff Data Request No. 559

1 See expense report 0000042836. Reference the June 4, 2014 "lunch
2 interview with potential candidate for controller position". Since this
3 interview for the controller position charge was made to Operating
4 Unit 10106 and account 921, KCPL believes this charge benefits only
5 KCPL and GMO regulated operations and should be allocated using
6 the Utility Mass Formula. 1. Please explain why this interview for the
7 controller position should only be allocated to KCPL and GMO
8 operations. 2. Who made the decision that this interview for the
9 controller position charge benefits only KCPL and GMO regulated
10 operations? 3. How does this interview for the controller position
11 charge benefit only KCPL and GMO regulated customers?
12

KCPL Response to Staff Data Request No. 559

13 The Company made an adjustment to reduce rate recovery of GPE
14 Officer expenses by approximately \$67k (Missouri jurisdictional) in
15 recognition of inconsistent coding of expenses during the test year.
16 The Company and Staff personnel have made significant progress in
17 establishing an agreed upon CAM which the Company expects will
18 improve consistency of coding going forward. The charge questioned
19 above should have been coded to Operating Unit 10105 which would
20 have spread the cost across all Business Units (including non-
21 regulated units).
22

Staff Data Request No. 564

23 See expense report 0000038836 Reference the prizes and favors for
24 Accounting Division for holiday luncheon on December 11, 2013 that
25 were charged to Operating Unit 101106 Utility Mass Formula account
26 921. 1. Does the Accounting Division only provide services to GMO
27 and KCPL's regulated operations, or does it provide services to all of
28 GPE's entities? 2. If it provides services to more than just KCPL's
29 and GMO's regulated operations, why was this charge made to Op
30 Unit 101106 which is only for KCPL's and GMO's regulated
31 operations? 3. Who made the decision that Accounting Division only
32 provides services to KCPL's and GMO's regulated operations? 4.
33 Please provide the name of the department and the KCPL/GPE
34 employee name(s) who are not in the Accounting Division and but
35 provide Accounting Services to GPE and KCPL businesses other than
36 KCPL and GMO.
37

KCPL Response to Staff Data Request No. 564

38 The Company made an adjustment to reduce rate recovery of GPE
39 Officer expenses by approximately \$67k (Missouri jurisdictional) in
40 recognition of inconsistent coding of expenses during the test year.
41 The Company and Staff personnel have made significant progress in
42 establishing an agreed upon CAM which the Company expects will
43 improve consistency of coding going forward. The charge questioned
44 above should have been coded to Operating Unit 10105 which would
45 have spread the cost across all Business Units (including non-
46 regulated units).
47

1 **Staff Data Request No. 565**

2 See expense report 0000039967. Reference the Kansas City Bar
3 Association dues for this GPE and KCPL Officer. Since this charge
4 was made to Operating Unit 101106 and account 921, KCPL believes
5 this charge benefits only KCPL and GMO regulated operations and
6 should be allocated on the Utility Mass Formula. Please explain how
7 the Kansas City Bar Association dues for this GPE and KCPL Officer
8 benefits only KCPL and GMO operations. Who made the decision
9 that this charge benefits only KCPL and GMO regulated operations?

10 **KCPL Response to Staff Data Request No. 565**

11 The Company made an adjustment to reduce rate recovery of GPE
12 Officer expenses by approximately \$67k (Missouri jurisdictional) in
13 recognition of inconsistent coding of expenses during the test year.
14 The Company and Staff personnel have made significant progress in
15 establishing an agreed upon CAM which the Company expects will
16 improve consistency of coding going forward. The charge questioned
17 above should have been coded to Operating Unit 10105 which would
18 have spread the cost across all Business Units (including non
19 regulated units).

20 **Staff Data Request No. 566**

21 See expense report 0000036735. Reference the August 18, 2013
22 "Political trip to Detroit . . . Since this political trip charge was made
23 to Operating Unit 10106 and account 921, KCPL believes this charge
24 benefits only KCPL and GMO regulated operations and should be
25 allocated using the Utility Mass Formula. 1. Please explain why this
26 political trip should only be allocated to KCPL and GMO operations.
27 2. Who made the decision that this political trip charge benefits only
28 KCPL and GMO regulated operations? 3. How does this political trip
29 charge benefit only KCPL and GMO regulated customers?

30 **KCPL Response to Staff Data Request No. 566**

31 Response: The Company made an adjustment to reduce rate recovery
32 of GPE Officer expenses by approximately \$67k (Missouri
33 jurisdictional) in recognition of inconsistent coding of expenses
34 during the test year. The Company and Staff personnel have made
35 significant progress in establishing an agreed upon CAM which the
36 Company expects will improve consistency of coding going forward.
37 The charge questioned above should have been coded to Operating
38 Unit 10105 which would have spread the cost across all Business
39 Units (including non-regulated units).

40 **Staff Data Request No. 567**

41 See expense report 0000036735. Reference the August 13, 2013
42 "funeral Flower Purchase" by a GPE officer for a relative of another
43 GPE Officer for \$71.53. Since this charge was made to Operating
44 Unit 101106 and account 921, KCPL believes this charge benefits
45 only KCPL and GMO regulated operations and should be allocated
46 on the Utility Mass Formula. 1. Please explain how this flower
47 purchase should only be allocated to KCPL and GMO operations. 2.

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1 Who made the decision that this charge benefits only KCPL and
2 GMO regulated operations?

3 **KCPL Response to Staff Data Request No. 567**

4 The Company made an adjustment to reduce rate recovery of GPE
5 Officer expenses by approximately \$67k (Missouri jurisdictional) in
6 recognition of inconsistent coding of expenses during the test year.
7 The Company and Staff personnel have made significant progress in
8 establishing an agreed upon CAM which the Company expects will
9 improve consistency of coding going forward. The charge questioned
10 above should have been coded to Operating Unit 10105 which would
11 have spread the cost across all Business Units (including non-
12 regulated units).

13 Q. Does the Commission's Affiliate Transactions Rule 4 CSR 240-20.015,
14 Affiliate Transactions, paragraph 5, Records of Affiliates, subparagraph (A) (3) require KCPL
15 to maintain its books and records to include, at a minimum, a description of costs that are not
16 subject to allocation to affiliate transactions as well as documentation supporting the
17 nonassignment of these costs to affiliate transactions?

18 A. Yes. If the costs charged to Operating Unit 10106 are not subject to allocation
19 to affiliate transactions, KCPL and Great Plains are required maintain books and records that
20 include this documentation. This is the type of documentation that KCPL would have
21 provided in response to many of these data request questions had it complied with the
22 Affiliate Transactions Rule and maintained this documentation.

23 Q. Was Mr. Klote aware of KCPL's lack of internal controls over its cost
24 allocations, especially the allocation of costs in Operating Unit 10106, when he criticized
25 Staff Adjustment 2 in his rebuttal testimony?

26 A. I do not know if Mr. Klote was aware of this significant problem, but if he was
27 not, I believe he should have been and he should have reviewed these transactions prior to
28 asserting in his rebuttal testimony that the associated costs were incurred for the benefit of
29 only KCPL and GMO operations.

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1 Q. What do KCPL's responses to Staff Data Request Nos. 559, 564, 565, 566 and
2 567 indicate to you?

3 A. First they indicate that KCPL has major problems in its allocation of corporate
4 overhead costs and it now recognizes that it has major problems. Secondly, it indicates
5 that KCPL is relying on Staff to create a CAM that minimizes the level of KCPL's
6 non-compliance with the Commission's affiliate transactions. It is problematic that it is Staff's
7 audit work that is identifying problems with KCPL's recording of corporate allocations and
8 affiliate transactions. KCPL has not demonstrated that its internal controls, if they even exist,
9 are sufficient to detect these problems without Staff oversight.

10 Q. Are the problems you noted the only instances of inappropriate cost allocations
11 by KCPL using the Utility Massachusetts Formula?

12 A. No. Several additional transactions recorded in KCPL's test year books and
13 records were noted by the Staff. Attached as Highly Confidential Schedule CRH-s5 is a list
14 of notes I compiled during my review of only a small number of KCPL's management's
15 expense reports.

16 Q. Do you have an estimate of the number of incorrectly recorded transactions or
17 the dollar amount of the inappropriately allocated charges to KCPL and GMO?

18 A. No. The body of evidence that I reviewed and on which my adjustment was
19 based was limited to a sampling of the test year expense report charges of only the 11 Great
20 Plains and KCPL officers.

21 KCPL employs over 1,000 management employees (including KCPL and Great Plains
22 Officers) who likely generate thousands of expense reports each year. My review, which only
23 included a fraction of these expense reports found a significant number of cost allocation and
24 affiliate transaction violations. There is no way to know exactly how many errors there are in

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1 KCPL's cost allocations and affiliate transactions charges related only to the area of employee
2 expenses, but I would estimate that the number is significant.

3 However, regardless of the exact number, given almost total absence of internal
4 controls that KCPL has placed over its cost allocations, the total number of transactions and
5 dollar amount of the inappropriate allocations to KCPL and GMO are, no doubt, a significant
6 concern. The significance of the problem is the failure of KCPL's internal control practices
7 and procedures to identify and correct these problems on a timely basis before being recorded
8 into its books and records.

9 The greater concern is that these problems are occurring at the highest level of the
10 KCPL organization and reflect the "tone at the top". The "tone at the top" is an audit risk
11 assessment factor that increases the potential audit risk of a problem when the problem is
12 occurring at the highest levels of a corporation. The "tone at the top" auditing principle
13 is based on the fact that a company's officers set the example for the rest of the organization
14 to follow.

15 Q. Did you find additional examples of inconsistency in KCPL's allocation of
16 costs to KCPL and GMO?

17 A. Yes. For example, the following reflects how the quarterly subscription to the
18 Wall Street Journal for KCPL's vice president of Safety and Corporate Services was allocated.
19 In four discrete periods, the costs were allocated using three different factors:

20 June 7, 2013 charged to Op Unit 10100 KCPL Direct Charge
21 December 6, 2013 charged to Op Unit 10105 – Corp Mass Formula
22 March 7, 2014 charged to Op Unit 10105 – Corp Mass Formula
23 September 28, 2014 charged to Op Unit 10106- Utility Mass Formula

24 Four charges for the exact same item, for the same KCPL employee, charged to KCPL's cost
25 of service using three different allocation factors. The level of internal controls over the

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1 recording of this simple subscription expense is an indicator of the level of internal controls
2 over thousands of expenses recorded in KCPL's books and records daily.

3 Q. How does KCPL charge its costs for travel and interactions with the Southwest
4 Power Pool ("SPP")?

5 A. I have noted that in several instances KCPL charges these costs to Operating
6 Unit 10106 which is allocated only to KCPL and GMO.

7 Q. Do these charges benefit Great Plains entities other than KCPL and GMO?

8 A. Yes. At a minimum, these charges benefit Transource Missouri.

9 Q. How does Transource describe itself?

10 A. On its website (<http://www.transourceenergy.com/about-us/>) AEP provides a
11 description of the Great Plains/AEP partnership in Transource that reflects the importance
12 Transource's membership in the Southwest Power Pool and other regional transmission
13 organizations.

14 Transource is a partnership between American Electric Power
15 and Great Plains Energy focused on the development of
16 competitive electric transmission projects. Transource's parent
17 companies combine more than 100 years of expertise in the
18 planning, design, engineering, construction and operation of
19 transmission systems with the innovative technologies, systems
20 and project management techniques of today. In all, AEP and
21 Great Plains Energy own and operate nearly 50,000 miles of
22 transmission lines.

23 Transource is a member of three regional transmission
24 organizations—the PJM Interconnection, the Midwest
25 Independent System Operator (MISO) and the Southwest Power
26 Pool (SPP)—which together serve all or part of 28 U.S. states,
27 the District of Columbia and the province of Manitoba in
28 Canada.

29 Headquartered in Columbus, Ohio and with offices in Kansas
30 City, Missouri and Dallas, Texas, Transource draws on the
31 experience and significant resources of AEP and Great Plains
32 Energy to drive down installed capital costs and achieve project
33 implementation milestones for customers

1 As noted above, Transource draws on the experience and significant resources of
2 Great Plains. Clearly, KCPL employees' interactions with the Southwest Power Pool benefit
3 KCPL's affiliate, Transource as much as they benefit KCPL and GMO. Yet, Staff has found
4 evidence that KCPL does not record costs associated with its interactions with the Southwest
5 Power Pool to Transource. If KCPL fails to directly charge Transource, or allocate to
6 Transource costs incurred that benefit Transource, KCPL's use of the General Allocator will
7 understate the allocation of residual corporate overhead costs to Transource.

8 **Allconnect Affiliate Transaction**

9 Q. At page 33 of his rebuttal testimony Mr. Klote states that the violation of the
10 Affiliate Transactions rule alleged by Staff related to Allconnect Inc. ("Allconnect") has
11 nothing to do with the allocation of corporate costs. Is that a true statement?

12 A. No. Each and every affiliate transaction engaged in by KCPL has an impact on
13 corporate cost allocations. Corporate cost allocations and affiliate transactions are inseparable.
14 Each affiliate transaction engaged in by KCPL must be charged to the affiliate directly and the
15 affiliate must be allocated its appropriate share of indirect costs, including an allocation of
16 residual corporate costs using the General Allocator.

17 When KCPL acts in partnership with Allconnect and Great Plains Energy Services
18 Incorporated ("GPES"), and treats the transaction as a nonregulated transaction, KCPL must
19 carve out of its cost of service, either the fully distributed cost ("FDC") of the transaction or
20 the fair market price ("FMP") of the transaction, whichever is higher.

21 Q. Please describe Allconnect and GPES.

22 A. Allconnect is a non-regulated marketing company. Allconnect markets
23 nonregulated services to KCPL and GMO regulated utility customers. GPES is a former

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1 Great Plains service company that consisted of transferred KCPL employees. It is now an
2 "inactive" KCPL affiliate with no employees. GPES entered into a contract with Allconnect,
3 (the Allconnect Direct Transfer Service Agreement, or "GPES/Allconnect contract") where
4 GPES committed KCPL to provide GPES with private customer information and access to
5 KCPL's regulated utility customers.

6 GPES is an affiliate of KCPL, and since Allconnect is under contract with GPES, and
7 not KCPL, KCPL's transactions entered into under the GPES/Allconnect contract are affiliate
8 transactions. This contractual relationship between GPES and Allconnect poses an additional
9 problem. An additional internal control issue identified by Staff's examination of these
10 activities is that GPES has no contractual authority to represent KCPL in contract
11 negotiations. In fact, KCPL employees perform all functions related to GPES as GPES has no
12 employees.

13 Q. Does GPES receive any reimbursement as a result of the Allconnect Direct
14 Transfer Service Agreement?

15 A. Yes. Allconnect pays KCPL in the form of monetary compensation for each
16 call transferred by KCPL-GMO to Allconnect, and other monetary compensation for
17 aforementioned products and services that Allconnect customer service representatives sell to
18 KCPL-GMO customers. These payments (revenues created solely due to employment of
19 KCPL's regulated tangible assets and intangible asset customer base) are excluded from
20 KCPL's cost of service used to determine Missouri electric customer rates.

21 Q. Is there evidence that GPES did not partner with Allconnect to benefit KCPL's
22 regulated customers?

23 A. Yes. GPES requires KCPL to record all revenues it receives from Allconnect
24 as non-regulated revenues and does not allow KCPL to record those revenues in its cost of

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1 service as a reduction to its cost of service. If KCPL's management was acting in its best
2 interest of KCPL as a regulated utility, it would record those revenues as a reduction in cost of
3 service and lessen the burden on its regulated customers. However, through its affiliate
4 relationship with GPES, KCPL is being forced to use regulated utility assets to provide non-
5 regulated services without adequate compensation to KCPL's regulated operations.

6 Q. Is the KCPL relationship with Allconnect controlled by Great Plains and
7 not KCPL?

8 A. Yes it is. The relationship is simply about Great Plains using KCPL's regulated
9 assets (call center facilities, software, and computers) and KCPL regulated employees to
10 generate revenues that KCPL will not record in its regulated operations. If KCPL had any
11 input on how these revenues would be recorded, and KCPL decided not to reflect these
12 revenues in KCPL's cost of service, then this would be a textbook definition of an imprudent
13 KCPL management decisions taken specifically to increase costs to KCPL's customers.
14 In this case, KCPL management does not even have the opportunity to act prudently as it
15 has no control over the Allconnect transactions. That control is maintained by Great Plains
16 using its "inactive" subsidiary, GPES. Staff witness Lisa Kremer will also address KCPL's
17 relationship with Allconnect in her surrebuttal testimony.

18 Q. Has KCPL violated the Commission's Affiliate Transaction Rule in its
19 partnership with Allconnect?

20 A. Yes. Commission Rule 4 CSR 240-20.015 Affiliate Transactions
21 paragraph (2) Standards, subparagraph (C) states:

22 Specific customer information shall be made available to
23 affiliated or unaffiliated entities only upon consent of the
24 customer or as otherwise provided by law or commission rules
25 or orders.

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1 In direct violation of this provision, KCPL has not, and does not, seek the consent of
2 its customers prior to making customer information such as address, phone number, etc.
3 available to Allconnect.

4 Also, the Commission's Affiliate Transactions Rule, 4 CSR 240-20.015
5 paragraph 2(A) prohibits KCPL from providing a financial advantage to GPES, its affiliate,
6 by servicing its contract with Allconnect. Paragraph 2(A)(2) determines that if KCPL does
7 not charge GPES the higher of the fair market price or KCPL's fully distributed cost of
8 providing customer information to Allconnect, KCPL is deemed to be providing GPES with a
9 prohibited financial advantage.

10 Q. Has KCPL made any attempt to determine the fair market price of the
11 customer information it gives to Allconnect?

12 A. No.

13 Q. Does this private customer information have value?

14 A. Yes. In fact, that is the only reason that Allconnect partners with GPES is to
15 gain access to KCPL's regulated utility customers and the customer information on which it
16 attempts to sell the customers other non-regulated services. This is private customer
17 information that KCPL does not make available to any other entity that is not an affiliate
18 of KCPL.

19 Q. What is KCPL witness Klote's response to the Staff's Adjustment 4 where
20 Staff removed the impact of KCPL's transactions with Allconnect from KCPL's above-
21 the-line utility operating accounts?

22 A. Mr. Klote opposes Staff Adjustment 4, although his testimony is not exactly
23 clear as to why Mr. Klote states that the initial purpose of using Allconnect was to transfer
24 calls from KCPL's customers seeking service to confirm the accuracy of customer

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1 information, such as name, address, etc.). He also states when KCPL's customers are
2 transferred to Allconnect, KCPL receives revenues that it records to nonutility below-the-line
3 accounts.

4 Staff disputes Mr Klote statements regarding of purpose of the Allconnect contract.
5 His explanation seems to suggest that the revenues received from Allconnect's verification of
6 the accuracy of KCPL customer information and the feature of allowing Allconnect to use the
7 customer information for its own purposes should be included in its cost of service because
8 this is a total regulated function. However, KCPL treats all revenues received from
9 Allconnect as non-regulated revenues.

10 Q. Mr. Klote implies at page 32 of his rebuttal testimony that Staff's Allconnect
11 adjustment results in ratepayer detriment. Is there any merit to this claim?

12 A. No. In the test year, KCPL only booked very minor expense credits on
13 KCPL's books to reflect the time and activities KCPL devotes to Allconnect. Based on an
14 inquiry from the Staff, KCPL advised (KCPL employee Amy Murray email to Staff on
15 March 30, 2015) that test year books and records only reflected \$41,465 in expense credits
16 related to Allconnect, which is approximately \$23,000 on a Missouri jurisdictional basis.

17 The Staff made its decision (as reflected in Staff Adjustment 4) to remove all the
18 effects of KCPL's affiliated relationship with Allconnect from KCPL's test year books and
19 records. This decision was based on Staff's belief that KCPL's relationship with Allconnect is
20 detrimental to KCPL's provision of utility service and KCPL's financial operations. Even if
21 KCPL's relationship with Allconnect was not inherently detrimental to KCPL's provision of
22 electric utility service, Great Plains has taken every effort to make sure that KCPL and its
23 customers are not fairly compensated for the use of KCPL's assets and employees in this
24 affiliated transaction relationship.

1 Q. Has the Staff filed a complaint case with the Commission related to KCPL's
2 relationship with Allconnect?

3 A. Yes. The Staff filed a complaint case against KCPL on May 20, 2015 seeking
4 that the Commission order KCPL to cease its relationship with Allconnect. The Staff finds
5 significant detriment to KCPL's regulated customers as a direct result of KCPL's dealings
6 with Allconnect. The Staff is seeking to protect KCPL's Missouri regulated customers from
7 KCPL's imprudent management actions causing a detriment to its regulated customers.

8 Q. In addition to the ratepayer detriment suffered as a result of KCPL's customers
9 being transferred to Allconnect, does the Staff have additional concerns with Allconnect?

10 A. Yes. KCPL's association with the servicing of the GPES contract with
11 Allconnect has resulted in an additional violation of the Commission's Affiliate Transaction
12 Rule related to the protection of customer information.

13 Q. Please explain.

14 A. When KCPL customer service employees transfer customer calls from the
15 KCPL Call Center to Allconnect's facilities and employees, it is also transferring customer
16 information without the customer's permission. 4 CSR 240-40.015 Affiliate Transactions
17 paragraph (2)(C) states that "Specific customer information shall be made available to affiliate
18 and unaffiliated entities only upon consent of the customer or as otherwise provided by law or
19 commission rules or orders." KCPL provides Allconnect with specific customer information
20 without the consent of the customer.

21 **Staff's Consolidated Corporate Allocations/Affiliated Transactions Adjustment**

22 Q. What is KCPL witness Klote's response to the Staff Adjustment 5, which is
23 Staff's \$750,000 Consolidated Corporate Allocations and Affiliate Transactions adjustment?

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1 A. Mr. Klote addresses this adjustment at pages 32 through 40 of his rebuttal
2 testimony in which he characterizes the adjustment as "unreasonable."

3 Q. Why does Mr. Klote find Staff Adjustment 5 to be unreasonable?

4 A. Mr. Klote believes the adjustment is arbitrary. He also believes that Staff has
5 overstated the level of KCPL's noncompliance with the Commission's Affiliate Transaction
6 rule, and that Staff has overstated the degree to which KCPL is currently, or will in the future,
7 be engaging in non-regulated operations.

8 Q. Does Staff Adjustment 5 include the approximate \$140,000 in GPE officer
9 expenses that, in response to a Staff Data Request, KCPL proposed to remove from its cost of
10 service in this rate case?

11 A. No. KCPL made the decision that it would not provide justification for certain
12 officer expense report costs addressed in Staff Data Request No. 502 ("DR 502"). KCPL
13 decided just to remove these costs from this rate case and stopped any further explanation into
14 these and other potentially related costs by its decision not to address this issue by providing
15 any further response to DR 502. KCPL notified the Staff of its decision not to address the
16 issues listed in DR 502 on or about April 6, 2015.

17 Based on certain expenses charged by just one KCPL management employee, Staff
18 asked a series of questions in an attempt to understand the business purpose of the expenses or
19 how these expenses received approval to be paid under KCPL's internal control procedures.
20 It is interesting to note that KCPL chose not to justify any of these charges as having a
21 legitimate business purpose, but nonetheless approved these expenses, paid these expenses
22 and charged them to regulated utility accounts where, unless challenged, the costs would have
23 been included in customer rates.

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1

Item	Tran Amt	Merchant	Long Descr
1	\$5,447	APPLESTORE #R283	Ipads for KCP&L Corp Communications team.
2	\$2,200	GREATER KANSAS CITY CH	Registration fee for the Greater KC Chamber of Comm Leadership Exch
3	\$1,119	CAPITAL GRILLE00080150	Marketing & Public Affairs Leadership Retreat. List attached.
4	\$918	APPLE STORE #R283	iPad for Communications team.
5	\$916	MGM GRAND/CRAFTSTEAK	Trave meal at EEI Conference. Attendee list attached to receipt.
6	\$815	HYATT HOTELS BOSTON	Hotel for CCIF Conference in Boston.
7	\$797	CHESAPEAKE ENERGY AREN	MPA Customer Research Trip to Oklahoma City. Attendee list attached.
8	\$738	12 BALTIMORE	Business Meal: Baby shower for (REDACTED). Attendee list attached.
9	\$659	CAPITAL GRILLE00080150	Business Meal RE: Customer Meeting RE: Guest list attached.
10	\$611	PIROPOS BRIARCLIFF	Business meeting to discuss KC city projects. Attendee list on receipt page.
11	\$559	DEL FRISCOS #8635	Business meal at EEI to discuss Solar
12	\$540	PIROPOS BRIARCLIFF	Business development meeting.
13	\$504	SOUTHWEST	Travel to Chicago/Hearland Dialogs
14	\$482	SOUTHWEST	Airfare to Chicago for meeting with Bridge Strategy.
15	\$454	SOUTHWEST	R/T business travel to Oklahoma City for Customer Experience trip.
17	\$411	AT&T*TEXT2PAY	Company cell phone data usage.
18	\$405	WARWICK ALLERTON HOTEL	Lodging/Chicgo/Hearland Dialogues
19	\$355	FINANCIAL RESEARCH INST	Purchase Big Book of Lists
20	\$344	SOUTHWEST	Airfare for Media Conference in St. Louis.
21	\$337	CAPITAL GRILLE00080150	Business development meeting. Attendee list attached.
22	\$327	SULLIVANS STEA00085365	Dinner w/(REDACTED), KC Royals
23	\$323	BRISTOL 162	Business Meal: Ameren
24	\$316	CAPITAL GRILLE00080150	Business Meal w/(REDACTED) of WPA Research to discuss customer research.
25	\$301	THE MAJESTIC RESTAURANT	Business meal to discuss iFactor additional attendees on receipt.
26	\$293	CAPITAL GRILLE00080150	Business meal with (REDACTED) to discuss government affairs.
27	\$293	AT&T*TEXT2PAY	Payment for company supported electronic device.
28	\$292	AT&T*TEXT2PAY	Payment for company provided electronic device.
29	\$287	APPLE STORE #R097	Ipad equipment for Corporate Communications Team
30	\$269	SULLIVANS STEA00085365	Dinner w/(REDACTED), Kansas City Water
31	\$263	APPLE STORE #R283	Ipad expense for Corporate Communicalton Team.
32	\$251	SULLIVANS STEA00085365	Business Meal RE: AllConnect Attendee list attached
35	\$220	LEGAL HARBORSIDE	Travel meal at CCIF in Boston w/ (REDACTED)
36	\$210	SOUTHWEST	KC Chamber of Comm Leadership Exch Conf in San Fransico, CA.
37	\$206	ATT*PAYMENT	Paymet for company provided electronic device.
38	\$206	ATT*PAYMENT	Payment for company cell phone replacement.
39	\$206	ATT*PAYMENT	Replacement of Company cell phone.
40	\$206	ATT*PAYMENT	Payment for company cell phone

2

3

4

Reference the attached Excel spreadsheet which lists certain expense report charges and questions listed below related to those charges:

5

A Nos. 37-40, please explain the reason for over \$800 in cell phone charges

6

B For all meal charges, please provide the cost per person, the name of the person who approved the charge and a description stating why the cost was necessary to provide regulated utility service

7

8

9

C. Item number 8, was the cost of the baby shower charged to regulated customers?

10

If so, why?

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- 1 D. For the Ipad related charges. Why were these Ipads purchased? Have they been
2 and are they currently being used for regulated utility operations?
- 3 E. For the Ipad related charges. Why were these Ipads not capitalized to plant in
4 service accounts?
- 5 F. No. 2, why is this cost to KCPL regulated accounts?
- 6 G. No. 18, what is the business purpose of this trip?
- 7 H. No, 19 how is this book related to KCPL's regulated operations?
- 8 I. No. 20, what is the business purpose of this trip?
- 9 J. No. 6, what is the business purpose of this trip?
- 10 K. No. 14, what is the business purpose of this trip?
- 11 L. No. 15, what is the business purpose of this trip?
- 12 M. Nos. 17, 27, 28, Does KCPL pay approximately \$300 to \$400 per month for one
13 employee's cell phone service? If so, is this the fair market price for one cell phone?

14 KCPL's response to DR 502, in part, was that "[s]ubsequent to its direct filing in this case,
15 the Company informed MPSC Staff that it was removing all GPE Officers expense report costs."
16 KCPL failed to attempt to explain or even address any of the individual Staff questions listed above in
17 DR 502.

18 Q. How do you as an auditor respond to KCPL's response to DR 502?

19 A. When a regulated utility company such as KCPL refuses to provide a
20 responsive answer to a Staff Data Request and also does not object to the data request that is
21 always a concern. In this particular instance KCPL is attempting to just substitute providing
22 money rather than a substantive response to the Staff Data Request. This is even a bigger
23 problem for a Staff auditor.

24 - If KCPL is unable to justify one dollar of expense for a list of expenses paid to one
25 employee, it is the regulatory auditor's responsibility to determine the risk of inappropriate
26 and excessive costs for all of KCPL management employees being passed on to Missouri
27 ratepayers. While I increasingly view Staff Adjustment 5 to be more and more conservative,
28 it is made with the intent, not just to quantify Great Plains' Officer excessive and imprudent
29 charges, but all of KCPL's approximately 1,000 managers' excessive charges. Great Plains'

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1 Officers set the "tone at the top" as they are in charge of creating and enforcing corporate
2 policies and procedures. The risk that all KCPL managers behave in a similar manner as
3 GPE officers is extremely high. If KCPL is not enforcing its expense report policies on
4 Great Plains officers, there is absolutely no reason to believe it is enforcing these policies on
5 other KCPL managers.

6 Q. Why do you consider the \$750,000 total company amount of Staff
7 Adjustment 5 to be conservative?

8 A. The fact is that KCPL could justify none of the \$23,000 in officer expenses it
9 was asked to justify in DR 502. In DR 502, Staff inquired about a small number of
10 transactions for only one KCPL management employee. Given this fact, it appears the Staff
11 may have underestimated the overall level of inappropriate, imprudent, excessive or
12 inappropriately-allocated costs in KCPL's test year regulated books of account. There is also
13 a strong indication that further and more extensive work in this area needs to be conducted in
14 this area in the future.

15 The Staff's consolidated corporate allocations and affiliate transactions adjustment is
16 designed to protect against the risk of inappropriate charges in all phases of KCPL's corporate
17 operations, not just management expense account expenses. However, when you add the
18 Staff's \$750,000 adjustment to the \$140,000 removal of GPE expenses, the total is \$890,000.
19 The amount \$890,000 divided by KCPL's 1,000 management employees only protects the
20 ratepayers from a maximum of \$890 per management employee of imprudent, excessive and
21 inappropriately allocated corporate charges in the test year. Given that Staff Adjustment 5
22 was not designed to cover only excessive and imprudent KCPL management expense report
23 charges but also under-allocation of residual corporate overhead charges, there is little doubt
24 that the Staff's adjustment could be much larger.

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1 Q. Did you consider a much larger dollar amount for Staff Adjustment 5?

2 A. Yes. However, at that time I did not realize the severity of KCPL's corporate
3 allocations issues. Also, I gave consideration that KCPL and Staff had made progress in the
4 development of an agreed-upon CAM and that KCPL did put a General Allocator into effect
5 in 2015. These are some of the considerations that were considered at the time Staff
6 Adjustment 5 was made in the Staff's Cost of Service Report.

7 Q. Are there other considerations that should be considered other than the dollar
8 amount of the management expense account charges?

9 A. Yes. When employee expense report expenses are inappropriately charged or
10 allocated, that is an indication that the salaries and benefits of the member of management are
11 also inappropriately charged. As an example, when KCPL management travel to Little Rock
12 Arkansas to meet with members of the Southwest Power Pool (SPP), KCPL routinely charted
13 this travel costs to Operating Unit 10106, which is then allocated to KCPL and GMO
14 regulated operations. Logically, the KCPL employees who made this trip would also charge
15 their payroll and benefit costs to only KCPL and GMO. However, Transource is also a
16 regulated by the Federal Energy Regulatory Commission and is a member of SPP.
17 As explained above, Transource would also benefit from KCPL management's meetings with
18 the SPP representatives just as KCPL and GMO would benefit.

19 Q. How do you respond to Mr. Klote's assertion that your adjustment was
20 arbitrary?

21 A. Merriam Webster's online dictionary defines "arbitrary" in part as "*not planned*
22 *or chosen for a particular reason: not based on reason or evidence: done without concern for*
23 *what is fair or right.*" If that is what Mr. Klote had in mind when he characterized this
24 adjustment as arbitrary, then I disagree.

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1 This adjustment was planned with a reason to protect KCPL's ratepayers from
2 excessive, imprudent or inappropriately allocated charges. The adjustment was based on my
3 review of hundreds of documents related to KCPL's corporate cost allocations and affiliate
4 transactions. The adjustment was based on my reliance on extensive work over several years
5 on KCPL's corporate allocations and affiliate transactions, including KCPL's current CAM
6 case. This adjustment is also based on the length of time that KCPL has had problems with
7 non-compliance with the Commission's affiliated transaction costs as discussed in prior
8 testimony regarding the improper handling of the Crossroads and GPP transactions. Finally,
9 this adjustment was certainly done with concern for what is "fair" and "right".

10 Q. Has Mr. Klote in previous KCPL rate cases reviewed and removed certain
11 KCPL management expenses from KCPL's requested cost of service in those rate cases?

12 A. Yes. This is not a new problem with KCPL. KCPL's lack of internal controls
13 over its management expense accounts has been a problem for years going back to at least
14 2006. Based on the problems found by Staff in Case No. ER-2007-0291 and problem areas
15 found by KCPL's own internal auditors, Mr. Klote and another KCPL employee were
16 assigned to review all, or a very significant number of officer expense reports and remove
17 inappropriate charges through a cost of service adjustment in its rate case.

18 Q. Did Mr. Klote perform a similar review in this rate case?

19 A. Staff has seen no evidence of such a review. If Mr. Klote performed such a
20 review, then he certainly would have found many of the same imprudent, excessive and
21 inappropriately allocated costs that I found during my review.

22 Q. How do you respond to Mr. Klote's characterization of that Staff has overstated
23 the level of KCPL's noncompliance with the Commission's Affiliate Transactions Rule?

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1 A. I have addressed KCPL's significant lack of compliance with the Commission's
2 Affiliate Transactions Rule. I have summarized some very significant violations (Crossroads
3 and GPP) that should convince anyone with an understanding of the Affiliate Transactions
4 Rule and utility operations that KCPL has in the past and continues to exercise little or no
5 internal control supported by effective policies and procedures designed to ensure compliance
6 with the Affiliate Transactions Rule.

7 Effective internal control would detect and prevent inappropriate expenditures and
8 related booking of such costs, as well as identify the individual(s) or culture (e.g., lack of
9 instruction or the following of directives) responsible for the problem. I have also listed
10 specific current Affiliate Transactions Rule violations between KCPL and Great Plains related
11 to what I consider KCPL's forced business relationship with Allconnect, Inc.

12 Even in response to several Staff data requests in this case KCPL admitted
13 noncompliance with the Affiliate Transactions Rule by stating, in effect, that KCPL needs
14 Staff's help to record corporate allocations and affiliate transactions correctly. KCPL's exact
15 response was "The Company and Staff personnel have made significant progress in
16 establishing an agreed upon CAM which the Company expects will improve consistency of
17 coding going forward." (KCPL-GMO responses to Staff Data Request Nos. 559, 564, 565,
18 566 and 567).

19 It is difficult to understand how Mr. Klote can state that the Staff has overstated the
20 level of KCPL's noncompliance with the Commission's Affiliate Transactions Rule given the
21 fact that KCPL admits it cannot even record corporate allocations and affiliate transactions
22 correctly without the Staff's assistance in creating a revised cost allocation manual and
23 effective internal controls. As with the level of Staff's \$750,000 adjustment, the Staff's

1 characterization of KCPL's noncompliance with the Affiliate Transactions Rule is not
2 overstated, but likely significantly understated.

3 Q. Was KCPL's response to Staff Data Request No. 502, or the other Staff Data
4 Requests noted above, the only Staff data requests where KCPL failed to explain or justify its
5 management's corporate expense account charges?

6 A. No. Staff Data Request No. 560 ("DR 560") is another example. The Staff's
7 questions submitted in DR 560 and KCPL's "non-responses" are provided below. In DR 560
8 the Staff attempted to obtain information whether certain expenses incurred by its employees
9 were in compliance with Great Plains-KCPL Procurement policies. KCPL refused to address
10 this Staff question related to internal controls and policies.

11 **Staff Data Request No. 560**

12 1. Reference Expense Report 0000038916. Was the purchase of
13 iPads for KCPL's Corporate Communications Team on
14 December 16, 2013 in compliance with KCPL's Procurement
15 policies in general and its procurement policies for computers in
16 particular? 2. Since this charge was booked to Operating Unit
17 101106, how does the use of these iPads for the Corporate
18 Communications Team only benefit KCPL and GMO's
19 regulated utility operations? 3. If this purchase does not only
20 benefit KCPL and GMO's regulated operations, why was it
21 booked to Operating Unit 101016 and account 921? 4. Please
22 provide the name of the KCPL employee who approved this
23 purchase. 5. Was the approval made prior to or subsequent to
24 the purchase? 6. Please provide a copy of the KCPL policy
25 which allows KCPL Officers to purchase computer equipment
26 on their expense reports. 7. Please provide a copy of all KCPL's
27 internal controls which reduces the potential for employees to
28 charge to Operating Unit 101106 Utility Mass Formula, when
29 the charge should be to 101105 Corporate Mass Formula. 2.
30 Reference expense report 0000038628 and the November 11,
31 2013 "business meeting" with . . . and a KCPL employee at the
32 Sullivan's Steak House in Leawood Kansas charged to account
33 921 101106 Utility MASS Formula 1. Who is . . . and what
34 services did he provide to KCPL? 2. Please describe these
35 services in detail. 3. Since the charge was made to Operating
36 unit 101106, please explain in detail how these charges benefit
37 only KCPL and GMO regulated operations and not GPE

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1 businesses in general. 4. Has KCPL ever entered into a contract
2 or agreement with . . .? If yes, please provide a copy. If not,
3 why did KCPL believe it was necessary to charge KCPL and
4 GMO ratepayers to meet with . . . DR requested by Chuck
5 Hyneman (Chuck.Hyneman@psc.mo.gov).

6 **KCPL Response to Staff Data Request No. 560**

7 The Company made an adjustment to reduce rate recovery of
8 GPE Officer expenses by approximately \$67k (Missouri
9 jurisdictional) in recognition of inconsistent coding of expenses
10 during the test year. The Company and Staff personnel have
11 made significant progress in establishing an agreed upon CAM
12 which the Company expects will improve consistency of coding
13 going forward. The charge questioned above should have been
14 coded to Operating Unit 10105 which would have spread the
15 cost across all Business Units (including non-regulated units).

16 Q. Do you have a response to KCPL's answer to Staff DR 560?

17 A. Yes. In instances where KCPL refused to respond to basic requests for
18 information, any auditor, especially a Certified Public Accountant, is expected to approach the
19 audit area with an even higher-than-normal level of professional skepticism. That is how
20 I reacted to KCPL's response to DR 560 as well as the other responses described above.

21 Q. Are Certified Public Accountants ("CPAs") required to adopt and maintain an
22 attitude of professionalism in the conduct of audits of financial statements?

23 A. Yes.

24 Q. Are you a CPA?

25 A. Yes. Mr. Klote is a CPA as well.

26 Q. What regulatory standards require the application of auditor professional
27 skepticism?

28 A. It is required by the Public Company Accounting Oversight Board (PCAOB)
29 audit standards. The PCAOB was established by Congress to oversee the audits of public
30 companies in order to protect the interests of investors and further the public interest in the

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1 preparation of informative, accurate and independent audit reports. As noted in the attached
2 Schedule CRH-s6, Staff Audit Practice Alert No. 10, *Maintaining and Applying Professional*
3 *Skepticism in Audits*, December 4, 2012, professional skepticism is essential to the
4 performance of effective audits under PCAOB standards. PCAOB standards require that
5 professional skepticism be applied throughout the audit by each individual auditor on the
6 engagement team.

7 Q. Does it appear to you that KCPL and GPE officers set the appropriate "tone at
8 the top" when it comes to the incurrence of expense account charges?

9 A. In my opinion, no. KCPL and Great Plains officers are supposed to set the
10 example of prudent behavior in the incurrence and approval of expenses charged when
11 travelling and when incurring or approving costs for purchases, travel, and for meals and
12 entertainment in the local area. As discussed above, KCPL and Great Plains officers set what
13 is referred to as the "tone at the top" as it relates to incurred expenses. This means that as
14 KCPL non-officer employees are aware of the standards actually used by KCPL and
15 Great Plains officers to incur and record expenses, they too will adopt and adhere to those
16 same standards.

17 For example, if one officer incurs expenses in one month but does not submit an
18 expense report until seven months later, this officer encourages his/her subordinates to do or
19 even accept this same poor internal control practice. KCPL has a policy for timely submittal
20 of expense reports with the indication that reimbursement will be denied if proper
21 documentation is not submitted on a timely basis. Likewise, if one officer purchases items
22 such as computers without going through the proper procurement channels, that officer
23 encourages other employees to follow his/her example. A final example is when an officer
24 incurs excessive meal costs and charges, including alcohol and charges not allowed by

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1 Company's policies, and allows these costs as expenses to be recovered by ratepayers.
2 This officer only encourages employees to follow his/her example instead of following
3 Company policies.

4 Q. What is the concept underlying the "tone at the top"?

5 A. I should point out that I am only referring to the principle of the "tone at the
6 top" in this testimony as it relates to the reasonableness and prudence of KCPL and
7 Great Plains management's internal controls over its employee expense reimbursement
8 process. I have not found nor am I implying KCPL has engaged in any unethical behavior.

9 Tone at the top is the climate generated by an organization's leadership. It is
10 well understood that the tone set by management has a significant influence on the employees
11 of the organization. The behavior and actions of the employees will naturally gravitate
12 toward what they witness in their supervisors, line managers, and upper management.
13 "Tone at the top" is also an important component of a company's internal control
14 environment. The tone at the top is set by all levels of management and has a trickle-down
15 effect on all employees of the company. Setting the proper tone starts with managers at all
16 levels leading by example. As it relates to this issue, KCPL leaders should demonstrate
17 through their own actions their commitment to ensuring only reasonable and prudent
18 employee expense account expenses are approved and reimbursed. Management cannot act
19 contrary to this commitment and expect others in the company to behave differently.

20 Q. Is there an example where a Great Plains officer incurred expenses in one
21 month but did not file an expense until seven months later?

22 A. Yes. The Staff found the following examples of extremely late submission of
23 expense reports that are repeat violations of KCPL's policies.

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1 1. Officer incurred expenses in May 2013 (0000036408) the date of
2 the expense report was October 16, 2013 and the officer signed
3 attesting to the accuracy of the expenses on December 30, 2013.

4 2. Officer incurred expenses in June 2013 (0000036729) the date of
5 the expense report was October 20, 2013 and the officer signed
6 attesting to the accuracy of the expenses on December 26, 2013.

7 3. Officer incurred expenses in July 2013 (0000036734) the date of
8 the expense report was October 29, 2013 and the officer signed
9 attesting to the accuracy of the expenses on December 26, 2013.

10 4. Officer incurred expenses in September 2013 (0000036742) the
11 date of the expense report was October 29, 2013 and the officer
12 signed attesting to the accuracy of the expenses on December 26,
13 2013.

14 Q. Has KCPL management been aware of significant problems with its
15 management's treatment of expenses for several years?

16 A. Yes. In response to Staff Data Request No. 162 in KCPL rate case No.
17 ER-2007-0291 Staff received a copy of Great Plains Energy Services Kansas City Power &
18 Light Officers and Directors Expense Report Review dated January 17, 2007. One of the
19 Audit steps in this KCPL Internal Audit Department review was to verify that "All expenses
20 should be coded to the correct account and given a sufficient description stating the business
21 purpose. KCPL internal auditors found that "12 out of 33 (36%) Officer expense reports did
22 not have the correct account coding on them. It is the employee's responsibility for coding
23 expense reports correctly and Corporate Accounting's responsibility for providing support and
24 training to employees to ensure that expenses are coded correctly."

25 Another significant finding by KCPL's internal auditors in 2007 that continues to exist
26 today is that "it was difficult to determine the business purpose by the description provided on
27 some expense reports." In my review of KCPL and GPE management expense reports in this
28 rate case audit I have found many charges which would seem to have a questionable business
29 purpose. When I inquired to KCPL for the provision of the business purpose of some of the

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Charles R. Hyneman

1 | questionable charges, KCPL could not or it decided not to provide the business purpose for
2 | even one of the charges.

3 | Q. What was the overall assessment of KCPL's internal auditors in its 2007
4 | review?

5 | A. The Overall Assessment of KCPL's internal auditors was that:

6 | Based on testing performed, at the time of our fieldwork,
7 | it appears that controls over Officers' expense reporting
8 | needs improvement. For the Officers' expense
9 | reimbursement process, the review noted several
10 | expense reports that were not in compliance with the
11 | Policy. Specific areas not in compliance included lack of
12 | required receipts, incorrect coding of expenses, and
13 | spousal travel without evidence of adequate approval
14 | and review.

15 | Q. Given KCPL's past problems with its officer expense reports does it appear to
16 | you that KCPL's internal audit function is performing effectively?

17 | A. No. I would assume that given KCPL's past officer expense report problems
18 | that KCPL's Internal Audit Department would make it a priority to audit KCPL's officer
19 | expenses regularly and ensure past non-compliance issues were addressed and corrected.
20 | My review of KCPL's officer expense reports in this rate case shows that these actions are not
21 | taking place.

22 | Q. Did you question the business purpose of a particularly questionable charge by
23 | a member of KCPL management?

24 | A. Yes. KCPL apparently approved the payment, reimbursed one of its
25 | employees, and charged to KCPL and GMO ratepayers for travel to a Board Retreat for an
26 | organization not related to KCPL or regulated operations or the utility industry in general.
27 | I inquired about this charge in Staff Data Request No. 576 and KCPL decided that it could not

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1 provide a business purpose for this charge. KCPL defended the appropriateness of this charge
2 and said it should have been allocated to all Great Plains entities, including KCPL and GMO
3 regulated operations in Operating Unit 10105. KCPL provided the same worded response
4 for Staff Data Request No. 576 as it did for Staff Data Request Nos. 559, 564, 565, 566, 567,
5 and 560.

6 It is extremely difficult for me to understand as it should be for anyone to understand
7 why KCPL ratepayers should pay, in part, as maintained by KCPL, the cost of a KCPL/Great
8 Plains Officer to travel to attend a "Board Retreat" for a company unrelated to regulated
9 utility business. Yet, this is KCPL's official position as attested to by Mr. Tim Rush, a KCPL
10 witness in this rate case.

11 **Staff Data Request No. 576**

12 Reference Expense Report 0000036742, airfare for the "MEM
13 Board Retreat" charged to Operating Unit 10106, account 921.

14 1) Is "MEM" referenced in this expense report the "Missouri
15 Employers Mutual," a provider of workers compensation
16 insurance? 2) What does the Missouri Employers Mutual Board
17 Retreat have to do with KCPL or GMO? 3) Who approved this
18 payment to the requesting KCPL employee? 3) Why was this
19 payment approved? 4) Why was the Operating Unit – Utility
20 Mass Formula allocated only to KCPL and GMO regulated
21 operations selected as the appropriate allocation factor?

22 **KCPL Response to Staff Data Request No. 576**

23 The Company made an adjustment to reduce rate recovery of
24 GPE Officer expenses by approximately \$67k (Missouri
25 jurisdictional) in recognition of inconsistent coding of expenses
26 during the test year. The Company and Staff personnel have
27 made significant progress in establishing an agreed upon CAM
28 which the Company expects will improve consistency of coding
29 going forward. The charge questioned above should have been
30 coded to Operating Unit 10105 which would have spread the
31 cost across all Business Units (including non-regulated units).

1 **MECG/OPC Affiliate Transaction proposals**

2 Q. Have other parties to this case made an adjustment similar to Staff
3 Adjustment 1?

4 A. Yes. The same adjustment, replacing the Corporate Massachusetts Formula
5 with the new General Allocator is also proposed by the Midwest Energy Consumers' Group
6 (MECG) and the Office of the Public Counsel ("OPC").

7 Q. Has MECG and OPC proposed additional adjustments to the General
8 Allocator?

9 A. Yes. As Mr. Klote describes at pages 27 through 29 of his rebuttal testimony,
10 MECG and OPC have proposed three adjustments to the General Allocator. The first
11 adjustment was to correct an error in the income tax component of the General Allocator.
12 There is no dispute among the parties on this issue. The second adjustment proposed by
13 MECG and OPC is to modify the income tax expense and interest expense inputs into the
14 General Allocator to reflect KCPL's cost of capital.

15 Q. Does Mr. Klote agree with MECG's and OPC's proposal to adjust the income
16 tax expense and interest expense inputs into the General Allocator?

17 A. No.

18 Q. Does Mr. Klote explain why KCPL disagrees with this proposal?

19 A. He does not explain KCPL's disagreement from a theoretical standpoint and
20 why this adjustment will not result in a more equitable General Allocator on which KCPL
21 allocates corporate overhead costs. Mr. Klote merely states at page 29 of his rebuttal
22 testimony that KCPL's method is appropriate and that KCPL's method was recommended by
23 the Commission Staff and adopted by KCPL.

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1 Q. Is it noteworthy why Mr. Klote does not rebut this proposal from a theoretical
2 ratemaking standpoint?

3 A. Yes. This indicates that KCPL does not have an argument why its method of
4 calculating the General Allocator is superior to the method proposed by MEGC and OPC.

5 Q. Does the Staff have a position on this proposal?

6 A. Not on this specific proposal at this time. The Staff is still evaluating this
7 methodology. However, as noted above, the Staff does not agree that KCPL is calculating it
8 General Allocator appropriately as reflected in the zero costs allocated to one of Great Plains'
9 major business ventures, Transource. The Staff supports any changes to KCPL's General
10 Allocator that will allow a more reasonable and equitable allocation of residual corporate
11 overhead costs.

12 Q. What is MECG's and OPC's third and final proposed adjustment?

13 A. MECG and OPC are proposing that KCPL's General Allocator should be
14 modified to include a charge by KCPL to GPE of a five percent (5%) management fee. This
15 management fee would represent KCPL's compensation to manage GPE's regulated and
16 unregulated portfolio.

17 Q. Does KCPL agree with this proposed adjustment to the General Allocator?

18 A. No, as explained by Mr. Klote at pages 28 and 29 of his rebuttal testimony.
19 Mr. Klote argues that this proposal is arbitrary because it was not based on an analysis of
20 KCPL and GPE's operations. He states that the proposal was based on the operations of
21 utility companies that are service companies and KCPL is not a service company.

22 Q. Do you agree that KCPL is not a service company?

23 A. As I noted in the Staff's Cost of Service Report, KCPL is not an official service
24 company. However, KCPL acts as a full service company to all affiliates of Great Plains.

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1 Of all the Great Plains entities, including KCPL, GMO, GMO's nonregulated operations,
2 KCPL Receivables Corporation, KCPL Solar, Transource Missouri, only KCPL has actual
3 physical employees. Since KCPL is the only entity that has employees, KCPL is the only
4 entity that provides services to all the other entities. In that sense, KCPL acts very much like
5 a service company and it is not unreasonable for a service company to receive compensation
6 for the services that it provides to other entities that benefit from the service company.

7 Q. What is the Staff's position on the MECG/OPC proposal to include a five
8 percent (5%) service fee in KCPL's affiliate transactions with GPE?

9 A. The Staff definitely supports the fact that KCPL should be compensated for
10 providing services to all Great Plains entities. Staff is of the opinion that KCPL should be
11 compensated for its role of servicing and governing these entities. KCPL should also be
12 compensated for maintaining the resources to timely service and govern these entities.

13 The Commission's Affiliate Transactions Rule requires that all goods and services
14 provided by a utility to an affiliate must be transacted at the higher of cost or market.
15 For each transaction where KCPL provides any service to Great Plains or its affiliates,
16 KCPL's management must consider two prices.

17 The first price is based on the calculation of its cost to provide the affiliate service.
18 This price is defined and referred to in the Rule as a "fully distributed cost" or FDC.
19 The second price that KCPL management must consider is the prevailing fair market price of
20 the good or service provided. When KCPL has obtained these two prices for comparison, it
21 must then charge its affiliate with the higher of the two prices or not engage in the transaction.
22 Both prices have embedded within the price a profit or capital cost that would serve as
23 compensation to KCPL.

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1 Q. Does the Staff support the proposal to add a 5 percent charge to transactions
2 between KCPL and GPE?

3 A. The Staff is not supporting or opposed to this specific methodology at this
4 time. However, the Staff supports any reasonable methodology that will result in KCPL
5 allocating a more fair and reasonable amount of residual corporate overhead charges to all of
6 its affiliates in the Great Plains corporate umbrella.

7 Q. You described earlier that KCPL acts like a utility service company.
8 Is KCPL's corporate structure unique?

9 A. Yes. KCPL's corporate structure is unique, at least in Missouri, and presents
10 the Staff and other parties with difficulties and challenges in attempts to ensure that KCPL's
11 customers are protected from KCPL subsidization efforts of its affiliate or non-regulated
12 activities. I believe that KCPL's corporate culture is a contributing factor and partly
13 responsible for KCPL's Affiliate Transactions Rule violations.

14 Q. Please explain.

15 A. One of the big concerns is that all of the Great Plains officers are also officers
16 of KCPL. There is no effective position that represents KCPL interests instead of the interests
17 of Great Plains. Staff has encountered several employees that identify themselves as
18 Great Plains employees when they are actually KCPL employees, as all individuals associated
19 with KCPL, GMO, Great Plains and Great Plains affiliates are KCPL employees.

20 The original CAM was the "Great Plains Energy" or GPE Cost Allocation Manual
21 2002 filed on May 9, 2003 in Case No. BAFT-2003-0542. This CAM was supposed to be
22 designed to protect KCPL's ratepayers from affiliate abuses. However, Great Plains is not a
23 regulated entity. It is a nonregulated affiliate of a regulated entity.

1 Great Plains' primary interest is in promoting the interests of its shareholders and
2 increasing its earnings through a combination of both regulated and nonregulated operations.
3 It is counterintuitive and naïve to believe that a Cost Allocation Manual written by a non-
4 regulated affiliate of a regulated electric utility would put, at its primary focus, protecting the
5 interests of the regulated utility and its customers. It is just not credible to believe that Great
6 Plains' design of its CAM protects the interest of KCPL and KCPL's ratepayers and gives
7 KCPL management any authority to override the wishes of Great Plains' Officers.

8 A CAM written by officers of a nonregulated company such as Great Plains cannot be
9 expected to provide KCPL officers with any opportunity or authority to oppose or challenge
10 Great Plains Officers in transactions like the GPP, Crossroads and Allconnect transactions
11 that all act to the detriment of the utility and the utility's customers. The Staff is working with
12 KCPL on a Cost Allocation Manual that, on a going-forward basis, will hopefully provide a
13 greater degree of assurance that utility rates of KCPL's regulated customers are not adversely
14 impacted from KCPL's affiliate and nonregulated activities.

15 Q. Does this conclude your testimony?

16 A. Yes, it does.

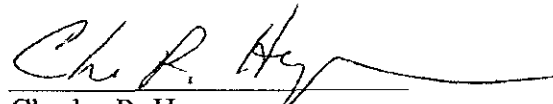
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Kansas City Power & Light)
Company's Request for Authority to) Case No. ER-2014-0370
Implement a General Rate Increase for Electric)
Service)

AFFIDAVIT

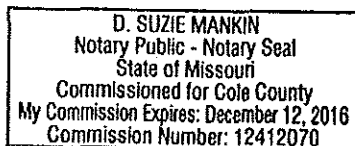
COMES NOW Charles R. Hyneman and on his oath declares that he is of sound mind and lawful age; that he contributed to the attached Surrebuttal Testimony; and that the same is true and correct according to his best knowledge and belief.


Further the Affiant sayeth not.


Charles R. Hyneman

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 4th day of June, 2015.




Notary Public



To: **Files**
From: Ron Klote, Senior Manager Regulatory Accounting
CC: Darrin Ives
Date: October 31, 2008
Subject: Crossroads Energy Center Transfer to the KCP&L Greater Missouri Operations Company Regulated Jurisdiction's MOPUB Business Unit

Purpose:

To document the reason for and the timing of the property accounting move of the Crossroads Energy Center to the books and records of KCP&L Greater Missouri Operations Company's ("GMO") MOPUB business unit. In addition, documenting the recording of the Crossroads Energy Center as a capital lease and how the accumulated deferred income taxes ("ADIT") should be treated associated with the plant.

Relevant Guidance Researched:

Code of Federal Regulations Title 18 Part 101

Background:

The Crossroads Energy Center is an approximately 300MW combustion turbine power plant consisting of four General Electric 7EA units. It was built in 2002 by a non-regulated subsidiary of Aquila, Inc. titled Aquila Merchant Services. It is located in Mississippi and is owned by the City of Clarksdale for property tax abatement purposes. GMO holds a purchase option that provides the opportunity for GMO to purchase the plant from the City of Clarksdale at any time for \$1,000. This purchase would eliminate the property tax abatement treatment of the plant. The Crossroads Energy Center is controlled by GMO through a long-term tolling agreement. The plant is recorded as a capital lease on the books and records of MOPUB.

The placement of the Crossroads Energy Center on the books and records of Aquila, Inc. was as follows. In October 2002, the Crossroads Energy Center was moved from business unit MEP (Merchant Energy Partners Investment LLC) CWIP account into business unit ACEC (Crossroads Energy Center) plant accounts. ACEC was a business unit under the non-regulated subsidiary of MEP. In March 2007, due to the wind down of Aquila's Merchant operations and their inability to effectively dispatch power from the Crossroads Energy Center, there was a negotiation of the rights and obligations of the plant to Aquila, Inc. This transfer was governed by a Master Transfer Agreement dated March 31, 2007. Aquila, Inc. paid \$117.9 million to Aquila Merchant which was equivalent to the net book value of Crossroads at this time. Rather than pay a cash purchase price, the purchase price took the form of a credit that reduced the amount of indebtedness owed by Aquila Merchant to Aquila parent. On March 31, 2007, Crossroads Energy Center was recorded at Net Book Value to a nonregulated business unit CECAQ (Crossroads Energy Center Aquila) where it resided at the time of the acquisition of Aquila, Inc. by Great Plains Energy (GPE).

On March 19, 2007, the regulated jurisdictional operations of GMO issued a request for proposal for a long-term supply option. The Crossroads Energy Center was bid into the request for proposal at net book value to satisfy the long-term supply option. The candidates submitting bids for the long-term supply option were evaluated and the Crossroads Energy Center was selected as the least cost and preferred option for long-term supply. The evaluation process and selection of the Crossroads Energy Center as the preferred option was presented to the Missouri Public Service Commission Staff on October 31, 2007.

On approximately May 14, 2008 Aquila's management presented a review of the IRP process presented to Staff in October 2007 with GPE management. During this presentation, the Request for Proposal process was discussed with GPE management and Aquila's decision to select Crossroads as the least cost and preferred option was reviewed. At this meeting, GPE concurred with Aquila's recommendation to use Crossroads as a long-term supply option. (Added by Tim Rush on 1/6/09: Attendees, Todd Kobayashi, Kevin Bryant, Tim Rush, Scott Heidtbrink, Davis Rooney, Gail Allen, Gary Clemens, Denny Williams, Jeremy Morgan. As a note, in the initial evaluation of the acquisition of Aquila, GPE had not made a decision on how it would address the Crossroads facility.)

On August 31, 2008 the Crossroads Energy Center was moved from GMO's business unit NREG, where it was recorded after the acquisition of Aquila, Inc. by Great Plains Energy on July 14, 2008, to MOPUB's books and records. MOPUB is the regulated business unit which previously served the territory known as Missouri Public Service. On September 5, 2008 GMO regulated jurisdictions filed a rate case including the Crossroads Energy Center in MPS's rate base at net book value.

Conclusion:

The following actions regarding the accounting of the Crossroads Energy Center are appropriate:

1. The Crossroads Energy Center should be recorded at net book value on the books and records of KCP&L Greater Missouri Operations Company's MOPUB business unit.
2. August 2008 was the appropriate time to move the Crossroads Energy Center to the MOPUB business unit.
3. The Crossroads Energy Center is appropriately recorded as a capital lease as part of the continuing property records.
4. The ADIT associated with the time period that the Crossroads Energy Center was recorded on the non-regulated subsidiary of Aquila, Inc. should be recorded on the non-regulated business unit AQP (GMO's non-regulated subsidiary). The ADIT balances from March 2007 when the Crossroads Energy Center was moved to a business unit under Aquila, Inc. parents books and records until the present should be recorded on the business unit MOPUB.

Support of Conclusion:

Recorded at Net Book Value on MOPUB's Books and Records

The support for the decision by GPE's management to record the Crossroads Energy Center at net book value can be directly linked to the Request for Proposal process by GMO. As discussed in the background section above, on March 19, 2007 the regulated jurisdictional operations of GMO sent out a Request for Proposal to evaluate and choose a long-term supply option. Aquila, Inc. bid the Crossroads Energy Center into the Request for Proposal process at net book value. All bids were accumulated and evaluated. The Crossroads Energy Center was selected as the least cost and most preferred option. This was presented to Missouri Public Service Commission Staff on October 31, 2007.

Additionally, with the acquisition of Aquila, Inc. by Great Plains Energy, PricewaterhouseCoopers was engaged to complete a Purchase Accounting Valuation. As part of this analysis, there was an assessment of the fair market value of the Crossroads Energy Center. This evaluation resulted in an amount that was in excess of the Net Book Value that was offered into the Request for Proposal process initiated by Aquila Inc. GPE's management made the decision to not record a fair market value adjustment on the Crossroads Energy Center, but instead record the plant at net book value and include the property as part of GMO's regulated jurisdiction. This amount is being requested to be part of rate base at net book value in GMO's current rate case filing, case number ER-2009-0090.

Recorded at August 2008 on Business Unit MOPUB

The support to move the Crossroads Energy Center to MOPUB's business unit in August 2008 can be linked to a series of events ultimately concluding in GPE management's decision to include the Crossroads Energy Center in the GMO's regulated jurisdiction rate base calculation in the September 5, 2008 rate case filing (ER-2009-0090). The series of events as discussed in the background section of this whitepaper are detailed below:

- On March 31, 2007, the non-regulated subsidiary Merchant Energy Partners negotiated an assignment of the rights and obligations of the Crossroads Energy Center to the Parent company Aquila, Inc.
- Subsequently, Aquila, Inc. bid the Crossroads Energy Center into a Request for Proposal by GMO's regulated jurisdiction for a long-term supply option.
- GMO's evaluation of the bids offered concluded that the Crossroads Energy Center was the least cost and preferred option for the long-term supply option.
- On October 31, 2007, a presentation was made to the Missouri Public Service Commission Staff communicating the results of the Request for Proposal process.
- Approximately May 14, 2008 Aquila's management reviewed the results of the IRP process and the results of the Request for Proposal process with GPE's management. GPE's management concurred with the decision that Crossroads was the least cost and preferred long-term supply option.
- On July 14, 2008 Great Plains Energy completed their acquisition of Aquila, Inc.
- August 2008, GPE's management decided to include the Crossroads Energy Center in rate base in its GMO regulated jurisdiction.
- On August 25, 2008, GPE's management met with Missouri Public Service Commission Staff and discussed GPE's decision to move the Crossroads Energy Center onto the books and records of GMO's regulated jurisdiction and include the net book value of the plant in rate base in the upcoming rate case filing.
- August 31, 2008 Crossroads Energy Center was transferred to GMO's regulated jurisdiction.
- September 5, 2008, GMO filed a rate case under the docket number ER-2009-0090 including the Crossroads Energy Center in rate base at net book value.

Recorded as a Capital Lease

The "General Instructions" number 19 of 18 CFR part 101 states the following:

If at the inception a lease meets one or more of the following criteria, the lease shall be classified as a capital lease. Otherwise, it shall be classified as an operating lease.

1. *The lease transfers ownership of the property to the lessee by the end of the lease term.*
2. *The lease contains a bargain purchase option.*
3. *The lease term is equal to 75 percent or more of the estimated economic life of the leased property.*
4. *The present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by the lessor.*

The Crossroads Energy Center has been recorded on the books and records since October 2002 as a capital lease. This is supported by the following:

- Criteria number 3 states that the lease term is equal to 75 percent or more of the estimated economic life of the leased property. The Crossroads Energy Center meets this criteria. The lease term agreed to with the City of Clarksdale was for an original term of 30 years and two 5 year extension options. The economic life of the plant is estimated at 40 years. This equates to 75 percent of the economic life when considering the original terms and 100 percent of the economic if the two 5 year extension periods are exercised. Both meet or exceed the 75 percent criteria discussed above.
- In addition, criteria number 2 states that the lease must contain a bargain purchase option. Effective March 28, 2008 GMO finalized a purchase option that allows it to purchase the Crossroads Energy Center from the City of Clarksdale at any time for \$1,000. \$1,000 would be considered a bargain purchase option as it is significantly less than the fair market value of the plant. Crossroads would meet this requirement.

Recording of ADIT Balances

ADIT balances to date associated with the Crossroads Energy Center can be grouped into two separate categories as follows:

- ADIT accumulated from original in service date during 2002 to the date the plant was transferred to Aquila, Inc.'s parents books CECAQ in March 2007.
- ADIT accumulated on Aquila, Inc.'s parents books from March 2007 to present.

The ADIT in the first grouping when the Crossroads Energy Center was recorded on Aquila's non-regulated subsidiary Merchant Energy Partner's with a business unit titled ACEC is attributable to the deferred intercompany gain from when the Plant was transferred to Aquila, Inc.'s parents books. The transfer of these ADIT balances to Parent would not be appropriate as the Parent or the future GMO jurisdiction has not received any benefits of the accelerated depreciation that was recognized on the non-regulated subsidiary books. As such, the ADIT associated with this time period is recorded presently on the non-regulated business unit AQP.

The ADIT associated with the time period of when the plant was recorded on Aquila Inc.'s parents books to the present is attributable to the tax effected difference between book and tax depreciation. Due to tax normalization rules, these amounts are required to follow the plant as it gets transferred to the GMO regulated jurisdiction of MOPUB. These ADIT amounts will be used as rate base offsets to the plants net book value that will be included in GMO's rate case filings.

409 S.W.3d 371
(Cite as: 409 S.W.3d 371)

H

Supreme Court of Missouri,
En Banc.
OFFICE OF the PUBLIC COUNSEL, Appellant,
v.
MISSOURI PUBLIC SERVICE COMMISSION and
Atmos Energy Corporation, Respondents.

No. SC 92964.

July 30, 2013.

Rehearing Denied Sept. 10, 2013.

Opinion Modified on Court's Own Motion Sept. 10,
2013.

Background: Office of Public Counsel (OPC) sought review of order of Public Service Commission (PSC), 2011 WL 5831353, approving actual cost adjustment rates for natural gas utility.

Holding: On transfer from the Court of Appeals, the Supreme Court, Laura Denvir Stith, J., held that in a matter of first impression, it was improper for PSC to rely on presumption that utility's costs in transactions with its affiliate were prudently incurred in rejecting PSC staff's proposed actual cost adjustment disallowances regarding utility's transactions with its affiliate.

Reversed and remanded; rehearing denied.

West Headnotes

[1] Public Utilities 317A  194

317A Public Utilities

317AIII Public Service Commissions or Boards
317AIII(C) Judicial Review or Intervention
317Ak188 Appeal from Orders of Com-

mission

317Ak194 k. Review and determination in general. Most Cited Cases

Appellate standard of review of an order of the Public Service Commission (PSC) is two-pronged: first, the reviewing court must determine whether the PSC's order is lawful, and second, the reviewing court must determine whether the order is reasonable.

[2] Public Utilities 317A  195

317A Public Utilities

317AIII Public Service Commissions or Boards
317AIII(C) Judicial Review or Intervention
317Ak188 Appeal from Orders of Commission

317Ak195 k. Presumptions in favor of order or findings of commission. Most Cited Cases

The Public Service Commission's (PSC) order has a presumption of validity, and the burden of proof is on the appellant to prove that the order is unlawful or unreasonable.

[3] Public Utilities 317A  147

317A Public Utilities

317AIII Public Service Commissions or Boards
317AIII(A) In General
317Ak145 Powers and Functions
317Ak147 k. Statutory basis and limitation. Most Cited Cases

Public Utilities 317A  194

317A Public Utilities

317AIII Public Service Commissions or Boards
317AIII(C) Judicial Review or Intervention

409 S.W.3d 371
(Cite as: 409 S.W.3d 371)

317Ak188 Appeal from Orders of Commission

317Ak194 k. Review and determination in general. Most Cited Cases

The lawfulness of an order of the Public Service Commission (PSC) is determined by whether statutory authority for its issuance exists, and all legal issues are reviewed de novo.

[4] Public Utilities 317A ↪194

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(C) Judicial Review or Intervention

317Ak188 Appeal from Orders of Commission

317Ak194 k. Review and determination in general. Most Cited Cases

The decision of the Public Service Commission (PSC) is reasonable where the order is supported by substantial, competent evidence on the whole record, the decision is not arbitrary or capricious, or where the PSC has not abused its discretion.

[5] Gas 190 ↪14.4(12)

190 Gas

190k14 Charges

190k14.4 Reasonableness of Charges

190k14.4(12) k. Evidence. Most Cited Cases

The burden is on the gas corporation to prove to the Public Service Commission (PSC) that the gas costs it proposes to pass along to customers are just and reasonable.

[6] Gas 190 ↪14.4(12)

190 Gas

190k14 Charges

190k14.4 Reasonableness of Charges

190k14.4(12) k. Evidence. Most Cited Cases

While the burden of proof rests on the gas corporation, the Public Service Commission's (PSC) practice has been to apply a presumption of prudence in determining whether a utility properly incurred its expenditures.

[7] Public Utilities 317A ↪128

317A Public Utilities

317AII Regulation

317Ak119 Regulation of Charges

317Ak128 k. Operating expenses. Most Cited Cases

Public Utilities 317A ↪165

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(B) Proceedings Before Commissions

317Ak165 k. Evidence. Most Cited Cases

The presumption of prudence that a utility's costs are prudently incurred, applied by Public Service Commission (PSC) in determining whether a utility properly incurred its expenditures does not survive a showing of inefficiency or improvidence that creates serious doubt as to the prudence of an expenditure; if such a showing is made, the presumption drops out and the utility has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent.

[8] Public Utilities 317A ↪128

317A Public Utilities

409 S.W.3d 371

(Cite as: 409 S.W.3d 371)

317AII Regulation

317Ak119 Regulation of Charges

317Ak128 k. Operating expenses. Most Cited Cases

A presumption that a utility's costs are prudently incurred is appropriately applied by the Public Service Commission (PSC) in arms-length transactions between a utility and a non-affiliated company; when dealing at arms-length, there is a diminished probability of collusion and the pressures of a competitive market create an assumption of legitimacy.

[9] Public Utilities 317A ↪ 128

317A Public Utilities

317AII Regulation

317Ak119 Regulation of Charges

317Ak128 k. Operating expenses. Most Cited Cases

The presumption that a utility's costs are prudently incurred, applied by Public Service Commission (PSC) in determining whether a utility properly incurred its expenditures, does not apply to transactions between a utility and its affiliate.

[10] Gas 190 ↪ 14.4(7)

190 Gas

190k14 Charges

190k14.4 Reasonableness of Charges

190k14.4(7) k. Operating expenses in general. Most Cited Cases

Gas 190 ↪ 14.5(9)

190 Gas

190k14 Charges

190k14.5 Judicial Review and Enforcement of Regulations

190k14.5(9) k. Determination and disposition. Most Cited Cases

It was improper for Public Service Commission (PSC) to rely on presumption that natural gas utility's costs in transactions with its affiliate were prudently incurred in issuing order rejecting PSC staff's proposed actual cost adjustment disallowances regarding utility's transactions with its affiliate, and, thus, remand was required so that PSC could determine whether utility complied with affiliate transaction rules, as the presumption of prudence applied only to transactions between a utility and a non-affiliate. 4 Mo.Code of State Regulations 240-40.016(3)(A), (4)(B), (5)(C).

*372 Marc Poston, Deputy Counsel, Jefferson City, for The Office of Public Counsel.

Jennifer Leigh Heintz, The Commission, Jefferson City, for The Public Service Commission.

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LAURA DENVIR STITH, Judge.

The Office of Public Counsel (OPC) appeals from an order entered by the Missouri Public Service Commission (PSC) rejecting the PSC staff's proposed actual cost adjustment disallowances regarding Atmos Energy Corporation's transactions with its affiliate. This Court reverses.

When a regulated gas corporation such as Atmos Energy engages in a business transaction with an affiliated entity, it is required to abide by the affiliate transaction rules set forth in the Missouri Code of State Regulations. 4 CSR 240-40.015-40.016. Due to the inherent risk of self-dealing, the presumption of prudence utilized by the PSC when reviewing regu-

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lated utility transactions should not be employed if a transaction is between a utility and the utility's affiliate.

Because the PSC reviewed the transaction between Atmos and its affiliate through the lens of the presumption of prudence, its order is unlawful and unreasonable. Accordingly, the order is reversed and the case remanded to the PSC for further review consistent with this opinion.

I. FACTUAL AND PROCEDURAL BACKGROUND

In 2007 and 2008, Atmos Energy Corporation operated as the largest natural-gas-only distributor in the United States. As a local distributing company, Atmos does not produce its own gas and does not purchase gas directly from producers. Instead, Atmos contracts with independent gas marketing companies to purchase natural gas. Atmos then delivers the purchased gas to customers through its local pipelines.

*373 Atmos is subject to regulation as a gas corporation and public utility by the Missouri Public Service Commission (PSC). *See* § 386.020; § 386.250; *chapter 393*.^{FN1} The PSC is a state agency established to regulate public utilities operating within the state. Pursuant to the statutory provisions in chapter 393, the PSC has jurisdiction over the rates and charges that Atmos imposes on its Missouri customers.^{FN2}

FN1. All Missouri statutory references are to RSMo 2000 unless otherwise indicated.

FN2. In 2012, Atmos sold its Missouri assets to Liberty Utilities.

In addition to the basic amount Atmos charges its customers under its published rate, Atmos also is permitted to charge its customers for additional costs it has incurred when the price it pays its suppliers for gas increases. These additional charges are recovered

through a two-part mechanism known as a purchased gas adjustment/actual cost adjustment process (PGA/ACA). In the PGA portion of this process, a utility such as Atmos files annual tariffs in which it estimates its costs of obtaining gas over the coming year. The PGA amounts are then included in the customers' bills over the ensuing 12 months. Because it is difficult to estimate the projected changes in cost precisely, the utility then files for an adjustment, or ACA, if its actual cost is different than projected in its PGA filing. This ACA allows the PSC to correct any discrepancies between the costs billed and the costs actually incurred. When an ACA is received, the PSC staff audits the utility's gas purchases made during the ACA period in question. As part of the review, the staff evaluates whether the rates paid by consumers for natural gas sold during the period were "just and reasonable." § 393.130.1. The PSC then takes the staff's audit into consideration and ultimately determines the proper ACA amount.^{FN3}

FN3. The PSC adopted the PGA/ACA rate mechanism pursuant to its broad power to regulate gas utilities, rather than pursuant to a specific statutory directive. *See chapter 393*; 4 CSR 240-13.010(I) (S) (defining "purchased gas adjustment clause"); 4 CSR 240-40.018(I)(B) (explaining use of purchased gas adjustment clauses to control financial gains or losses associated with gas price volatility). This Court has not addressed the authority of the PSC to utilize the PGA/ACA mechanism as part of its regulation of gas utilities, although one court of appeals decision has done so. *See State ex rel. Midwest Gas Users' Ass'n v. Pub. Serv. Comm'n or State*, 976 S.W.2d 470 (Mo.App.1998) (discussing implied authorization for use of PGA/ACA mechanism when certain procedural protections are in place). Here, as neither party challenges the use of the PGA/ACA mechanism, this Court still does not reach that issue. *Cf. State ex rel.*

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Util. Consumers' Council of Missouri, Inc. v. Pub. Serv. Comm'n, 585 S.W.2d 41, 46 (Mo. banc 1979) (disapproving *electric* utility's use of a fuel adjustment clause, which is similar to a PGA mechanism, because automatic adjustment clauses were unlawful under statutory scheme then in place); *State ex rel. AG Processing v. Pub. Serv. Comm'n*, 340 S.W.3d 146, 151 (Mo.App.2011) (approving *electric* utility's use of fuel adjustment clause, which permitted automatic adjustment for actual fuel costs without a full rate hearing, pursuant to legislature's 2005 enactment of section 386.266).

Atmos submitted its 2007–2008 ACA filings to the PSC on October 16, 2008. PSC staff audited the ACA filing by reviewing and analyzing the billed revenues and actual gas costs for the period of September 1, 2007, to August 31, 2008, for each of Atmos' eight Missouri service areas. The staff's review raised concerns regarding Atmos' transactions with Atmos Energy Marketing LLC (“AEM”).

AEM is a separate, unregulated but affiliated gas marketing company that is wholly owned by Atmos. Between April 2004 and November 2009, Atmos issued 48 requests for proposals (RFPs) in six other service areas. Of these 48 RFPs, AEM *374 submitted bids in response to 24 and was the winning bidder in six.

Two of these six winning bids were for supplying gas to the Hannibal area operating system during the 2007–2008 ACA period. As required when taking bids, Atmos issued a RFP and interested suppliers submitted confidential bids proposing pricing for supplying gas services to Atmos for the Hannibal area. For the 2007–2008 ACA period at issue here, Atmos had two overlapping RFP processes; the first covered the period April 1, 2007, to March 31, 2008, and the second covered the period April 1, 2008, to March 31, 2009. For each period, Atmos sent RFP letters to 56

gas marketing companies.

During the first period, Atmos received only five bids that Atmos said conformed to the RFP requirements. Its affiliate, AEM, submitted the lowest bid at \$14,723,472. The lowest conforming bid submitted by a non-affiliated gas marketer was for \$15,069,726, approximately \$346,000 higher than AEM's bid. During the second period, only three suppliers submitted bids that Atmos said conformed to its RFP. Its affiliate, AEM, submitted a bid of \$13,947,511. This bid was approximately \$100,000 lower than the next lowest bid of \$14,049,424. Atmos awarded AEM both contracts.

Staff raised an issue about how the RFP set out certain supply requirements and whether AEM's bid actually conformed to the RFP requirements. It is uncontested that the RFP mandated that all gas supply be “firm and warranted.” But the RFP process also allowed bidders to use either a primary natural gas receipt point or a secondary receipt point. Primary firm delivery is the highest priority gas supply and costs more because timely delivery is assured. Secondary in-path delivery is just below primary firm delivery. The secondary delivery method, though, is still “firm” though less convenient. Both forms of delivery are preferred over “interruptible” supply, because the timing of supplying interruptible gas may be interrupted if the supplier has an inadequate quantity of gas to meet all commitments at a specific time. Staff contended it was not clear that AEM's bid was for firm rather than interruptible gas because the transaction confirmation document that normally specifies “firm” delivery was left blank. Staff also contended the distinction between primary and secondary receipt points was not made clear in the RFP bidding, which could have allowed AEM an advantage if it had insider knowledge that Atmos was willing to accept a secondary receipt point bid. Staff contends this gave AEM a benefit in the transactions because of its affiliation with Atmos.

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The transactions between a utility such as Atmos and its affiliate are governed by the PSC's affiliate transaction rules. The rules establish standards for a regulated gas utility's dealings with its affiliated companies. When acquiring natural gas from an affiliate, a regulated local distribution company can compensate its affiliate only at the lesser of the gas' fair market price or the fully distributed cost to the regulated gas company were it to acquire the gas for itself. 4 CSR 240-40.016(3)(A).^{FN4} This provision is known as *375 the asymmetrical pricing standard. *State ex rel. Atmos Energy Corp. v. Pub. Serv. Comm'n of State*, 103 S.W.3d 753, 762 (Mo. banc 2003).

FN4. 4 CSR 240-40.015 is the general affiliate transaction rule, while 4 CSR 240-40.016 specifically regulates transactions between regulated gas corporations and affiliated gas marketing companies. Both 240-40.015 and 240-40.016 provide:

(A) A regulated gas corporation shall not provide a financial advantage to an affiliated entity. For the purposes of this rule, a regulated gas corporation shall be deemed to provide a financial advantage to an affiliated entity if—

1. It compensates an affiliated entity for goods or services above the lesser of—

A. The fair market price; or

B. The fully distributed cost to the regulated gas corporation to provide the goods or services for itself ...

Following its audit of the 2007-2008 ACA period, the PSC staff report indicated that Atmos had failed to comply with the affiliate transaction rules because it failed to properly document the fair market

value and fully distributed cost of its transactions with AEM. Staff proposed a disallowance of \$308,733 for the Hannibal area, an amount equal to the profit AEM earned on that transaction.

In its filed response to the staff's recommendation, Atmos disagreed with the proposed disallowance and requested a hearing. The PSC conducted an evidentiary hearing on March 23 and 24, 2011, and issued a report and order on November 9, 2011.

In considering whether Atmos complied with the affiliate transaction rules, the PSC applied a presumption that Atmos' gas purchases were prudent and put the burden on staff to prove that the purchases from AEM were not prudent. The PSC determined that staff had failed to rebut this presumption, that the fair market price was established by Atmos' bidding process, and that this fair market price was less than the fully distributed cost for Atmos to acquire the gas itself. Based on this presumption, the PSC found compliance with the affiliate transaction rules and rejected staff's proposed disallowances regarding Atmos' transactions with AEM.

OPC filed an application for rehearing, which the PSC denied.^{FN5} OPC appealed and the court of appeals affirmed. This Court granted transfer pursuant to art. V, sec. 10 of the Missouri Constitution after opinion by the court of appeals.

FN5. OPC acts as consumers' advocate and represents the public in utility cases before the PSC. The powers of the OPC are set forth in section 386.710.

II. STANDARD OF REVIEW

[1][2][3][4] "Pursuant to section 386.510, the appellate standard of review of a [PSC] order is two-pronged: 'first, the reviewing court must determine whether the [PSC]'s order is lawful; and second, the court must determine whether the order is rea-

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sonable.’ ” *State ex rel. AG Processing, Inc. v. Pub. Serv. Comm’n of State*, 120 S.W.3d 732, 734 (Mo. banc 2003). The PSC’s order has a presumption of validity, and the burden of proof is on the appellant to prove that the order is unlawful or unreasonable. *State ex rel. Sprint Missouri, Inc. v. Pub. Serv. Comm’n of State*, 165 S.W.3d 160, 164 (Mo. banc 2005). The lawfulness of an order is determined “by whether statutory authority for its issuance exists, and all legal issues are reviewed de novo.” *AG Processing*, 120 S.W.3d at 734. “The decision of the [PSC] is reasonable where the order is supported by substantial, competent evidence on the whole record; the decision is not arbitrary or capricious or where the [PSC] has not abused its discretion.” *State ex rel. Praxair, Inc. v. Missouri Pub. Serv. Comm’n*, 344 S.W.3d 178, 184 (Mo. banc 2011).

III. ANALYSIS

The OPC argues that the PSC’s order is unlawful and unreasonable in that it violates 4 CSR 240–40.016 and is not based on competent and substantial evidence. The order is unlawful, the OPC contends, because*376 the PSC did not adhere to the asymmetrical pricing standard rules, which require documentation showing that Atmos charged customers the lesser of the fair market price or the fully distributed cost for the gas supply acquired from Atmos’ affiliate, AEM. The OPC claims the order is unreasonable because it believes the PSC’s conclusion that Atmos acquired gas supply from AEM at the lesser of the fully distributed cost or fair market price is not supported by competent and substantial evidence. This error was contributed to by the PSC’s misreliance on the presumption of prudence in reviewing the bid of an affiliate, which OPC says is improper.

A. Presumption of Prudence

[5] The burden is on the gas corporation to prove that the gas costs it proposes to pass along to customers are just and reasonable. § 393.150.2; *see also Matter of Kansas Power and Light Co.*, 30 Mo. P.S.C. (N.S.) 76 (1989) (The gas corporation has the burden

of showing its proposed rates are just and reasonable ... [and] of showing the reasonableness of costs associated with its rates for gas.)

[6] While the burden of proof rests on the gas corporation, the PSC’s practice has been to apply a “presumption of prudence” in determining whether a utility properly incurred its expenditures. The presumption of prudence is not a creature of statute or regulation. It first was recognized by the PSC in *Matter of Union Electric*, 27 Mo. P.S.C. (N.S.) 183 (1985) and has been applied by it since that point.

[7] Under the presumption of prudence, a utility’s costs “are presumed to be prudently incurred.... However, the presumption does not survive a showing of inefficiency or improvidence” that creates “serious doubt as to the prudence of an expenditure.” *Id.* at 193, quoting *Anaheim, Riverside, Etc. v. Fed. Energy Reg. Com’n*, 669 F.2d 799, 809 (D.C.Cir.1981). If such a showing is made, the presumption drops out and the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent. *Id.*

The Missouri court of appeals has applied the presumption of prudence in cases involving affiliated companies without discussing whether its rationale is applicable to affiliates. *See, e.g., State ex rel. Pub. Counsel v. Pub. Serv. Comm’n*, 274 S.W.3d 569, 582 (Mo.App.2009) (stating without analysis that “[a]lthough UE purchased the CTGs from its affiliates, the commission properly presumed that UE was prudent in its purchase of the CTGs”); *State ex rel. Assoc. Natural Gas Co. v. Public Serv. Comm’n*, 954 S.W.2d 520 (Mo.App.1997) (without discussing rationale court assumes presumption applies and finds Commission erred in finding it was overcome and disallowing increase where no harm to customers was shown).

This Court has not addressed directly whether the

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presumption of prudence is valid in either affiliate or non-affiliate cases, although it did note its existence, without addressing its legitimacy, in *dicta* in a non-affiliate case, *State ex rel. Riverside Pipeline Co., LP. v. Pub. Serv. Comm'n of State*, 215 S.W.3d 76, 85 (Mo. banc 2007). *Riverside* upheld a stipulation between the PSC and certain energy companies that precluded prudence review by the PSC.

[8] The OPC agrees that a presumption of prudence is appropriately applied in arms-length transactions, and this Court concurs. When dealing at arms-length, there is a diminished probability of collusion and the pressures of a competitive market create an assumption of legitimacy.

[9] OPC argues, however, that a presumption that a transaction was agreed to prudently should not apply to *affiliate* transactions because of the greater risk of self-dealing when contracting with an affiliate. This Court again agrees. As noted in the report of a Congressional staff investigation of the particularly egregious affiliate dealings between Enron and its pipeline subsidies in the wake of Enron's collapse:

[W]henver a company conducts transactions among its own affiliates there are inherent issues about the fairness and motivations of such transactions.... One concern is that where one affiliate in a transaction has captive customers, a one-sided deal between affiliates can saddle those customers with additional financial burdens. Another concern is that one affiliate will treat another with favoritism at the expense of other companies or in ways detrimental to the market as a whole.

Staff of Senate Comm. on Gov't Affairs, 107th Cong., *Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron* 26, n. 75 (Nov. 12, 2002); see also Judy Sheldrew, *Shutting the Barn Door Before the Horse Is Stolen: How and Why State Public Utility Commissions*

Should Regulate Transactions Between A Public Utility and Its Affiliates, 4 NEV. L.J. 164, 195 (2003).

This greater risk inherent in affiliate transactions arises because agreements between a public utility and its affiliates are not "made at arm's length or on an open market. They are between corporations, one of which is controlled by the other. As such they are subject to suspicion and therefore present dangerous potentialities." *Pac. Tel. & Tel. Co. v. Pub. Utils. Comm'n*, 34 Cal.2d 822, 215 P.2d 441, 449 (1950) (*Carter, J., dissenting*).

Indeed, as the PSC acknowledged in *State ex rel. Atmos Energy Corp. v. Pub. Serv. Comm'n of State*, 103 S.W.3d 753, 763–64 (Mo. banc 2003), the affiliate transaction rules were adopted in response to the very kinds of concerns now raised by OPC. In that case, the concern was with a profit-producing scheme among certain public utilities termed "cross-subsidization," through which some utilities would abandon their traditional monopoly structure and expand into non-regulated areas. "This expansion [gave] utilities the opportunity and incentive to shift their non-regulated costs to their regulated operations with the effect of unnecessarily increasing the rates charged to the utilities' customers." *Id.* at 764. See also *United States v. Western Elec. Co.*, 592 F.Supp. 846, 853 (D.D.C.1984) ("As long as a [utility] is engaged in both monopoly and competitive activities, it will have the incentive as well as the ability to 'milk' the rate-of-return regulated monopoly affiliate to subsidize its competitive ventures").

Here, the concern is with an ability to offer a lower bid than one's competitors because of access to inside information about costs and terms and because of an ability to shift fixed costs to the regulated utility, thereby allowing the affiliate to bid lower due to lower overhead costs. While this Court does not suggest that there was such conduct here, the risk of this conduct and the incentive to undertake it inherently exists in affiliate transactions.

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For these reasons, the rationale for permitting a presumption of prudence in arms-length transactions simply has no application to affiliate transactions. The PSC enacted the affiliate transaction rules in 2000 with the precise purpose of thwarting unnecessary rate hikes due to cross-subsidization. *State ex rel. Atmos*, 103 S.W.3d at 764. Those rules require that a utility must show that it paid the lesser of the fair market rate or the fully distributed cost to the regulated gas corporation *378 and require that records be kept supporting these calculations. 4 CSR 240-40.016(4)(B) (“[T]he regulated gas corporation shall document both the fair market price of such ... goods and services and the fully distributed cost to the regulated gas corporation to produce the ... goods or services for itself”)

The affiliate rules' stated purpose is to “prevent regulated utilities from subsidizing their non-regulated operations ... and provide the public the assurance that their rates are not adversely impacted by the utilities' nonregulated activities.” 240-40.015. A presumption that costs of transactions between affiliates were prudent is inconsistent with these rules.

For these reasons, the majority of other courts to address the issue have concluded that a presumption of prudence should not be applied to affiliate transactions. In *US W. Commc'ns, Inc. v. Pub. Serv. Comm'n of Utah*, 901 P.2d 270 (Utah 1995), the Supreme Court of Utah held that the Utah Public Service Commission correctly placed the burden on a telephone provider of proving that the services rendered by its affiliate were not duplicative. In support of its decision, the court remarked; “While the pressures of a competitive market might allow us to assume, in the absence of a showing to the contrary, that nonaffiliate expenses are reasonable, the same cannot be said of affiliate expenses not incurred in an arm's length transaction.” *Id.* at 274.

The Supreme Court of Idaho reached a similar

conclusion in *Boise Water Corp. v. Idaho Pub. Utilities Comm'n*, 97 Idaho 832, 555 P.2d 163 (1976). The court refused to make an exception to the rule placing upon the utility the burden of proving reasonableness of its operating expenses paid to an affiliate, stating; “The reason for this distinction between affiliate and non-affiliate expenditures appears to be that the probability of unwarranted expenditures corresponds to the probability of collusion.” *Id.* at 169. *See also*, *Turpen v. Oklahoma Corp. Comm'n*, 769 P.2d 1309, 1320-21 (Okla.1988) (“It is generally held that, while the regulatory agency bears the burden of proving that expenses incurred in transactions with nonaffiliates are unreasonable, the utility bears the burden of proving that expenses incurred in transactions with affiliates are reasonable”); *Michigan Gas Utilities v. Michigan Pub. Serv. Comm'n*, 206234, 1999 WL 33454925 (Mich.App. Feb. 9, 1999) (“the utility has the burden of demonstrating that its transactions with its affiliate are reasonable”). This Court concurs. A presumption of prudence is inconsistent with the rationale for the affiliate transaction rules and with the PSC's obligation to prevent regulated utilities from subsidizing their non-regulated operations.

The PSC counters that it always has recognized a presumption of prudence and that this Court cannot read the affiliate transaction rules to negate that presumption in the case of affiliated transactions because the affiliate transaction rules themselves state that they did not “modify existing legal standards regarding which party has the burden of proof in commission proceedings.” 4 CSR 240-40.015(6)(C) & 240-40.016(7)(C). This argument is based on a misunderstanding of the concept of burden of proof.

Missouri law sets out the burden of proof in PSC proceedings. As noted earlier, those statutes provide that a gas corporation has the burden to prove that the gas costs it proposes to pass along to customers are just and reasonable. § 393.150.2. The PSC has no authority to adopt rules changing the burden of proof set out in the relevant statutes, and it was proper for

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the affiliate transaction rules to note that they did not attempt to do so. See *379 *Kanakuk—Kanakomo Kamps, Inc. v. Dir. of Revenue*, 8 S.W.3d 94, 98 (Mo. banc 1999) (A regulation that is beyond the scope of the statute is a nullity).

A change in the presumption of prudence does not change the burden of proof set out in the PSC governing statutes. The presumption of prudence does not address the burden of proof at all. It sets out *an evidentiary presumption* created by the PSC. That standard provides that the utility's expenditures are presumed to be prudent until adequate contrary evidence is produced, at which point the presumption disappears from the case. See *Deck v. Teasley*, 322 S.W.3d 536, 539 (Mo. banc 2010) (discussing general law of presumptions). This presumption affects who has the burden of proceeding, but it does not change the burden of proof, which by statute must remain on the utility.^{FN6} § 393.150.2.

FN6. Although the above analysis is dispositive, it bears noting that the PSC has not identified any rule, regulation or decision in which it affirmatively determined prior to the adoption of the affiliate transaction rules that the presumption of prudence was applicable to affiliate transactions. For this reason also, AEM's argument is not well taken.

Further, the presumption of prudence is not even a creature of statute or of PSC regulations or rules. It was created by PSC case law. It cannot be applied inconsistently with the PSC's governing statutes and rules. As discussed above, the application of a presumption of prudence to a transaction with an affiliated company is inconsistent with the PSC's statutory and regulatory obligations to review affiliate transactions. Accordingly, the presumption of prudence is inapplicable to affiliate transactions.

B. PSC Order Inappropriately Relied on Presump-

tion of Prudence

[10] The PSC used the presumption of prudence to shift the burden from Atmos, which should have been required to show that it complied with the affiliate transaction rules, and instead placed the burden on staff to show that Atmos did not do so.

The effect of the PSC's reliance on the presumption of prudence is particularly obvious in regard to the PSC's discussion of what would have been the fully distributed cost had Atmos obtained the gas itself rather than going through third parties. As noted earlier, the affiliate transaction rules mandate that a utility shall not provide a financial advantage to an affiliated entity. The utility provides a financial advantage if it "compensates an affiliated entity for ... goods or services above the lesser of ... [t]he fair market price ... or [t]he fully distributed cost to the [utility] to provide the ... goods or services for itself." 4 CSR 240-40.016(3)(A).

In all transactions that involve the purchase or receipt of goods or services from an affiliated entity, the utility must document the fair market value and the fully distributed cost, 4 CSR 240-40.016(4)(B),^{FN7} and this documentation must be kept in books and records with "sufficient detail to permit verification with this rule." 4 CSR 240-40.016(5)(C)1.^{FN8} The rules specifically *380 define what figures must be included in the calculation of the fully distributed cost:

FN7. The regulation states in relevant part:

In transactions that involve either the purchase or receipt of information, assets, goods or services by a regulated gas corporation from an affiliated entity, the regulated gas corporation shall document both the fair market price of such information, assets, goods and services and the fully distributed cost to the regulated gas corporation to produce the information, as-

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sets, goods or services for itself.

4 CSR 240-40.016(4)(B).

FN8. The evidentiary requirement requires a regulated gas company maintain the following records:

1. Records identifying the basis used (e.g., fair market price, fully distributed cost, etc.) to record affiliate transactions; and
2. Books of accounts and supporting records in sufficient detail to permit verification of compliance with this rule.

4 CSR 240-40.016(5)(C).

Fully distributed cost (FDC) means a methodology that examines all costs of an enterprise in relation to all the goods and services that are produced. FDC requires recognition of all costs incurred directly or indirectly used to produce a good or service. Costs are assigned either through a direct or allocated approach. Costs that cannot be directly assigned or indirectly allocated (e.g., general or administrative) must also be included in the FDC calculation through a general allocation.

4 CSR 240-40.016(1)(F).

Due to its reliance on the presumption of prudence, the PSC did not consider whether Atmos kept the required books and records and whether Atmos showed that its fully distributed costs were higher than the fair market value of the services received from its affiliate. Neither did it require Atmos or AEM to produce most of these records to staff or OPC.^{FN9} Staff did not have evidence as to how ABM prepared its bid or as to the sharing of costs between Atmos and AEM because it had not been able to obtain this information. This led the PSC to reject staff's proposed disallowance of \$308,733 in profits because, it found, staff did

not offer "any serious argument to suggest that Atmos could provide gas-marketing services for itself cheaper if it did not use the services of gas marketing companies."

FN9. This also led the PSC to not resolve the issue whether Atmos adequately complied with the PSC's order compelling production of certain information in its books and records and whether the order went beyond what was required by the affiliate transaction rules. In light of the presumption of prudence, the PSC found that this discovery was not necessary. Because it is appropriate for the PSC to determine the parties' disagreement on the meaning, effect and compliance with the motion to compel in the first instance in light of this Court's ruling on the inappropriateness of using the presumption of prudence in affiliate transactions, this Court does not resolve this issue here but leaves it for the PSC to resolve on remand.

Of course, it was not up to staff to prove a negative. Whether staff thought the cost would have been cheaper if Atmos had not used the affiliate was the not the relevant question; the affiliate transaction rules put the burden on Atmos to keep records that would allow it to show it would not have been cheaper.

The PSC notes that staff did not specifically contest what Atmos' costs of providing its own gas marketing services would have been. OPC, however, did contest this issue. In its initial brief before the PSC, OPC specifically challenged the prudence of purchasing gas at a marked-up price from an affiliate rather than by Atmos acquiring the gas itself at a similar or lesser cost, stating, "Atmos' decision to purchase gas through its marketing affiliate AEM, rather than by making the gas purchases itself (and avoiding the AEM profit mark-up) is reason alone to render Atmos' purchasing decisions imprudent."

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OPC argues that the PSC erred in simply presuming that, because there was a bid process, the lowest price bid must have been the lowest fair market value of the gas. It argues that the number of bidders was so low that the bid process was inadequate to identify the fair market value of the gas. OPC also specifically questions whether Atmos required AEM to bid for the same service as the other companies to whom Atmos sent an RFP in light of staff's evidence that the agreement between Atmos and AEM left blank whether "381 the gas was to be "firm" or "interruptible gas," whereas other gas-supply agreements between Atmos and non-affiliates specifically identified that firm gas was required. This was an important distinction because, as noted earlier, firm gas transportation, for which delivery is guaranteed, is generally more expensive than interruptible transportation, for which delivery can be delayed if the pipeline's capacity is completely in use.

OPC suggests that if Atmos requested proposals for firm gas transportation with the understanding that it would be sufficient if AEM bid the cost of interruptible gas transportation, it would have allowed AEM to undercut the other gas marketers' bids. If this were what happened, the bid by AEM most certainly would not have reflected the "fair market price" of firm gas.

Similarly, OPC questioned whether the bidding process adequately established the fair market price due to the low number of conforming bids submitted by non-affiliated gas marketers. In the first RFP, only four non-affiliated gas marketers submitted conforming bids; in the second RFP, only two did so (and only if one presumes that they all bid on firm rather than interruptible gas). The record does not show whether the PSC would have considered this a sufficient response to enable it to determine the fair market value of the gas had it not relied on the presumption of prudence.

As with the question of fully distributed costs, due to its reliance on the presumption of prudence, the PSC did not develop a sufficient record on these or related issues to permit this Court to determine whether Atmos complied with the affiliate transaction rules and whether the PSC order is reasonable and lawful. This Court remands so that the PSC can resolve these issues in the first instance based on the proper standard.

IV. CONCLUSION

The PSC erred in relying upon the presumption of prudence in rejecting staff and OPC's proposed disallowance for Atmos' Hannibal service area gas costs. The affiliate transaction rules were enacted in an effort to prevent regulated utilities from subsidizing their non-regulated activities. To presume that a regulated utility's costs in a transaction with an affiliate were incurred prudently is inconsistent with these rules.

The PSC relied heavily on the presumption of prudence in rejecting staff's proposed disallowance. This error resulted in an order that is unlawful and unreasonable. On remand, the PSC again must consider whether Atmos compensated AEM above the lesser of the fair market price or the fully distributed cost to Atmos to provide the gas for itself. To satisfy the affiliate transaction rules' requirements, Atmos must provide sufficient asymmetrical pricing documentation as to fair market value, including the bidding process, and the calculation of the fully distributed cost. The PSC's order is reversed, and the case remanded.

All concur.

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

In the Matter of Missouri Gas Energy and)
Its Tariff Filing to Implement a General) Case No. GR-2009-0355
Rate Increase for Natural Gas Service)

STAFF RESPONSE TO COMMISSION REQUEST

COMES NOW the Staff of the Commission and in response to Commissioner Davis' request for additional information concerning allocations states:

1. During this rate case hearing Commissioner Davis requested Staff provide information concerning corporate allocations.

2. Staff has reviewed various documents and is attaching portions of section section 19.03 [4] [d], "Allocation of Corporate Overhead Costs." Specifically 19-12 to 19-14 as the subsection contain the most direct answer to allocation methods, including the "Massachusetts Formula."

3. This section is from Accounting for Public Utilities, by Robert L. Hahne and Gregory E. Aliff, Release No. 25, October 2008. The excerpt is specifically from Chapter 19 of this text, "Cost Allocations for a Diversified Utility," which is available in the Accounting Department's library and will be made available to any party requesting review of the publication.

4. This is a fairly large text so Staff has included only limited portions of the document in direct response to Commissioner Davis' request (Transcript Vol. 8, p. 89.)

5. Staff would be happy to provide additional information and do additional research on the whole topic of corporate allocations if the Commission wishes.

6. Staff does not necessarily endorse or agree with any of the conclusions or recommendations contained in the text provided.

WHEREFORE Staff requests the Commission accept this answer to Commissioner request and further direct Staff if the Commission requires additional information.

Respectfully submitted,

/s/ Lera L. Shemwell

Lera L. Shemwell
Deputy General Counsel
Missouri Bar No. 43792

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-7431 Telephone)
(573) 751-9285 (Fax)
lera.shemwell@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered or transmitted by facsimile or electronic mail to all counsel of record this 2nd day of February, 2010.

/s/ Lera Shemwell

In summary, the CASB standards clearly enumerate the following cost allocation principles:

- (1) Expenses are to be directly assigned to the maximum extent possible;
- (2) Centralized corporate functions or management staff costs should be accumulated into homogenous cost pools;
- (3) Such cost pools should be allocated using representative bases that reflect cost causation or benefits, where identifiable; and
- (4) Where direct causal relationships or benefits cannot be determined or a directly relevant allocation base cannot be identified, costs pools may be allocated on some other reasonable basis that reflects the benefits of the services received.

Federal Communications Commission. With the deregulation of the telecommunications industry, the FCC issued Report and Order, CC Docket No. 86-111 to establish rules regarding the assignment and apportionment of costs related to both regulated and nonregulated subsidiaries. While providing both general and specific rules regarding cost apportionment, the underlying principles in FCC Docket No. 86-111 are intended to reflect fully distributed cost principles as contained in Section 64.901 of the FCC's rules. The guidelines contained in this docket for assigning and allocating costs to regulated and nonregulated activities include the following provisions:

- Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.
- Costs that cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between regulated and nonregulated activities in accordance with the following hierarchy:
 - Wherever possible, common costs categories are to be allocated based upon direct analysis of the origin of the costs themselves;
 - When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another category (or group of cost categories) for which a direct assignment or allocation is available;
 - When neither direct or indirect measures of cost causation can be identified, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

These cost assignment and allocation principles reflect the results of extended and detailed debate and discussion by inter-exchange carriers, local exchange carriers, customers, regulators, and vendors and provide an indication of the parameters considered relevant and implementable.

Federal Energy Regulatory Commission. There are a number of methods used by

the utility industry to allocate residual corporate support service costs that have been accepted as reasonable by state and federal regulatory authorities. Among the cost allocation methods that have been accepted by state and federal regulators as reasonable are those that are based on multi-factor formulas representing the overall business activity levels of utility companies.

Three of the most commonly used multi-factor formulas approved for use by state and federal regulators include the Kansas-Nebraska formula (KN formula), the Massachusetts formula, and the modified Massachusetts formula, or Distrigas Formula, for allocation of certain administrative and general costs. Following is a brief overview of each of these methodologies.

- (1) *KN formula.* The KN formula is based on the ratio of direct labor and capital investment of each division to total direct labor and capital investment. The allocation of costs using a multi-factor formula consisting of direct labor and gas plant was initially approved in 1975 in Federal Power Commission Opinion No. 73-1, Kansas-Nebraska Natural Gas Company, Inc., Docket No. RP72-32.
- (2) *Massachusetts formula.* The Massachusetts formula is based on the ratio of direct labor, capital investment and gross revenue of each affiliate to total direct labor, capital investment and gross revenue. The unmodified Massachusetts formula is derived from *Midwestern Gas Transmission Co. v. Federal Power Com.*, 32 FPC 993 (1964).
- (3) *Distrigas formula.* The Distrigas formula is based on the ratio of direct labor, capital investment and net operating revenue of each affiliate to total direct labor, capital investment and net operating revenues. The allocation of costs using a multi-factor formula consisting of direct labor, capital investment and net operating revenues was initially approved in 1987 in FERC Opinion No. 291, Distrigas of Massachusetts Corporation, Docket No. R.P850125-000.

The choice of whether to use the KN formula or either the Massachusetts formula or Distrigas formula turns primarily on whether separate affiliated corporate entities are involved in the allocation of common overhead costs (Massachusetts or Distrigas formulas), or whether functions or services involve the same legal entity (KN formula).

The only difference between the Distrigas and Massachusetts formulas is the calculation of the revenue factor. The Massachusetts formula is computed based on gross revenue (including purchased gas costs) and the Distrigas formula includes net operating revenues (excluding purchased gas costs). While both methods are acceptable, in certain instances the Distrigas formula may be preferable, as it provides more stability in the allocations from year to year since purchased gas costs (i.e., gas revenues) may fluctuate significantly from year to year. In FERC Opinion No. 291, the FERC stated that it adopted the use of net operating revenue rather than gross income for the third allocation factor because of the significant increases over the years in the portion of a pipeline's total revenues that are related to its purchased gas costs.

In order to develop an effective comprehensive cost allocation system, the goals of rate regulation must be known. A primary objective of utility regulation is to recognize all reasonable costs associated with the provision of utility service and to provide adequate rates to cover these costs. This objective is the same whether a utility functions as an independent entity, an entity with other regulated or unregulated activities, or a member of a holding company group.

[e] Transfer Pricing

Transfer pricing, or the process of pricing goods and services between affiliates, generally should be applied at the transactional level and can reflect either of the following two alternative approaches:

- (1) Under the market price alternative, the price charged to the utility should not be greater than the price the utility would incur to obtain the goods or service itself from available outside resources.
- (2) Under the cost alternative, the transfer price should include all costs plus an appropriate return on utilized assets for all goods or services provided.

Pricing is largely dependent on types of transactions. These transactions can be classified as transfers of assets, of goods or services for sale, and of goods or services not for sale.

Transfers of assets generally should be priced at fair market value. Of course, any transfer policy would be subject to the original cost rules of regulatory accounting and to limitations on the recognition of intercompany profits under GAAP. (See Chapter 4 for a discussion of original cost concepts.)

Transfers of goods or services for sale generally should be priced at fair market value, except perhaps for sales involving captive relationships that should be priced at cost. Transfers of goods or services not for sale would generally be priced at cost because of difficulties in determining a comparable market price.

These pricing policies can be viewed as consistent with the goals that were noted above. If the market value of an asset, goods, or services exceeds cost, a policy requiring a transfer to an affiliate at cost would harm the selling entity by causing it to incur a loss or reduced profit. In this situation, the purchasing entity would receive a subsidy if it purchased something at a below-market price. The use of fair market value pricing prevents the subsidization of one affiliated entity at the expense of another. Pricing transactions at fair market value also prevents transactions from occurring that do not have an economic purpose.

The exceptions to fair market value pricing are generally limited to three areas:

- (1) immaterial assets;
- (2) goods and services not for sale; and
- (3) sales involving captive relationships.

For immaterial assets, the time and expense necessary to determine fair market value does not warrant the effort and would not significantly affect the transfer price.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 8-K

Current Report

Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

Date of Report (Date of earliest event reported):
June 1, 2015

<u>Commission File Number</u>	<u>Exact Name of Registrant as Specified in its Charter, State of Incorporation, Address of Principal Executive Offices and Telephone Number</u>	<u>I.R.S. Employer Identification No.</u>
001-32206	GREAT PLAINS ENERGY INCORPORATED (A Missouri Corporation) 1200 Main Street Kansas City, Missouri 64105 (816) 556-2200 NOT APPLICABLE (Former name or former address, if changed since last report)	43-1916803
000-51873	KANSAS CITY POWER & LIGHT COMPANY (A Missouri Corporation) 1200 Main Street Kansas City, Missouri 64105 (816) 556-2200 NOT APPLICABLE (Former name or former address, if changed since last report)	44-0308720

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
- Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
- Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

This combined Current Report on Form 8-K is being furnished by Great Plains Energy Incorporated (Great Plains Energy) and Kansas City Power & Light Company (KCP&L). KCP&L is a wholly-owned subsidiary of Great Plains Energy and represents a significant portion of its assets, liabilities, revenues, expenses and operations. Thus, all information contained in this report relates to, and is furnished by, Great Plains Energy. Information that is specifically identified in this report as relating solely to Great Plains Energy, such as its financial statements and all information relating to Great Plains Energy's other operations, businesses and subsidiaries, including KCP&L Greater Missouri Operations Company (GMO), does not relate to, and is not furnished by, KCP&L. KCP&L makes no representation as to that information. Neither Great Plains Energy nor GMO has any obligation in respect of KCP&L's debt securities and holders of such securities should not consider Great Plains Energy's or GMO's financial resources or results of operations in making a decision with respect to KCP&L's debt securities. Similarly, KCP&L has no obligation in respect of securities of Great Plains Energy or GMO.

Item 7.01 Regulation FD Disclosure

Representatives of Great Plains Energy will participate in meetings with investors on June 2-4, 2015. A copy of the presentation slides to be used in the investor meetings is attached hereto as Exhibit 99.1.

The presentation slides contain information regarding KCP&L. Accordingly, information in the presentation slides relating to KCP&L is also being furnished on behalf of KCP&L. The information under this Item 7.01 and in Exhibit 99.1 hereto is being furnished and shall not be deemed "filed" for the purposes of Section 18 of the Securities Exchange Act of 1934, as amended or otherwise subject to the liabilities of that section. The information under this Item 7.01 and Exhibit 99.1 hereto shall not be deemed incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as amended, unless otherwise expressly indicated in such registration statement or other document.

Item 9.01 Financial Statements and Exhibits

(d) Exhibits

<u>Exhibit No.</u>	<u>Description</u>
99.1	Investor Presentation

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrants have duly caused this report to be signed on their behalf by the undersigned hereunto duly authorized.

GREAT PLAINS ENERGY INCORPORATED

/s/ Lori A. Wright
Lori A. Wright
Vice President - Investor Relations and Treasurer

KANSAS CITY POWER & LIGHT COMPANY

/s/ Lori A. Wright
Lori A. Wright
Vice President - Investor Relations and Treasurer

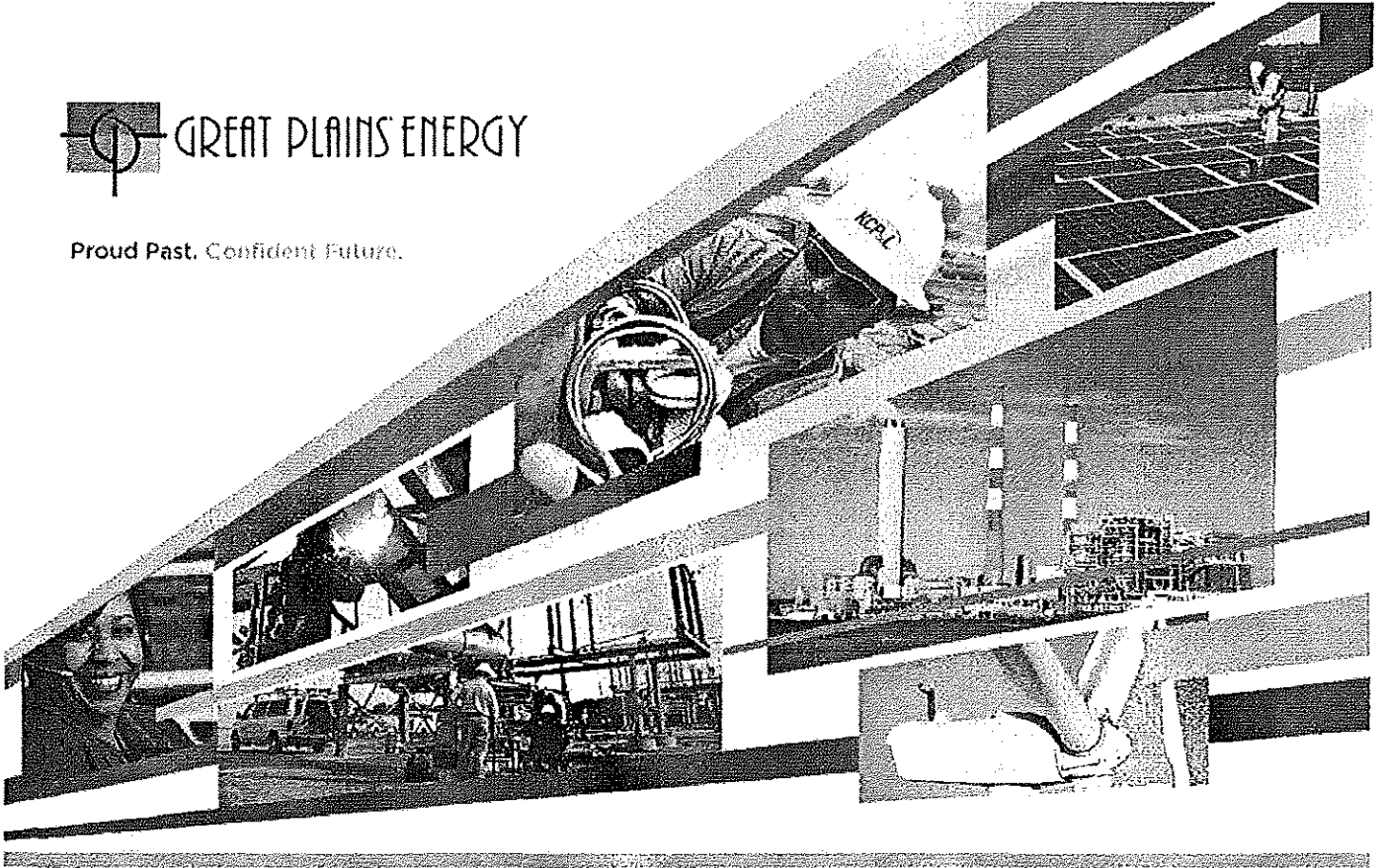
Date: June 1, 2015

Exhibit Index

<u>Exhibit No.</u>	<u>Description</u>
99.1	Investor Presentation



Proud Past. Confident Future.



June 2015 Investor Presentation

Forward-Looking Statement

Statements made in this presentation that are not based on historical facts are forward-looking, may involve risks and uncertainties, and are intended to be as of the date when made. Forward-looking statements include, but are not limited to, the outcome of regulatory proceedings, cost estimates of capital projects and other matters affecting future operations. In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, Great Plains Energy and KCP&L are providing a number of important factors that could cause actual results to differ materially from the provided forward-looking information. These important factors include: future economic conditions in regional, national and international markets and their effects on sales, prices and costs; prices and availability of electricity in regional and national wholesale markets; market perception of the energy industry, Great Plains Energy and KCP&L; changes in business strategy, operations or development plans; the outcome of contract negotiations for goods and services; effects of current or proposed state and federal legislative and regulatory actions or developments, including, but not limited to, deregulation, re-regulation and restructuring of the electric utility industry; decisions of regulators regarding rates the companies can charge for electricity; adverse changes in applicable laws, regulations, rules, principles or practices governing tax, accounting and environmental matters including, but not limited to, air and water quality; financial market conditions and performance including, but not limited to, changes in interest rates and credit spreads and in availability and cost of capital and the effects on nuclear decommissioning trust and pension plan assets and costs; impairments of long-lived assets or goodwill; credit ratings; inflation rates; effectiveness of risk management policies and procedures and the ability of counterparties to satisfy their contractual commitments; impact of terrorist acts, including but not limited to cyber terrorism; ability to carry out marketing and sales plans; weather conditions including, but not limited to, weather-related damage and their effects on sales, prices and costs; cost, availability, quality and deliverability of fuel; the inherent uncertainties in estimating the effects of weather, economic conditions and other factors on customer consumption and financial results; ability to achieve generation goals and the occurrence and duration of planned and unplanned generation outages; delays in the anticipated in-service dates and cost increases of generation, transmission, distribution or other projects; Great Plains Energy's ability to successfully manage transmission joint venture; the inherent risks associated with the ownership and operation of a nuclear facility including, but not limited to, environmental, health, safety, regulatory and financial risks; workforce risks, including, but not limited to, increased costs of retirement, health care and other benefits; and other risks and uncertainties.

This list of factors is not all-inclusive because it is not possible to predict all factors. Other risk factors are detailed from time to time in Great Plains Energy's and KCP&L's quarterly reports on Form 10-Q and annual report on Form 10-K filed with the Securities and Exchange Commission. Each forward-looking statement speaks only as of the date of the particular statement. Great Plains Energy and KCP&L undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.



Recent Events

Earnings Review

- Reported first quarter 2015 earnings per share of \$0.12 compared with \$0.15 in 2014
- Affirmed 2015 earnings per share guidance range of \$1.35 - \$1.60

Operations Update

- La Cygne environmental upgrade project placed into service and final costs are expected to be below budget
- Wolf Creek Nuclear Generating Station refueling outage successfully completed in early May

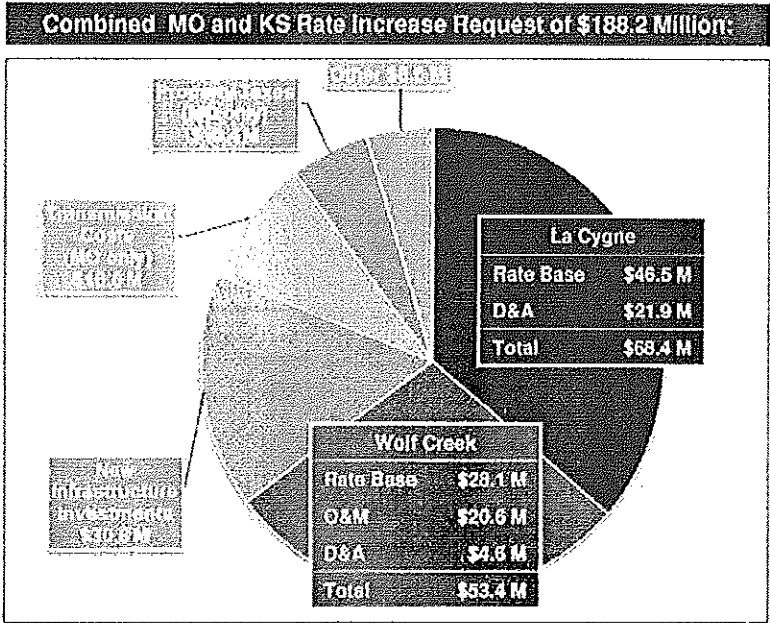
Transource Update

- Iatan to Nashua project completed ahead of schedule and under budget

Regulatory & Legislative Update

- Evidentiary hearings scheduled for June in KCP&L's general rate cases
 - Missouri hearings scheduled to begin June 15 – docket ER-2014-0370
 - Kansas hearings scheduled to begin June 22 – docket 15-KCPE-116-RTS
- Kansas renewable portfolio standards changed from mandatory to voluntary goal
 - Cost recovery for utilities maintained for costs incurred to comply with mandatory standards

KCP&L's Rate Cases - A Key Driver of 2015 to 2016 Earnings Growth



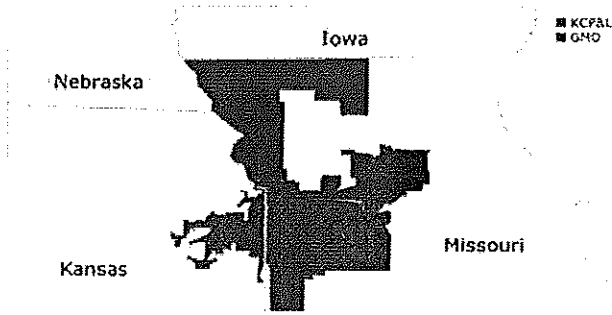
- On track to deliver 2016 rate base growth target of \$6.5 billion with an increase of approximately \$750 million since the conclusion of KCP&L's most recent rate cases
- Anticipate earnings improvement from 2015 to 2016 associated with true-up of regulatory lag associated with property taxes, transmission costs and capital investments totaling approximately \$75 million

Rate Case Schedule

	2015		
	2Q	3Q	4Q
KCP&L Missouri General Rate Case Docket: ER-2014-0370	<u>April 2</u> Staff / Intervenor Testimony Due <u>May 31</u> True-up date <u>June 15 – 19 and June 29 – July 2</u> Evidentiary Hearings	<u>September 30</u> Anticipated Effective Date of New Retail Rates	
KCP&L Kansas General Rate Case Docket: 15-KCPE-116-RTS	<u>May 11</u> Staff / Intervenor Testimony Due <u>June 22 – 26</u> Evidentiary Hearings	<u>September 10</u> Order Date	<u>October 1</u> Anticipated Effective Date of New Retail Rates

Solid Vertically Integrated Midwest Utilities

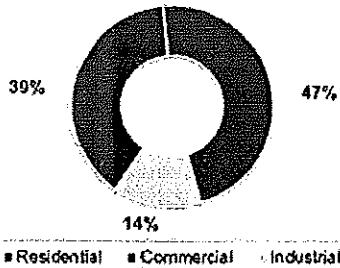
Service Territories: KCP&L and GMO



Business Highlights

- Solid Midwest fully regulated electric utility operating under the KCP&L brand
- Company attributes
 - Regulated operations in Kansas and Missouri
 - ~842,700 customers / ~3,000 employees
 - ~6,600 MW of primarily low-cost coal baseload generation
 - ~3,600 circuit miles of transmission lines; ~22,500 circuit miles of distribution lines
 - ~\$10.5 billion in assets at 2014 YE
 - ~\$5.8 billion in rate base

2014 Retail MWh Sold by Customer Type

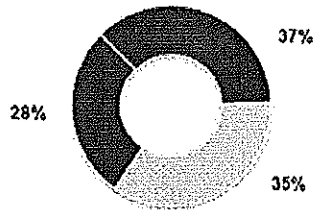


■ Residential ■ Commercial ■ Industrial

Total: ~ 23,115 MWh¹

¹ In thousands

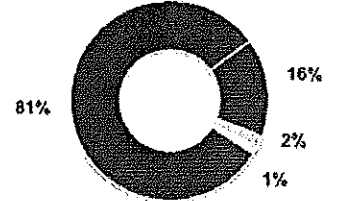
2014 Retail MWh Sales by Jurisdiction



■ Kansas ■ Missouri (KCP&L) ■ GMO

Total: ~ 23,116 MWh¹

2014 MWh Generated by Fuel Type



■ Coal ■ Nuclear ■ Wind ■ Natural Gas and oil

Strengthening Great Plains Energy for the Long Term

Regulatory:

Seek constructive regulatory outcomes
in general rate cases

Operations:

La Cygne environmental
upgrade placed into service and
final costs are expected to be
below budget

Focused on Execution

Financial:

On plan to deliver on 2014 –
2016 earnings, rate base and
dividend growth targets

Transmission:

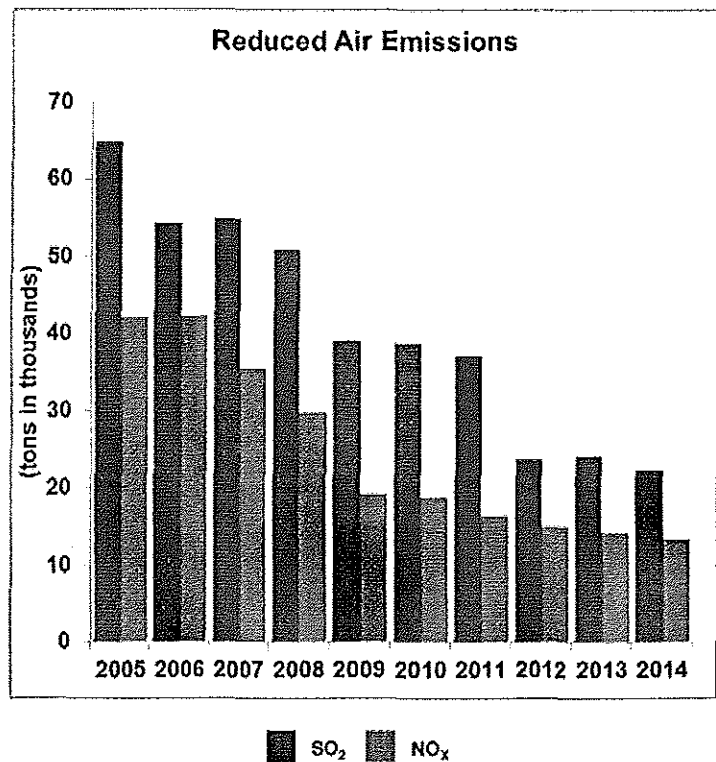
Pursue competitive transmission
projects through Transource Energy,
LLC joint venture

Investment Thesis

- Solid track record of execution and constructive regulatory treatment
- Focused on providing competitive total shareholder returns through earnings growth and a competitive dividend
- Flexible investment opportunities with improved risk profile
- Well positioned on the environmental investment curve
- Expect growing competitive transmission opportunities through Transource Energy, LLC

Track Record of Performance: Environmental Sustainability Investments

- Providing customers with affordable, reliable energy while also improving regional air quality
- Since 2005:
 - Invested more than \$1.5 billion in state-of-the-art emissions control equipment
 - Reduced SO₂ and NO_x emissions by approximately 66 and 68 percent, respectively
- Plan to cease burning coal in the coming years at three plants totaling more than 700 megawatts or nearly 20% of the Company's coal fleet



Track Record of Performance: Regulatory Track Record

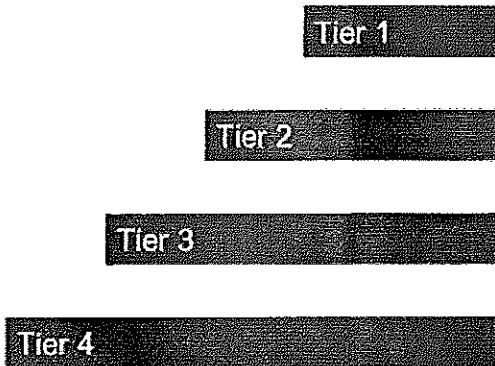
- Proven record of constructive regulatory treatment, allowing for the recovery of capital investments and utilization of cost recovery mechanisms
- Seeking approval in KCP&L Missouri general rate case to utilize fuel adjustment clause
- Competitive retail rates on regional and national level that have grown less than inflation over the past 20 years

Recovery Mechanism	KCP&L Kansas	KCP&L Missouri	GMO
Energy Cost Adjustment Rider (KS) / Fuel Adjustment Clause Rider (MO)	√	Requested in docket ER-2014-0370	√
Property Tax Surcharge Rider	√		
Energy Efficiency Cost Recovery Rider	√		
Pension and OPEB Tracker	√	√	√
Missouri Energy Efficiency Investment Act (MEEIA) Programs (KCP&L: Rider / GMO: Tracker)		√	√
Renewable Energy Standards Tracker		√	√
Renewable Energy Standard Rate Adjustment Mechanism (RESRAM) Rider			√
Predetermination (La Cygne)	√		
Construction Work in Progress in rate base (La Cygne)	√		
Abbreviated rate case	√		
Budget Treatment with Depreciation Deferral (La Cygne)	√		
Construction Accounting (La Cygne)		√	

Track Record of Performance: Operational Excellence

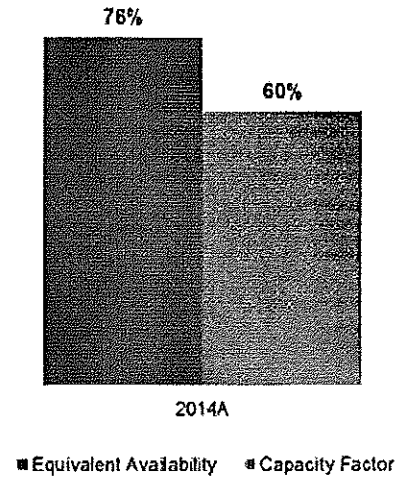
In 2014, awarded the most reliable utility for the Plains Region for eight consecutive years

Reliability a Key Focus



Targeting modest improvements in generation fleet to improve unit availability and performance

Combined Fleet



Focused on top tier customer satisfaction and operational excellence

Track Record of Performance: Financial Profile

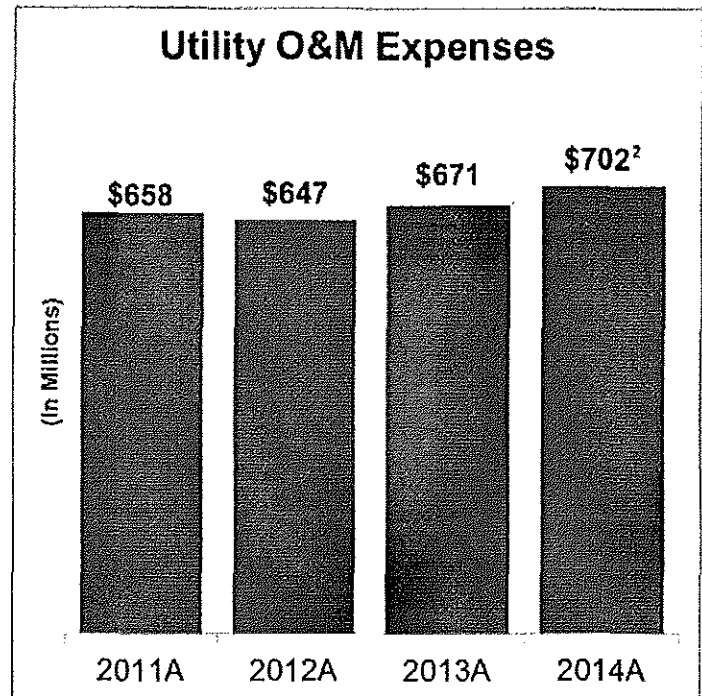
- Total shareholder return of 21% in 2014
- Received credit rating upgrades by Standard and Poor's and Moody's Investor Service in 2014
- Increased common stock dividend for fourth consecutive year
- General rate cases expected to support targeted annualized earnings growth of 4% - 6% from 2014 - 2016¹
- Continued focus on diligent cost management
- Reducing regulatory lag through cost recovery mechanisms

¹ Off initial 2014 earnings per share guidance range of \$1.60 - \$1.75



Solid TSR Opportunities Ahead with Flexibility: Focused on Reducing Lag

- Successfully managed O&M growth below inflation rate from 2011 - 2014¹
- Reduced headcount over 10% since 2008 and will continue to manage through attrition
- Pursuit of legislative initiatives and regulatory mechanisms to reduce regulatory lag
- Continue proactive management of O&M, expect O&M to increase 1 - 2% in 2015¹



¹ Exclusive of regulatory amortizations and items with direct revenue offsets

² Approximately \$30 million of the \$55 million increase from 2012 to 2014 is due to regulatory amortizations, and items with direct revenue offsets

Long-Term Growth Targets

Strategy – To provide Safe and Reliable Service to Our Customers at a Reasonable Cost and Deliver Competitive Total Shareholder Returns

Targeting Earnings Growth

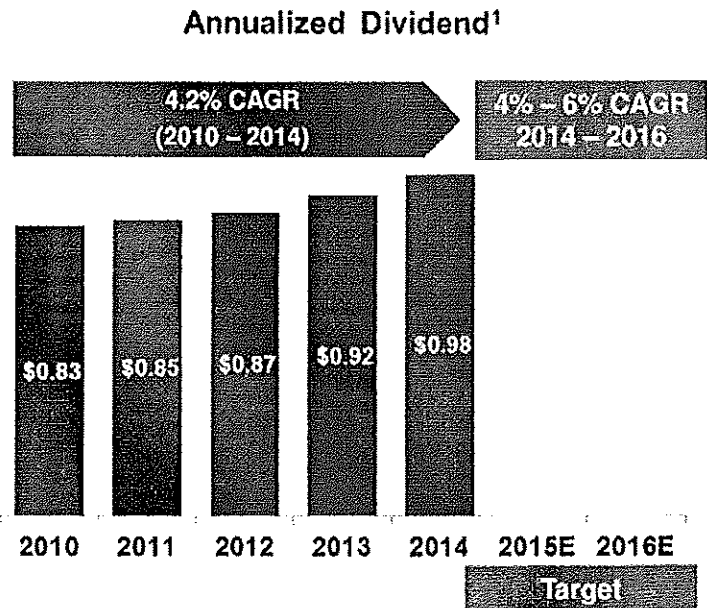
- **Near term (2014 - 2016)**
 - Compounding annual EPS growth of 4% - 6%
 - Compounding annual rate base growth of 4% - 5% to \$6.5 billion in 2016
- **Longer term (2016+)**
 - Competitive customer rates
 - Infrastructure & system reliability
 - Physical & cyber security
 - Investments in sustainability
 - National transmission

Targeting Dividend Growth

- **Near term (2014 - 2016)**
 - Compounding annual dividend growth of 4% - 6%
 - 55% - 70% payout ratio
- **Longer term (2016+)**
 - 60% - 70% payout ratio
 - Increasing cash flow flexibility post 2016
 - Favorable tax position through 2023 due to NOL's
 - Improving credit metrics

Solid TSR Opportunities Ahead with Flexibility: Dividend Growth

- Increased common stock dividend at compound annual rate of nearly 4.2% since 2010
- Targeted annual dividend growth rate of 4% - 6% from 2014 - 2016
- Dividend yield of 3.8% as of May 28, 2015²
- Paid a cash dividend on common stock every quarter since first quarter 1921



¹ 2010 - 2014 based on fourth quarter declared dividend
² Based on May 2015 declared dividend

GXP – Attractive Platform for Shareholders

Focused on Shareholder Value Creation

- Target significant reduction in regulatory lag
- Seek to deliver earnings growth and increasing and sustainable dividends as a key component of total shareholder return
- Improvement in / stability of key credit metrics is a priority

Flexible Investment Opportunities

- **Environmental** – approximately \$500 million of capital projects over the next five years, does not include potential impact of Clean Power Plan proposed in June 2014
- **Transmission** – formed Transource Energy, LLC joint venture to pursue competitive transmission projects
- **Renewables** – driven by Missouri and Kansas Renewable Portfolio Standards
- **Other Growth Opportunities** – selective future initiatives that will leverage our core strengths

Diligent Regulatory Approach

- Proven track record of constructive regulatory treatment
- Credibility with regulators in terms of planning and execution of large, complex projects
- Competitive retail rates on a regional and national level supportive of potential future investment

Excellent Relationships with Key Stakeholders

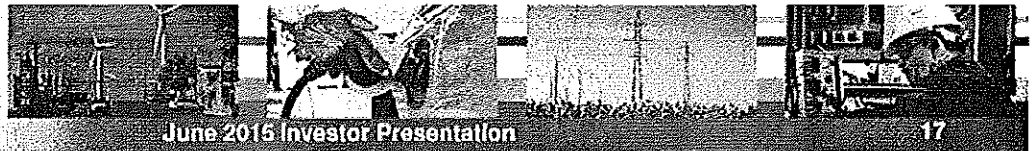
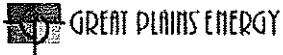
- **Customers** – focused on top tier customer satisfaction
- **Suppliers** – strategic supplier alliances focused on long-term supply chain value
- **Employees** – strong relations between management and labor (3 IBEW locals)
- **Communities** – leadership, volunteerism and high engagement in the areas we serve

Investor Relations Information

- NYSE: GXP
- www.greatplainsenergy.com
- Company Contacts:

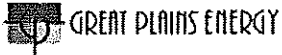
Lori Wright
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Tony Carreño
Director, Investor Relations
(816) 654-1763
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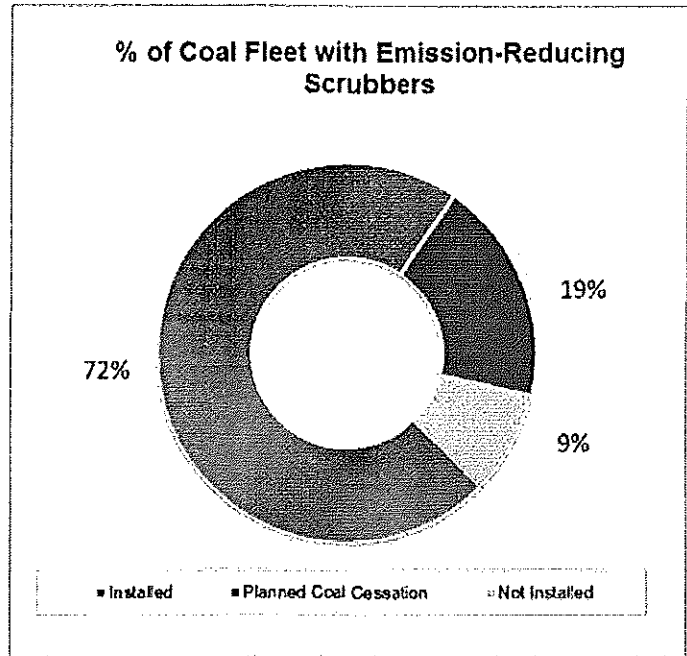
Appendix

	Pages
Operations Overview	19 – 30
2015 Earnings Guidance and Projected Drivers and Assumptions	31 – 33
2016 and 2017 Considerations and Projected Capital Expenditures Plan	34 – 35
First Quarter 2015 Update	36 – 40



Environmental¹

- La Cygne project
 - Unit 1 (367 MW²) scrubber and baghouse placed into service in April 2015
 - Unit 2 (329 MW²), full Air Quality Control System (AQCS) placed into service in March 2015
- Approximately \$500 million of environmental capital projects over the next five years³
- Plan to cease burning coal at Montrose Station, Sibley Units 1 & 2, and Lake Road 6
- Flexibility provided by environmental investments already made



¹ KCP&L and GMO filed Integrated Resource Plans (IRP) with the Missouri Public Service Commission in April 2015, outlining various resource planning scenarios for environmental compliance with its operations; ² KCP&L's share of jointly-owned facility; ³ Does not include potential impact of Clean Power Plan proposed in June 2014

La Cygne Environmental Upgrade, Construction Update

La Cygne Generation Station

- La Cygne Coal Unit 1 367 MW¹ - Wet scrubber, baghouse, activated carbon injection
- La Cygne Coal Unit 2 329 MW¹ - Selective catalytic reduction system, wet scrubber, baghouse, activated carbon injection, over-fired air, low No_x burners
- Initial cost estimate, excluding AFUDC, \$615 million¹. Kansas jurisdictional share is approximately \$280 million
- 2011 predetermination order issued in Kansas deeming project as requested and cost estimate to be reasonable
- Project has been placed into service and final costs are expected to be below budget

Key Steps to Completion	Status
• New Chimney Shell Erected	Completed
• Site Prep; Major Equipment Purchase	Completed
• Installation of Over-fired Air and Low No _x Burners for La Cygne 2	Completed
• Major Construction	Completed
• Commence Startup Testing	Completed
• Tie-in Outage Unit 2	Completed
• Tie-in Outage Unit 1	Completed
• In-service	Completed

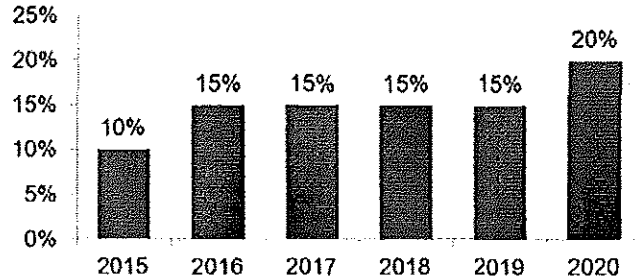
¹ KCP&L's 50% share



Renewable Energy and Energy Efficiency

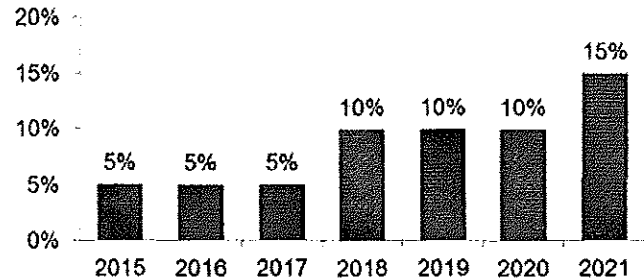
- Renewable portfolio of approximately 1,000 MW of wind, hydroelectric, landfill gas and solar power of owned assets and commitments in place representing 13% of total generation capacity
- Future renewable investments driven by the Renewable Portfolio Standards (RPS) in Kansas and Missouri
 - Well positioned to satisfy goals in Kansas through 2023 and requirements in Missouri through at least 2035
- Flexibility regarding acquisition of future renewable resources:
 - Through Purchased Power Agreements (PPAs) and purchases of Renewable Energy Credits (RECs); or
 - Adding to rate base if supported by credit profile and available equity and debt financing
- Energy efficiency expected to be a key component of future resource portfolio:
 - Aggressive pursuit planned with appropriate regulatory recovery

Kansas RPS Goals



Based on three-year average peak retail demand

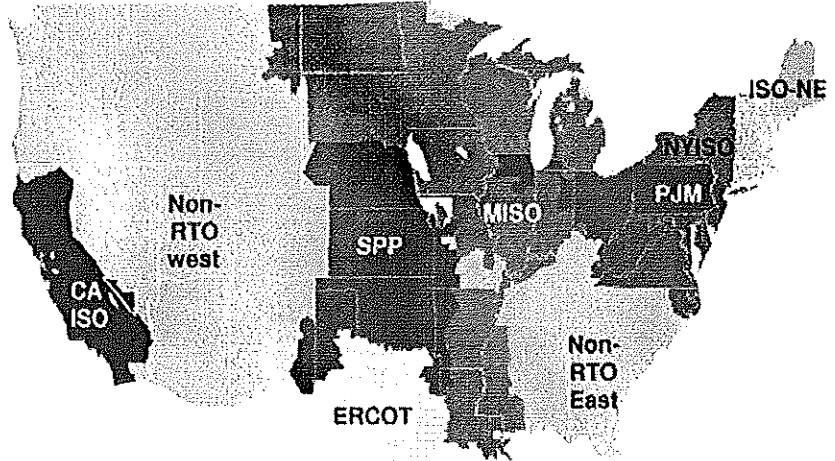
Missouri RPS Requirements



Based on electricity provided to retail customers

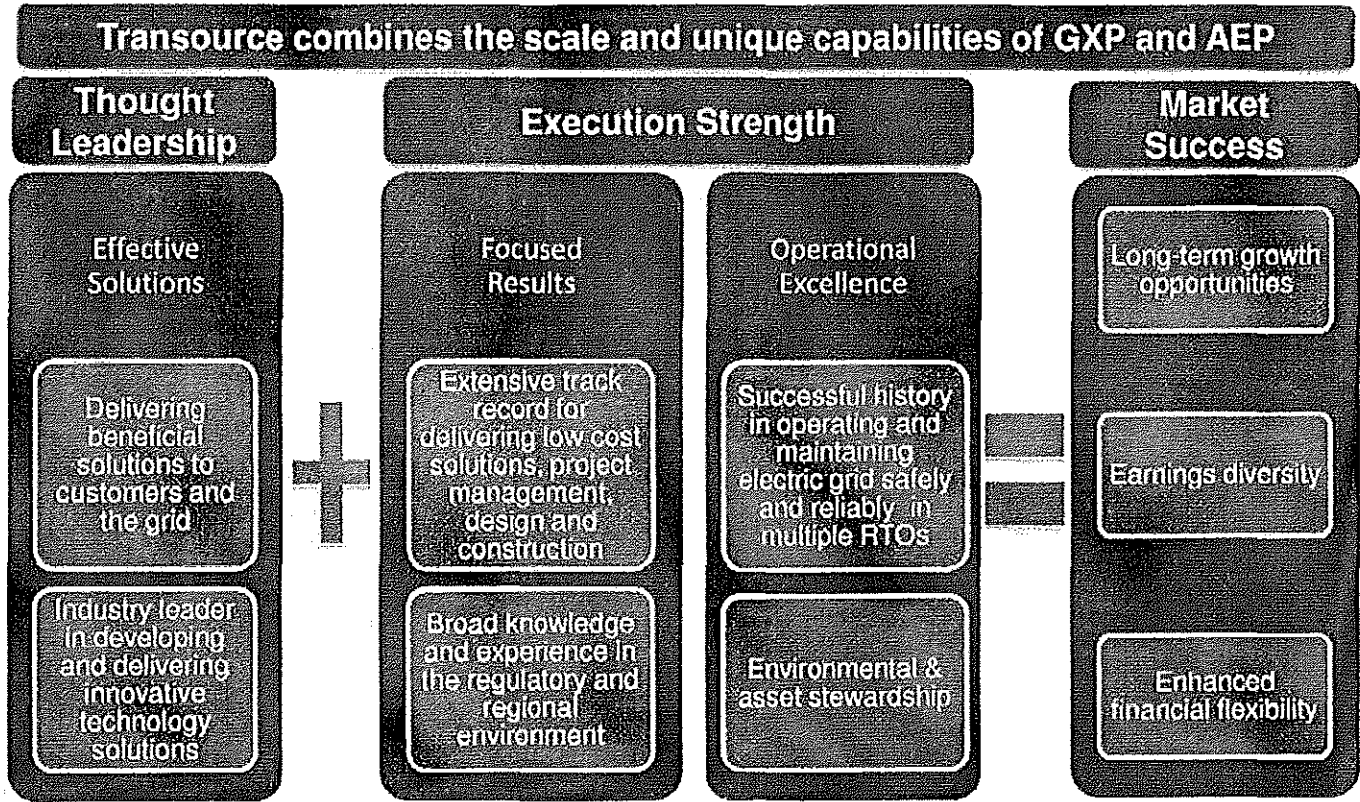
Transource Energy, LLC

- Transource is a joint venture between GXP (13.5%) and AEP (86.5%) structured to pursue competitive transmission projects¹
- Actively pursuing transmission projects in broad range of existing and emerging regions
- Transource Project Portfolio:
 - Recently completed Iatan-Nashua 345 kV project in the SPP region. Estimated cost was \$65 million
 - Sibley – Nebraska City Project, under development in the SPP region. Estimated cost is \$330 million



¹ The venture excludes transmission projects in the Electric Reliability Council of Texas (ERCOT) and AEP's existing transmission project joint ventures

Transource's Competitive Advantage



Competitive Process Timeline for Initial Focus Regions

PJM: Competitive process underway. RFPs may be issued on a quarterly basis using sponsorship model, whereby PJM solicits proposals to identified transmission system needs

SPP
Issues RFPs
10 Yr. & Annual Plan

One competitive project identified in recent planning cycle. Transource intends to bid on this project

SPP
Developer Bids Due

SPP¹
Awards Projects

MISO
10 Yr. Plan

No competitive projects identified in recent planning window

1Q 2015

2Q 2015

3Q 2015

4Q 2015

¹ Due to the delay of the issuance of the RFP during the current cycle the award decision is expected to occur in 1Q 2016

Transource's Transmission Investments

(Transource share)	Iatan – Nashua Project ¹ – 345 kV	Sibley – Nebraska City Project ¹ – 345 kV
RTO	SPP	SPP
Estimated Cost (\$M)	\$65	\$330
Line Miles	31	135
Expected In-Service	Completed in 2015	2017
CWIP Included	Yes	Yes
Cap on equity % in capital structure:		
During construction	60%	60%
Post construction	55%	55%
Authorized ROE:		
Base	9.8%	9.8%
Risk	-	1.0%
RTO Participation	0.5%	0.5%
Total	10.3%²	11.3%²

¹ Includes abandoned plant recovery of prudently incurred costs and pre-commercial costs/regulatory asset treatment

² Weighted average all-in ROE for SPP projects, inclusive of risk and RTO participation incentives, is approximately 11.1%

Local Economy

Economic Development Activity

Kansas City area now the largest auto manufacturing center in the United States, outside of Detroit

Cerner Corporation's \$4.5 billion business expansion underway and is expected to create up to 16,000 new jobs between 2017 and 2025

Well-developed transportation and distributed network strengthened by BNSF Railways state-of-the art intermodal facility

Housing Market

April 2015 year to date single family housing permits highest since 2007

April 2015 year to date sales of new and existing homes are up over 11% compared to 2014 with an average sales price increase of 8%

Employment

Kansas City area has experienced 45 consecutive months of job growth through March 2015 and employment levels are above the pre-recession peak

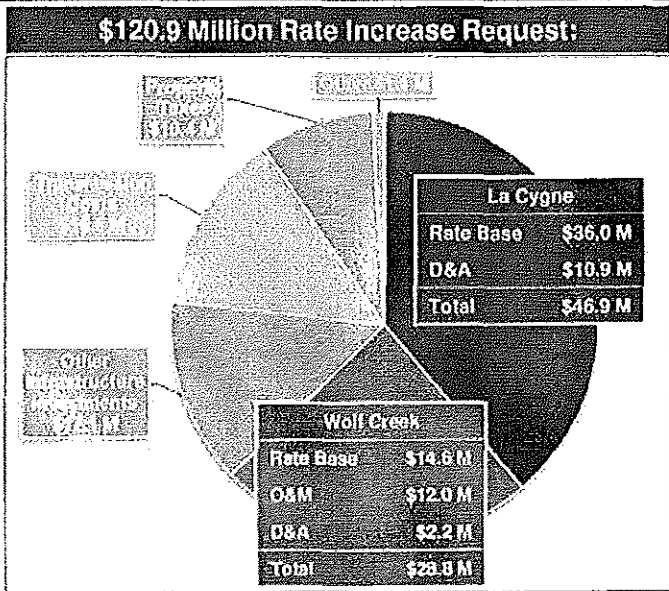
Kansas City area unemployment rate of 5.4% in March 2015 compared with the national average of 5.6%¹

¹ On a non-seasonally adjusted basis

KCP&L – Missouri Rate Case Summary

Case Number	Date Filed	Requested Increase (in Millions)	Requested Increase (Percent)	Rate Base (in Millions)	ROE	Cost of Debt	Rate-Making Equity Ratio	Rate of Return	Anticipated Effective Date of New Rates
ER-2014-0370	10/30/14	\$120.9	15.75%	\$2,557 ¹	10.3%	5.56%	50.36%	7.94%	9/30/15

Rate Case Attributes:
<ul style="list-style-type: none"> • Test year ended March 31, 2014 with May 31, 2015 true-up date • Primary drivers of increase: <ul style="list-style-type: none"> – Environmental investments at the La Cygne Generating Station and upgrades to the Wolf Creek Nuclear Generating Station – New infrastructure investments to ensure reliability, security and dependable service to customers – Transmission costs and property taxes • Requested authorization to implement: <ul style="list-style-type: none"> – Fuel adjustment clause (FAC) including transmission costs – Property tax tracker – Critical Infrastructure Protection Standards (CIPS) / Cybersecurity tracker – Vegetation management tracker



¹ Projected rate base is approximately \$505 million or 25% higher than at the conclusion of the last rate case



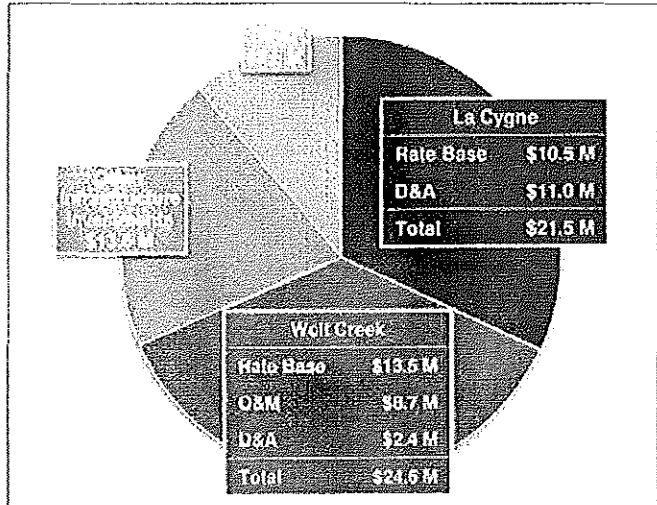
KCP&L – Kansas Rate Case Summary

Case Number	Date Filed	Requested Increase (in Millions)	Requested Increase (Percent)	Rate Base (in Millions)	ROE	Cost of Debt	Rate – Making Equity Ratio	Rate of Return	Anticipated Effective Date of New Rates
15-KCPE-116-RTS	1/2/15	\$67.3	12.53%	\$2,155 ^{1,2}	10.3%	5.55%	50.48%	7.94%	10/1/15

Rate Case Attributes:

- Test year ended June 30, 2014 with certain known and measurable changes projected through March 31, 2015
- Primary drivers of increase:
 - Environmental investments at the La Cygne Generating Station and upgrades to the Wolf Creek Nuclear Generating Station
 - New infrastructure investments to ensure reliability, security and dependable service to customers
- Requested authorization to implement:
 - Transmission delivery charge (TDC) rider
 - Critical Infrastructure Protection Standards (CIPS) / Cybersecurity tracker
 - Vegetation management tracker
- File abbreviated rate case August 29, 2016 or sooner to true-up actual cost of environmental investments at La Cygne and upgrades at Wolf Creek

\$67.3 Million Rate Increase Request:



¹ Projected rate base is approximately \$239 million or 12% higher than at the conclusion of the La Cygne abbreviated rate case

² Includes transmission plant in rate base of \$68.4 million included in the proposed TDC

Key Elements of 2006 - 2013 Rate Cases

Rate Case Outcomes (\$millions)							
Rate Jurisdiction	Date Filed	Effective Date	Rate Base	Rate-making Equity Ratio	Return on Equity	Rate Increase Approved (\$)	Rate Increase Approved (%)
KCP&L – Missouri	2/1/2006	1/1/2007	\$1,270	53.69%	11.25%	\$50.6	10.5%
KCP&L – Missouri	2/1/2007	1/1/2008	\$1,298	57.62%	10.75%	\$35.3	6.5%
KCP&L – Missouri	9/5/2008	9/1/2009	\$1,496 ¹	46.63%	n/a ²	\$95.0	16.16%
KCP&L – Missouri	6/4/2010	5/4/2011	\$2,036	46.30%	10.00%	\$34.8	5.25%
KCP&L – Missouri	2/27/2012	1/26/2013	\$2,052	52.25% ³	9.7%	\$67.4	9.6%
KCP&L – Kansas	1/30/2006	1/1/2007	\$1,000 ¹	n/a	n/a ²	\$29.0	7.4%
KCP&L – Kansas	2/28/2007	1/1/2008	\$1,100 ¹	n/a	n/a ²	\$28.0	6.5%
KCP&L – Kansas	9/5/2008	8/1/2009	\$1,270 ¹	50.75%	n/a ²	\$59.0	14.4%
KCP&L – Kansas	12/17/2009	12/1/2010	\$1,781	49.68%	10.00%	\$22.0	4.6%
KCP&L – Kansas	4/20/2012	1/1/2013	\$1,798	51.82%	9.5%	\$33.2	6.7%
KCP&L – Kansas	12/9/2013	7/25/2014	\$1,916	51.82% ²	9.5% ³	\$11.5	2.2%
GMO - Missouri	7/3/2006	5/31/2007	\$1,104	48.17%	10.25%	\$58.8	Refer to fn. ⁴
GMO - Missouri	9/5/2008	9/1/2009	\$1,474 ¹	45.95%	n/a ²	\$63.0	Refer to fn. ⁵
GMO - Missouri	6/4/2010	6/25/2011	\$1,758	46.58%	10.00%	\$65.5	Refer to fn. ⁶
GMO - Missouri	2/27/2012	1/26/2013	\$1,830	52.25% ³	9.7%	\$47.9 ⁷	Refer to fn. ⁶
GMO (Steam) –Missouri	9/5/2008	7/1/2009	\$14	n/a	n/a ²	\$1.0	2.3%

¹ Rate Base amounts are approximate amounts since the cases were black box settlements; ² Not available due to black box settlement; ³ MPSC authorized an equity ratio of approximately 52.6% or approximately 52.3% after including other comprehensive income; ⁴ MPS 11.6%, L&P 12.8%; ⁵ MPS 10.5%, L&P 11.9%; ⁶ MPS 7.2%, L&P 21.3%; ⁷ L&P \$21.7 million - includes full impact of phase in from rate case ER-2010-0356; ⁸ MPS 4.9%, L&P 12.7% - includes full impact of phase in from rate case ER-2010-0356; ⁹ Abbreviated rate case to include La Cygne CWIP; maintain previously authorized Kansas jurisdictional rate-making equity ratio and return on equity based on its 2012 order.

State Commissioners

Missouri Public Service Commission (MPSC)



Mr. Robert S. Kenney (D)
Chair (since March 2013)
 Term began: July 2009
 Term expired: April 2015



Mr. Stephen M. Stoll (D)
Commissioner
 Term began: June 2012
 Term expires: December 2017



Mr. William P. Kenney (R)
Commissioner
 Term began: January 2013
 Term expires: January 2019



Mr. Daniel Y. Hall (D)
Commissioner
 Term began: September 2013
 Term expires: September 2019



Mr. Scott T. Rupp (R)
Commissioner
 Term began: March 2014
 Term expires: March 2020

MPSC consists of five (5) members, including the Chairman, who are appointed by the Governor and confirmed by the Senate.

- Members serve six-year terms (may continue to serve after term expires until reappointed or replaced)
- Governor appoints one member to serve as Chairman

Kansas Corporation Commission (KCC)



Ms. Shari Feist Albrecht (I)
Chair (since January 2014)
 Term began: June 2012
 Term expires: March 2016



Mr. Jay S. Emler (R)
Commissioner
 Term began: January 2014, reappointed May 2015
 Term expires: March 2019



Mr. Pat Apple (R)
Commissioner
 Term began: March 2014
 Term expires: March 2018

KCC consists of three (3) members, including the Chairman, who are appointed by the Governor and confirmed by the Senate.

- Members serve four-year terms (may continue to serve after term expires until reappointed or replaced)
- Commissioners elect one member to serve as Chairman

2015 Earnings Guidance

Drivers and Assumptions

- ↑ Assumes flat to 0.5% weather-normalized retail sales growth, net of energy efficiency
 - Demand before impact of energy efficiency programs of 0.5% - 1.0%
- ↑ New retail rates
 - Approximately an additional seven months of new Kansas rates from abbreviated rate case
 - New KCP&L rates in Kansas and Missouri expected in October 2015
- ↓ Decrease in AFUDC from lower CWIP balances as La Cygne and other capital investments are placed in service
- ↓ Increasing depreciation expense driven by capital additions being placed in service
- ↓ Increasing transmission expense and property taxes under-recovered in Missouri
- ↓ O&M increase of approximately 3% - 4%
 - Increase of 1% - 2% exclusive of regulatory amortizations and items which have direct revenue offsets
- ↓ Lower natural gas prices impacting off system sales which has an earnings impact at KCP&L Missouri where the Company does not have a fuel adjustment clause (FAC)
- Other assumptions
 - La Cygne construction accounting treatment
 - Deferral of depreciation and carrying costs in Missouri
 - Depreciation deferral in Kansas
 - Potential KCP&L long-term debt issuance
 - No plans to issue equity
 - NOLs minimizing cash income tax payments

2015 Earnings Per Share Guidance Range of \$1.35 - \$1.60

2015 Guidance Assumptions Income Taxes

- Effective income tax rate of approximately 35%
- Federal/state combined statutory rate of approximately 38.9% impacted by:
 - AFUDC Equity (non-taxable)
 - Wind Production Tax Credits (PTC)
 - Amortization of Investment Tax Credits (ITC)
- Do not expect to generate significant income tax liability or pay significant income taxes during 2015 due to:
 - Ongoing wind PTC
 - Utilization of prior year Net Operating Losses (NOLs) and tax credits

2015 Guidance Assumption Deferred Income Tax

- Year-end 2014 deferred income taxes include:
 - \$242.7 million tax credit carry forwards primarily related to Advanced Coal ITCs, wind PTCs, and Alternative Minimum Tax (AMT) credits (\$88.1 million related to GMO acquisition)
 - Coal and wind credits expire in years 2028 to 2034
 - AMT credits do not expire
 - \$0.4 million valuation allowance on federal and state tax credits
 - \$586.9 million of tax benefits on NOL carry forwards (\$353.9 million related to the GMO acquisition)
 - Federal NOL carry forwards expire in years 2023 to 2034
 - \$16.2 million valuation allowance on state NOL tax benefits
- Do not expect to generate significant income tax liability during 2015 (see previous slide)
- Do not anticipate paying significant income taxes through the end of 2023
 - Expect to utilize year-end 2014 NOL and tax credit carry forwards, net of valuation allowances

2016 and 2017 Considerations

	2016	2017
Earnings Growth	<ul style="list-style-type: none"> • 4 – 6% growth target from 2014 – 2016 off of initial 2014 earnings per share guidance range 	
Monitor Demand and Tightly Control O&M	<ul style="list-style-type: none"> • Demand before impact of energy efficiency programs of 0.5 – 1.0% <ul style="list-style-type: none"> – Flat to 0.5% weather-normalized retail sales growth, net of energy efficiency • Proactive management of O&M 	<ul style="list-style-type: none"> • Demand before impact of energy efficiency programs of 0.5 – 1.0% <ul style="list-style-type: none"> – Flat to 0.5% weather-normalized retail sales growth, net of energy efficiency • Proactive management of O&M
Operational and Regulatory Execution	<ul style="list-style-type: none"> • Full year of new KCP&L retail rates on projected total Great Plains Energy rate base of \$6.5 billion <ul style="list-style-type: none"> – Fuel adjustment clause (FAC) requested in Missouri • GMO general rate case 	<ul style="list-style-type: none"> • New GMO retail rates
Improve Cash Flow Position and Support Targeted Dividend Growth	<ul style="list-style-type: none"> • No plans to issue equity • No plans to issue long-term debt • Utilization of NOLs, minimizing cash income tax payments 	<ul style="list-style-type: none"> • No plans to issue equity • Refinance long-term debt • Increasing cash flow flexibility post 2016 • Utilization of NOLs, minimizing cash income tax payments

Projected Utility Capital Expenditures

Projected Utility Capital Expenditures (In Millions) ^{1,2}	2015E	2016E	2017E	2018E	2019E
Generating facilities	\$245.2	\$222.5	\$204.8	\$205.1	\$203.2
Distribution and transmission facilities	260.1	229.6	201.0	203.0	222.9
General facilities	148.2	84.2	71.8	28.6	15.9
Nuclear fuel	20.0	21.0	44.4	21.2	23.5
Environmental	117.4	41.8	129.3	102.1	113.5
Total utility capital expenditures	\$790.9	\$599.1	\$651.3	\$560.0	\$579.0

Considerations

Generating facilities	<ul style="list-style-type: none"> Includes expenditures associated with KCP&L's 47% interest in Wolf Creek
Distribution and Transmission facilities	<ul style="list-style-type: none"> Includes expenditures associated with vehicle fleet, expanding service areas and infrastructure replacement
General facilities	<ul style="list-style-type: none"> Expenditures associated with information systems and facilities
Environmental	<ul style="list-style-type: none"> KCP&L's share of environmental upgrades at La Cygne to comply with the Best Available Retrofit Technology (BART) rule Upgrades to comply with the Mercury and Air Toxic Standards (MATS) rule Estimates for compliance with the Clean Air Act and Clean Water Act based on proposed or final regulations where the timing is uncertain

¹ Projected capital expenditures excludes Allowance for Funds Used During Construction (AFUDC)

² Great Plains Energy accounts for its 13.5% ownership in Transource Energy, LLC (Transource) under the equity method of accounting. Great Plains Energy's capital contributions to Transource are not reflected in projected capital expenditures

2015 First Quarter EPS Reconciliation Versus 2014

	2015 EPS	2014 EPS	Change in EPS
1Q	\$ 0.12	\$ 0.15	\$ (0.03)

Contributors to Change in 2015 EPS Compared to 2014					
	Other O&M	Weather	Depreciation & Amortization	Other Margin	Total
1Q 2015	\$ 0.05	\$ (0.05)	\$ (0.02)	\$ (0.01)	\$ (0.03)

**Great Plains Energy Consolidation Earnings and Earnings Per Share –
Three Month Ended March 31 (Unaudited)**

	Earnings (millions)		Earnings per Share	
	2015	2014	2015	2014
Electric Utility	\$ 20.9	\$ 26.1	\$ 0.14	\$ 0.17
Other	(2.0)	(2.3)	(0.02)	(0.2)
Net income	18.9	23.8	0.12	0.15
Preferred dividends	(0.4)	(0.4)	-	-
Earnings available for common shareholders	\$ 18.5	\$ 23.4	\$ 0.12	\$ 0.15

Common stock outstanding for the quarter averaged 154.4 million shares, compared with 154.0 million shares for the same period in 2014

Great Plains Energy Reconciliation of Gross Margin to Operating Revenues (Unaudited)

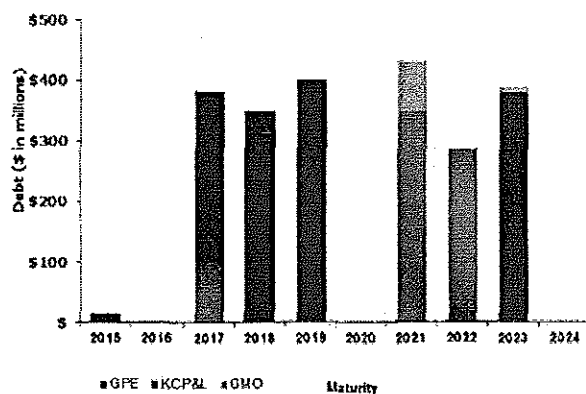
	Three Months Ended March 31 (millions)	
	2015	2014
Operating revenues	\$ 549.1	\$ 585.1
Fuel	(107.6)	(135.2)
Purchased power	(45.4)	(45.4)
Transmission	(20.9)	(17.6)
Gross margin	\$ 375.2	\$ 386.9

Gross margin is a financial measure that is not calculated in accordance with generally accepted accounting principles (GAAP). Gross margin, as used by Great Plains Energy, is defined as operating revenues less fuel, purchased power and transmission. The Company's expense for fuel, purchased power and transmission, offset by wholesale sales margin, is subject to recovery through cost adjustment mechanisms, except for KCP&L's Missouri retail operations. As a result, operating revenues increase or decrease in relation to a significant portion of these expenses. Management believes that gross margin provides a more meaningful basis for evaluating the Electric Utility segment's operations across periods than operating revenues because gross margin excludes the revenue effect of fluctuations in these expenses. Gross margin is used internally to measure performance against budget and in reports for management and the Board of Directors. The Company's definition of gross margin may differ from similar terms used by other companies. A reconciliation to GAAP operating revenues is provided in the table above.

March 31, 2015 Debt Profile and Credit Ratings

(\$ In Millions)	Great Plains Energy Debt							
	KCP&L		GMO ¹		GPE		Consolidated	
	Amount	Rate ²	Amount	Rate ²	Amount	Rate ²	Amount	Rate ²
Short-term debt	\$ 534.0	0.60%	\$ 173.0	0.64%	\$ 10.0	1.69%	\$ 717.0	0.62%
Long-term debt ³	2,298.5	5.13%	447.7	5.04%	741.7	5.30%	3,487.9	5.15%
Total	\$2,832.5	4.28%	\$620.7	3.81%	\$751.7	5.25%	\$4,204.9⁴	4.38%

Long-Term Debt Maturities⁵



Current Credit Ratings

	Moody's	Standard & Poor's
Great Plains Energy		
Outlook	Stable	Stable
Corporate Credit Rating	-	BBB+
Preferred Stock	Ba1	BBB-
Senior Unsecured Debt	Baa2	BBB
KCP&L		
Outlook	Stable	Stable
Senior Secured Debt	A2	A
Senior Unsecured Debt	Baa1	BBB+
Commercial Paper	P-2	A-2
GMO		
Outlook	Stable	Stable
Senior Unsecured Debt	Baa2	BBB+
Commercial Paper	P-2	A-2

¹ Great Plains Energy guarantees approximately 34% of GMO's debt; ² Weighted Average Rates – excludes premium/discounts and other amortizations; ³ Includes current maturities of long-term debt; ⁴ Secured debt = \$760M (18%), Unsecured debt = \$3,445M (82%); ⁵ Includes long-term debt maturities through December 31, 2024

Customer Consumption

Retail MWh Sales Growth Rates, net of Energy Efficiency			
1Q 2015 Compared to 1Q 2014			
	Total Change in MWh Sales	Weather – Normalized Change in MWh Sales	% of Retail MWh Sales
Residential	(10.3%)	0.1%	40%
Commercial	0.2%	0.9%	47%
Industrial	0.4%	(2.7%)	13%
	(4.3%)	0.1% ¹	

¹ Weighted average

SCHEDULE CRH-s5

HAS BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

STAFF AUDIT PRACTICE ALERT NO. 10

**MAINTAINING AND APPLYING
PROFESSIONAL SKEPTICISM IN AUDITS**

December 4, 2012

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Executive Summary

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board ("PCAOB" or "Board") standards. Those standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team.

PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. The standards also state that professional skepticism should be exercised throughout the audit process. While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant management judgments or transactions outside the normal course of business. Professional skepticism also is important as it relates to the auditor's consideration of fraud in an audit. When auditors do not appropriately apply professional skepticism, they may not obtain sufficient appropriate evidence to support their opinions or may not identify or address situations in which the financial statements are materially misstated.

Observations from the PCAOB's oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including

incentives and pressures resulting from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management. Audit firms and individual auditors should be alert for these impediments and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits performed under PCAOB standards.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including setting a proper tone at the top that emphasizes the need for professional skepticism; implementing and maintaining appraisal, promotion, and compensation processes that enhance rather than discourage the application of professional skepticism; assigning personnel with the necessary competencies to engagement teams; establishing policies and procedures to assure appropriate audit documentation, especially in areas involving significant judgments; and appropriately monitoring the quality control system and taking necessary corrective actions to address deficiencies, such as, instances in which engagement teams do not apply professional skepticism.

The engagement partner is responsible for, among other things, setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations. It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence regardless of whether it corroborates or contradicts management's assertions.

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on

the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

Professional Skepticism and Due Professional Care

Professional skepticism, an attitude that includes a questioning mind and a critical assessment of audit evidence, is essential to the performance of effective audits under PCAOB standards. The audit is intended to provide investors with an opinion on whether the financial statements prepared by company management are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. If the audit is conducted without professional skepticism, the value of the audit is impaired.

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.^{1/} This responsibility includes obtaining sufficient appropriate evidence to determine whether the financial statements are materially misstated rather than merely looking for evidence that supports management's assertions.^{2/}

PCAOB standards require the auditor to exercise due professional care in planning and performing the audit and in preparing the audit report. Due professional care requires the auditor to exercise professional skepticism. PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB standards require the auditor to exercise professional skepticism throughout the audit.^{3/}

While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant

^{1/} Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

^{2/} See, e.g., paragraph 3 of Auditing Standard No. 8, *Audit Risk* and paragraph 3 of Auditing Standard No. 14, *Evaluating Audit Results*.

^{3/} See paragraphs .01 and .07-.08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

management judgments or transactions outside the normal course of business, such as nonrecurring reserves, financing transactions, and related party transactions that might be motivated solely, or in large measure, by an expected or desired accounting outcome. Effective auditing involves diligent pursuit of sufficient appropriate audit evidence, particularly if contrary evidence exists, and critical assessment of all the evidence obtained.

Professional skepticism is also important as it relates to the auditor's consideration of fraud in the audit.^{4/} Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.^{5/} Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this incentive, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.^{6/}

Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources.^{7/}

PCAOB inspectors continue to observe instances in which the circumstances suggest that auditors did not appropriately apply professional skepticism in their audits.^{8/} As examples, audit deficiencies like the following

^{4/} See paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{5/} AU sec. 316.08.

^{6/} See AU secs. 230.07-.09.

^{7/} Paragraph 7 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

^{8/} The PCAOB is not alone in identifying concerns regarding professional skepticism in audits. Regulators in countries such as Australia, Canada, Germany, the Netherlands, Singapore, Switzerland, and the United

raise concerns that a lack of professional skepticism was at least a contributing factor:

- For certain hard-to-value Level 2 financial instruments, the engagement team did not obtain an understanding of the specific methods and/or assumptions underlying the fair value estimates that were obtained from pricing services or other third parties and used in the engagement team's testing related to these financial instruments. Further, the firm used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.
- The issuer discontinued production of a significant product line during the prior year and introduced a new product line to replace it. There were no sales of the discontinued product line during the last nine months of the year under audit. The engagement team did not test, beyond inquiry, the significant assumptions management used to calculate its separate inventory reserve for this product line.
- The engagement team did not evaluate the effects on the financial statements of management's determination not to test a significant portion of its property and equipment for impairment, despite indicators that the carrying amount may not have been recoverable. These indicators in this situation included operating losses for the relevant segment for the last three years, substantial charges for

Kingdom have cited concerns about professional skepticism in public reports on their inspections. See, e.g., the Financial Reporting Council's *Audit Quality Inspections Annual Report 2011/12*, available at <http://www.frc.org.uk/Our-Work/Publications/AIU/Audit-Quality-Inspections-Annual-Report-2011-12.aspx>, the Canadian Public Accountability Board's, *Meeting the Challenge "A Call to Action" 2011 Public Report*, available at [http://www.cpab-ccrc.ca/en/content/2011Public Report EN.pdf](http://www.cpab-ccrc.ca/en/content/2011Public%20Report%20EN.pdf), the Australian Securities & Investments Commission's Report 242, *Audit inspection program public report for 2009 – 2010*, available at [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/\\$file/rep242-published-29-June-2011.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/$file/rep242-published-29-June-2011.pdf), and the Accounting and Corporate Regulatory Authority *Practice Monitoring Programme Sixth Public Report*, August 2012, available at <http://www.acra.gov.sg/NR/rdonlyres/E7E2A4BF-EC46-4AB2-877D-297D4E618042/0/PMPReport2012170712finalclean.pdf>.

the impairment of goodwill and other intangible assets during the year, a projected loss for the segment for the upcoming year, and reduced and delayed customer orders.

- After the date of the issuer's balance sheet, but before the release of the firm's opinion, the issuer reported that it anticipated that comparable store sales for the first quarter of the year would be significantly lower than those for the first quarter of the year under audit. The engagement team had performed sensitivity analyses as part of its assessment on the issuer's evaluation of its compliance with its debt covenants, the issuer's ability to continue as a going concern, and the possibility of the impairment of the issuer's long-lived assets. The engagement team did not consider the implications of the anticipated decline in sales on its sensitivity analyses and its conclusions with respect to compliance with debt covenants, the issuer's ability to continue as a going concern, and impairment of long-lived assets.

The PCAOB's enforcement activities also have identified instances in which auditors did not appropriately apply professional skepticism. For example, in one recent disciplinary order, the Board found, among other things, that certain of a firm's audit partners accepted a company's reliance on an exception to generally accepted accounting principles ("GAAP") requirements for reserving for expected future product returns even though doing so conflicted with the plain language of the exception and the firm's internal accounting literature. The partners were aware of, but did not appropriately consider, contradictory audit evidence indicating that the returns were not eligible for the exception. This illustration of a lack of professional skepticism reappeared in the firm's response when the issue was questioned by the firm's internal audit quality reviewers. Although certain of the partners involved determined that the company's reliance on the exception to GAAP did not support the company's accounting, they, along with other firm personnel, formulated another equally deficient rationale that supported the company's existing accounting result.^{9/}

Impediments to the Application of Professional Skepticism

Although PCAOB standards require auditors to appropriately apply professional skepticism throughout the audit, observations from the PCAOB's

^{9/} See *In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, Respondents*, PCAOB Release No. 105-2012-001, (Feb. 8, 2012).

oversight activities indicate that, as a practical matter, auditors are often challenged in meeting this fundamental audit requirement. In maintaining an attitude that includes a questioning mind and a critical assessment of audit evidence, it is important for auditors to be alert to unconscious human biases and other circumstances that can cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.

Certain conditions inherent in the audit environment can create incentives and pressures that can serve to impede the appropriate application of professional skepticism and allow unconscious bias to prevail. For example, incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.

In addition, over time, auditors may sometimes develop an inappropriate level of trust or confidence in management, which may lead auditors to accede to inappropriate accounting. In some situations, auditors may feel pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management) instead of representing the interests of the investors they are charged to protect.

Other circumstances also can impede the appropriate application of professional skepticism. For example, scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, which might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence.

Although powerful incentives and pressures exist that can impede professional skepticism, the importance of professional skepticism to an effective audit cannot be overstated, particularly given the increasing judgment and complexity in financial reporting and issues posed by the current economic environment.^{10/} Auditors and audit firms must remember that their overriding duty is to put the interests of investors first. Appropriate application of professional skepticism is key to fulfilling the auditor's duty to investors. In the words of the U.S. Supreme Court:

^{10/} See Staff Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (Dec. 6, 2011).

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.^{11/}

However, inadequate performance of audit procedures may be caused by factors other than the lack of skepticism, or in combination with a lack of skepticism. As discussed further below, firms should take appropriate steps to understand the various factors that influence audit quality, including those circumstances and pressures that can impede the application of professional skepticism.

Promoting Professional Skepticism via an Appropriate System of Quality Control

PCAOB standards require firms to establish a system of quality control to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.^{12/} This includes designing and implementing policies and procedures that lead engagement teams to appropriately apply professional skepticism in their audits.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including the following:

- *"Tone-at-the-Top" Messaging.* The PCAOB's inspection findings have identified instances in which the firm's culture allows or tolerates audit approaches that do not consistently emphasize the need for professional skepticism. Consistent communication from firm leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed by audit partners and staff. On the other hand, messages from firm leadership that are

^{11/} *U. S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

^{12/} See paragraph .03 of Quality Control ("QC") sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

excessively focused on revenue or profit growth over achieving audit quality, can undermine the application of professional skepticism.

- *Performance Appraisal, Promotion, and Compensation Processes.* An audit firm's performance appraisal, promotion, and compensation processes can enhance or detract from the application of professional skepticism in its audit practice, depending on how they are designed and executed. For example, if a firm's promotion process emphasizes selling non-audit services or places an undue focus on reducing audit costs, or retaining and acquiring audit clients over achieving high audit quality, the firm's personnel may perceive those goals as being more important to their own compensation, job security, and advancement within the firm than the appropriate application of professional skepticism.
- *Professional Competence and Assigning Personnel to Engagement Teams.* A firm's quality control system depends heavily on the proficiency of its personnel,^{13/} which includes their ability to exercise professional skepticism. To perform the audit with professional skepticism, it is important that personnel assigned to engagement teams have the necessary knowledge, skill, and ability required in the circumstances,^{14/} which includes appropriate technical training and experience. Professional skepticism is interrelated with an auditor's training and experience, as auditors need an appropriate level of competence in order to appropriately apply professional skepticism throughout the audit. In addition, it is important for the firm's culture to continually reinforce the appropriate application of professional skepticism throughout the audit.
- *Documentation.* It is important for a firm's quality control system to establish policies and procedures that cover documenting the results of each engagement.^{15/} Although documentation should support the basis for the auditor's conclusions concerning every

^{13/} QC sec. 20.11.

^{14/} See QC sec. 20.12.

^{15/} See QC secs. 20.17-.18. Also, see generally Auditing Standard No. 3, *Audit Documentation*.

relevant financial statement assertion, areas that require greater judgment generally need more extensive documentation of the procedures performed, evidence obtained, and rationale for the conclusions reached. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions.^{16/}

- *Monitoring.* Under PCAOB standards, a firm's quality control policies and procedures should include an element of monitoring to ensure that quality control policies and procedures are suitably designed and being effectively applied.^{17/} If the firm identifies deficiencies, the firm should evaluate the reasons for the deficiencies and determine the necessary corrective actions or improvements to the quality control system.^{18/} Accordingly, if a firm identifies deficiencies that include failures to appropriately apply professional skepticism as a contributing factor, the firm should take appropriate corrective actions.

Importance of Supervision to the Application of Professional Skepticism

The supervisory activities performed by the engagement partner and other senior engagement team members are important to the application of professional skepticism.^{19/} The engagement partner is responsible for the proper supervision of the work of engagement team members.^{20/} Accordingly, the

^{16/} See, e.g., paragraphs 7-8 of Auditing Standard No. 3.

^{17/} See QC sec. 20.07 and paragraph .02 of QC sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

^{18/} See QC sec. 30.03.

^{19/} Besides supervision by the engagement partner and other engagement team members, the engagement quality reviewer also plays an important role in assessing the application of professional skepticism by the engagement team. In particular, the engagement quality reviewer is required to perform specific procedures to evaluate the significant judgments made by the engagement team.

^{20/} Paragraph 3 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

engagement partner is responsible for setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations.^{21/}

It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention are identified and addressed appropriately. In directing the work of others, senior engagement team members, including the engagement partner, may have knowledge and experience that may assist less experienced engagement team members in applying professional skepticism. For example, senior engagement team members might help more junior auditors identify matters that are unusual or inconsistent with other evidence. In addition, senior members of the engagement team might be better able to challenge the assertions of senior levels of management, when necessary.

Appropriate Application of Professional Skepticism

Although a firm's quality control systems and the actions of the engagement partner and other senior engagement team members can contribute to an environment that supports professional skepticism, it is ultimately the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including the following areas among others:

- Identifying and assessing risks of material misstatement;
- Performing tests of controls and substantive procedures; and
- Evaluating audit results to form the opinion to be expressed in the auditor's report.

Identifying and Assessing Risks of Material Misstatement

By its nature, risk assessment involves looking at internal and external factors to determine what can go wrong with the financial statements, whether due to error or fraud. When properly applied, the risk assessment approach set forth in PCAOB standards should focus auditors' attention on those areas of the

^{21/} See paragraph 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

financial statements that are higher risk and thus most susceptible to misstatement. This includes considering events and conditions that create incentives or pressures on management or create opportunities for management to manipulate the financial statements. The evidence obtained from the required risk assessment procedures should provide a reasonable basis for the auditor's risk assessments, which, in turn, should drive the auditor's tests of accounts and disclosures in the financial statements.

The risk assessment procedures required by PCAOB standards also should provide the auditor with a thorough understanding of the company and its environment as a basis for identifying unusual transactions or matters that warrant further investigation. They also provide a basis for the auditor to evaluate and challenge management's assertions.^{22/} It is important to note that the auditor's understanding should be based on actual information obtained from the risk assessment procedures. It is not sufficient for auditors merely to rely on their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

Performing Tests of Controls and Substantive Procedures

Appropriately applying professional skepticism is critical to obtaining sufficient appropriate audit evidence to determine whether the financial statements are free of material misstatement and, in an integrated audit, whether internal controls over financial reporting are operating effectively. Application of professional skepticism is not merely obtaining the most readily available evidence to corroborate management's assertion.

The need for auditors to appropriately apply professional skepticism is echoed throughout PCAOB standards. For example, PCAOB standards caution that representations from management are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.^{23/} Also, the standards warn that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.^{24/}

^{22/} For example, risk assessment procedures may provide the auditor a basis for challenging management's responses to the required inquiries of management in Auditing Standard No. 12.

^{23/} See paragraph .02 of AU sec. 333, *Management Representations*.

^{24/} Paragraph 39 of Auditing Standard No. 13.

In addition, PCAOB standards require auditors to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement and to obtain more persuasive evidence the higher the assessment of risk.^{25/} The auditor is required to apply professional skepticism, which includes a critical assessment of the audit evidence.^{26/} Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable.^{27/} When discussing the characteristics of reliable audit evidence, PCAOB standards observe that generally, among other things, evidence obtained from a knowledgeable source independent of the company is more reliable than evidence obtained only from internal company sources and evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.^{28/}

Taken together, this means that in higher risk areas, the auditor's appropriate application of professional skepticism should result in procedures that are focused on obtaining evidence that is more relevant and reliable, such as evidence obtained directly and evidence obtained from independent, knowledgeable sources.^{29/} Further, if audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.^{30/}

The following are examples of audit procedures in PCAOB standards that reflect the need for professional skepticism:

^{25/} See paragraphs 8-9 of Auditing Standard No. 13. For fraud risks and significant risks, the auditor also is required to perform procedures, including tests of details, that are specifically responsive to the assessed risks.

^{26/} See AU sec. 230.07.

^{27/} Paragraph 39 of Auditing Standard No. 13.

^{28/} See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

^{29/} See paragraph 9.a. of Auditing Standard No. 13.

^{30/} Paragraph 29 of Auditing Standard No. 15.

- Resolving inconsistencies in or doubts about the reliability of confirmations;^{31/}
- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;^{32/}
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud;^{33/}
- Evaluating the business rationale for significant unusual transactions;^{34/} and
- Evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.^{35/}

Evaluating Audit Results to Form the Opinion to be Expressed in the Audit Report

When professional skepticism is applied appropriately, the auditor does not presume that the financial statements are presented fairly in conformity with the applicable financial reporting framework. Instead, the auditor employs an attitude that includes a questioning mind in making critical assessments of the evidence obtained to determine whether the financial statements are materially misstated. PCAOB standards indicate that the auditor should take into account all relevant audit evidence, regardless of whether the evidence corroborates or contradicts the assertions in the financial statements.^{36/} Examples of areas in the evaluation that reflect the need for the auditor to apply professional skepticism, include, but are not limited to, the following:

^{31/} See, e.g., paragraphs .27 and .33 of AU sec. 330, *The Confirmation Process*.

^{32/} See AU secs. 316.58-.62.

^{33/} See AU secs. 316.63-.65.

^{34/} See AU secs. 316.66-.67.

^{35/} See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

^{36/} See paragraph 3 of Auditing Standard No. 14.

- *Evaluating uncorrected misstatements.* This includes evaluating whether the uncorrected misstatements identified during the audit result in material misstatement of the financial statements, individually or in combination, considering both qualitative and quantitative factors.^{37/}
- *Evaluating management bias.* This includes evaluating potential bias in accounting estimates, bias in the selection and application of accounting principles, the selective correction of misstatements identified during the audit, and identification by management of additional adjusting entries that offset misstatements accumulated by the auditor.^{38/} When evaluating bias, it is important for auditors to consider the incentives and pressures on management to manipulate the financial statements.
- *Evaluating the presentation of the financial statements.* This includes evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.^{39/}

When evaluating misstatements, bias, or presentation and disclosures, it is important for auditors to appropriately apply professional skepticism and avoid dismissing matters as immaterial without adequate consideration.

Conclusion

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits, which includes an attitude of a questioning mind and a critical assessment of audit evidence. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

^{37/} See paragraph 17 of Auditing Standard No. 14.

^{38/} See paragraph 25 of Auditing Standard No. 14.

^{39/} See paragraphs 30-31 of Auditing Standard No. 14.

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