

In the Matter of Kansas City Power & Light Company's..., 2015 WL 5244724...

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In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service

ER-2014-0370, et al.  
YE-2015-0194  
YE-2015-0195

Missouri Public Service Commission

September 2, 2015  
**REPORT AND ORDER**

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same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.<sup>14</sup>

The Supreme Court has further indicated:

'[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.<sup>15</sup>

\*9 In undertaking the balancing required by the Constitution, the Commission is not bound to apply any particular formula or combination of formulas. Instead, the Supreme Court has said:

Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.<sup>16</sup>

Furthermore, in quoting the United States Supreme Court in *Hope Natural Gas*, the Missouri Court of Appeals said: [T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' ... Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts.<sup>17</sup>

### III. DISPUTED ISSUES

#### A. Cost of capital

### FINDINGS OF FACT

17. Four financial analysts offered recommendations regarding an appropriate cost of capital in this case. Robert B. Hevert testified on behalf of KCPL. Hevert is Managing Partner of Sussex Economic Advisors, LLC. He holds a Bachelor of Science degree in Finance from the University of Delaware and a Master of Business Administration with a concentration in finance from the University of Massachusetts. He also holds the Chartered Financial Analyst designation.<sup>18</sup> He recommends the Commission allow KCPL a return on equity of 10.3 percent, within a range of 10.0 percent to 10.6 percent.<sup>19</sup>

18. Michael Gorman testified on behalf of Missouri Industrial Energy Consumers ("MIEC") and Midwest Energy Consumers Group ("MECG"). Gorman is a consultant in the field of public utility regulation and is a managing principal of Brubaker & Associates. He holds a Bachelor of Science degree in Electrical Engineering from Southern Illinois University and a Master's Degree in Business Administration with a concentration in Finance from the University of Illinois at Springfield.<sup>20</sup> Gorman recommends the Commission allow KCPL a return on equity of 9.10 percent, within a recommended range of 8.80 percent to 9.40 percent.<sup>21</sup>

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\*10 19. Maureen L. Reno testified on behalf of the U.S. Department of Energy and the Federal Executive Agencies. Reno holds a Bachelor of Arts in Economics from the University of Maine at Orono, Maine and a Master of Arts in Economics from the University of New Hampshire in Durham, New Hampshire. She is employed as an independent consultant.<sup>43</sup> Reno recommends the Commission allow KCPL a return on equity of 9.0 percent, within a recommended range of 8.2 percent to 9.6 percent.<sup>44</sup>

20. Zephania Marevangeo testified on behalf of Staff. Marevangeo is employed by the Commission as a Utility Regulatory Auditor III in the Financial Analysis Unit. Marevangeo holds a Bachelor of Science degree in Business Administration from Columbia College in Columbia, Missouri and a Masters of Business Administration from Lincoln University in Jefferson City, Missouri.<sup>45</sup> Marevangeo recommends a return on equity of 9.25 percent, within a range of 9.00 percent to 9.50 percent.<sup>46</sup>

21. An essential ingredient of the cost-of-service ratemaking formula is the rate of return, which is premised on the goal of allowing a utility the opportunity to recover the costs required to secure debt and equity financing. If the allowed rate of return is based on the costs to acquire capital, then it is synonymous with the utility's weighted average cost of capital, which is calculated by multiplying each component ratio of the appropriate capital structure by its cost and then summing the results. In order to arrive at a rate of return, the Commission must examine an appropriate ratemaking capital structure, KCPL's embedded cost of debt, and KCPL's cost of common equity, or return on equity.<sup>47</sup>

22. The actual capital structure of Great Plains Energy Incorporated ("GPE") as of May 31, 2015, was 50.090 percent common equity, .552 percent preferred stock, and 49.358 percent long-term debt.<sup>48</sup> This capital structure is consistent with the capital structure of utility operating companies held by proxy companies.<sup>49</sup>

\*11 23. In KCPL's last rate case, File No. ER-2012-0174, the Commission used a consolidated capital structure and embedded cost of debt for KCPL consistent with that of GPE, KCPL's parent company.<sup>50</sup>

24. In KCPL's most recent retail rate case in Kansas, the Kansas Corporation Commission approved the use of a capital structure based on the GPE consolidated capital structure.<sup>51</sup>

25. All of the expert witnesses on this issue recommended using the GPE capital structure for KCPL, except for witness Maureen Reno.<sup>52</sup> Ms. Reno used KCPL's actual capital structure as of December 31, 2014, which included short-term debt.<sup>53</sup>

26. The consolidated cost of long-term debt of GPE as of May 31, 2015, was 5.557 percent.<sup>54</sup> KCPL's weighted average coupon rate for KCPL's debt instruments is consistent with the prevailing market conditions at the time of issuance.<sup>55</sup>

27. Excluding short-term debt from the capital structure is consistent with the Federal Energy Regulatory Commission ("FERC") Order 561, which set forth the formula for calculating the allowance for funds used during construction. Since short-term debt is first used to fund construction work in progress, that same debt cannot be included in the regulatory capital structure without double-counting that debt.<sup>56</sup>

28. A utility's cost of common equity is the return investors require on an investment in that company. Investors expect to achieve their return by receiving dividends and through stock price appreciation. To comply with standards established by the United States Supreme Court, the Commission must authorize a return on equity sufficient to maintain financial integrity, attract capital under reasonable terms, and be commensurate with returns investors could earn by investing in other enterprises of comparable risk.<sup>57</sup>

\*12 29. Financial analysts use variations on three generally accepted methods to estimate a company's fair rate of return on equity. The Discounted Cash Flow ("DCF") method is based on a theory that a stock's current price represents the present value of all expected future cash flows. In its simplest form, the Constant Growth DCF model expresses the cost of equity as the discount rate that sets the current price equal to expected cash flows.<sup>58</sup>

The analysts also use variations of the DCF model including the multi-stage growth DCF and the sustainable growth DCF.<sup>59</sup> The Risk Premium method is based on the principle that investors require a higher return to assume a greater risk. Common

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equity investments have greater risk than bonds because bonds have more security of payment in bankruptcy proceedings than common equity and the coupon payments on bonds represent contractual obligations.<sup>59</sup> The Capital Asset Pricing Method ("CAPM") assumes the investor's required rate of return on equity is equal to a risk-free rate of interest plus the product of a company-specific risk factor, beta, and the expected risk premium on the market portfolio.<sup>60</sup> No one method is any more correct than any other method in all circumstances. Analysts balance their use of all three methods to reach a recommended return on equity.

30. State public utility commissions in the country are reducing authorized returns on equity to follow the significant decline in capital market costs. A comparison of industry authorized returns on equity indicates that they have been steadily declining over the last several years. In calendar year 2014, the industry authorized return on equity for fully litigated cases was 9.63 percent. In the first quarter of 2015, the industry authorized return on equity for fully litigated cases was 9.57 percent.<sup>61</sup> Witness Gorman states credibly that based on returns awarded by other commissions, a reasonable finding for a return on equity in this case is conservatively at 9.5 percent or less.<sup>62</sup>

31. The Commission mentions the industry authorized return on equity because KCPL must compete with other utilities all over the country for the same capital. Therefore, the industry authorized return on equity provides a reasonableness test for the recommendations offered by the return on equity experts.

\*13 32. In its decision regarding KCPL's last rate case, the Commission established a return on equity of 9.7 percent.<sup>63</sup> Over the last four years, the market capital costs for Missouri electric utilities are significantly lower, due to increases in utility stock prices and decreases in bond yields and utility dividend yields.<sup>64</sup>

33. KCPL's expert witness, Robert Hevert, supports an increased return on equity at 10.3 percent. The Commission finds that such a return on equity would be excessive. Hevert's return on equity estimate is high because 1) his constant growth DCF results are based on excessive and unsustainable long-term growth rates, 2) his multi-stage DCF is based on a flawed accelerated dividend cash flow timing and an inflated gross domestic product growth estimate as a proxy for long-term sustainable growth, 3) his CAPM is based on inflated market risk premiums, and 4) his bond yield plus risk premium is based on inflated utility equity risk premiums.<sup>65</sup>

34. If a fuel adjustment clause is implemented in this case, it will reduce KCPL's prospective investment risk, and this risk reduction should be considered in establishing a reasonable return on equity for KCPL.<sup>66</sup>

35. Since April 2015, some capital market and general economic indicators have changed, indicating expanding macroeconomic growth and increased required returns.<sup>67</sup>

36. The return on equity recommendations of witnesses Gorman, Marevange, and Reno are all reasonable and an accurate estimate of the current market cost of capital for KCPL, as those recommendations rely on verifiable and independent market data and accepted market-based rate of return models. Gorman testified credibly that these return on equity recommendations demonstrate that KCPL's current cost of equity is 9.5 percent or less.<sup>68</sup>

### CONCLUSIONS OF LAW AND DECISION

\*14 In determining the rate of return, the Commission must first consider KCPL's capital structure and cost of debt. This Commission has historically used the actual capital structure of GPE in determining the capital structure of KCPL, as has the Kansas Corporation Commission when setting KCPL's rates in that state. It is appropriate to use a consistent capital structure across all regulatory jurisdictions to avoid disagreements about one operating company's capital structure having more or less equity than another operating company. Ms. Reno's testimony was not persuasive that short-term debt should be included in the capital structure. The Commission concludes that in calculating KCPL's cost of capital, the correct capital structure to use is the actual capital structure of GPE as of May 31, 2015, which was 50.090 percent common equity, .552 percent preferred stock, and 49.358 percent long-term debt. The use of short-term debt is not appropriate, so the correct cost of debt for KCPL is its actual cost of long-term debt as of May 31, 2015, which was 5.557%.

In order to set a fair rate of return for KCPL, the Commission must determine the weighted cost of each component of the

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utility's capital structure. One component at issue in this case is the estimated cost of common equity, or the return on equity. Estimating the cost of common equity capital is a difficult task, as academic commentators have recognized.<sup>69</sup>

Determining a rate of return on equity is imprecise and involves balancing a utility's need to compensate investors against its need to keep prices low for consumers.<sup>70</sup> Missouri court decisions recognize that the Commission has flexibility in fixing the rate of return, subject to existing economic conditions.<sup>71</sup> "The cases also recognize that the fixing of rates is a matter largely of prophecy and because of this commissions, in carrying out their functions, necessarily deal in what are called 'zones of reasonableness', the result of which is that they have some latitude in exercising this most difficult function."<sup>72</sup> Moreover, the United States Supreme Court has instructed the judiciary not to interfere when the Commission's rate is within the zone of reasonableness.<sup>73</sup>

\*15 The evidence shows that return on equity recommendations of witnesses Gorman, Marevangepo, and Reno are all reasonable and an accurate estimate of the current market cost of capital for KCPL. The ranges of those recommendations overlap, and the upper end of those ranges is between 9.4 percent and 9.6 percent. The Commission finds that witness Gorman testified credibly and persuasively that KCPL's current cost of equity is 9.5 percent or less. The Commission has considered other factors, such as recent indicators of growth that may suggest an increased return, and the reduction of investment risk to KCPL by approving a fuel adjustment clause, which suggests a reduced return. However, based on the competent and substantial evidence in the record, on its analysis of the expert testimony offered by the parties, and on its balancing of the interests of the company's ratepayers and shareholders, the Commission concludes that 9.5 percent is a fair and reasonable return on equity for KCPL. This rate of return will allow KCPL to compete in the capital market for the funds needed to maintain its financial health.

#### B. Fuel adjustment clause 2005 stipulation and agreement

#### FINDINGS OF FACT

37. A fuel adjustment clause ("FAC") is a mechanism established in a general rate case that allows periodic rate adjustments, outside a general rate proceeding, to reflect increases and decreases in an electric utility's prudently incurred fuel and purchased power costs.<sup>74</sup>

38. While the three other investor-owned electric utilities in Missouri have FACs in place, KCPL does not have an FAC.<sup>75</sup> In Pile No. EO-2005-0329, the Commission approved a stipulation and agreement which included an Experimental Regulatory Plan ("2005 Stipulation"). That 2005 Stipulation included a provision that stated:

KCPL agrees that, prior to June 1, 2015, it will not seek to utilize any mechanism authorized in current legislation known as "SB 179" or other change in state law that would allow riders or surcharges or changes in rates outside of a general rate case based upon a consideration of less than all relevant factors. In exchange for this commitment, the Signatory Parties agree that if KCPL proposes an Interim Energy Charge ("IEC") in a general rate case filed before June 1, 2015 in accordance with the following parameters, they will not assert that such proposal constitutes retroactive ratemaking or fails to consider all relevant factors: ...<sup>76</sup> (emphasis added)

\*16 39. The 2005 Stipulation, including the above provision, was approved by the Commission in its Report and Order issued on July 28, 2005. The Report and Order directed that the signatory parties, including KCPL, shall abide by all of the terms and requirements in the 2005 Stipulation.<sup>77</sup>

40. Senate Bill 179 was passed by the Missouri General Assembly, signed by the Governor, and became effective on January 1, 2006. This bill became section 386.266, RSMo, which authorizes electrical corporations to apply to the Commission for an FAC.<sup>78</sup>

41. In Missouri, public utilities must file tariff sheets with the Commission with a specific effective date that determines when rates can first be charged or programs contained on those tariff sheets can be implemented.<sup>79</sup> The tariff sheets KCPL filed in this case for an FAC cannot be used by KCPL until the Commission approves an FAC tariff.<sup>80</sup>



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53 Ex. 166, Klote True-Up Rebuttal, p. 2.

54 Ex. 700, Renn Direct, p. 52.

55 Ex. 116, Hevert Rebuttal, p. 64.

56 Ex. 550, Gorman Direct, p. 11.

57 Ex. 115, Hevert Direct, p. 15.

58 Ex. 550, Gorman Direct, p. 11.

59 *Id.* at p. 27.

60 *Id.* at p. 33.

61 Ex. 552, Gorman Surrebuttal, p. 3, Schedule MPG-SR-1.

62 Ex. 552, Gorman Surrebuttal, p. 4.

63 Report and Order, *In the Matter of Kansas City Power & Light Company's Request for Auth. to Implement A Gen. Rate Increase for Elec. Serv. & in the Matter of KCP&L Greater Missouri Operations Company's Request for Auth. to Implement A Gen. Rate Increase for Elec. Serv.*, ER-2012-0174, 2013 WL 299322 (Jan. 9, 2013).

64 Transcript, Vol. 9, p. 265, 279-80.

65 Ex. 551, Gorman Rebuttal, p. 6-7, 9-24.

66 Ex. 552, Gorman Surrebuttal, p. 13.

67 Ex. 117, Hevert Surrebuttal, p. 46-47.

68 Ex. 552, Gorman Surrebuttal, p. 2.

69 See Phillips, *The Regulation of Public Utilities*, Public Utilities Reports, Inc., p. 394 (1993).

70 *State ex rel. Pub. Counsel v. Pub. Serv. Comm'n*, 274 S.W.3d 569, 574 (Mo. Ct. App. 2009).

71 *State ex rel. Laclede Gas Co. v. Public Service Commission*, 535 S.W.2d 561, 570-571 (Mo. App. 1976).

72 *State ex rel. Laclede Gas Co. v. Public Service Commission*, 535 S.W.2d 561, 570-571 (Mo. App. 1976). In fact, for a court to find that the present rate results in confiscation of the company's private property, that court would have to make a finding based on evidence that the present rate is outside of the zone of reasonableness, and that its effects would be such that the company would suffer financial disarray. *Id.*

73 *State ex rel. Public Counsel v. Public Service Commission*, 274 S.W.3d 569, 574 (Mo. App. 2009). See, *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968) ("courts are without authority to set aside any rate selected by the Commission [that] is within a "'zone of reasonableness'"DD").

74 Commission Rule 4 CSR 240-20.090(1)(C).

75 Ex. 134, Rush Direct, p. 9.

76 Ex. 200, Staff Report, Revenue Requirement Cost of Service, p. 189-90; Ex. 153.

77 Report and Order, EO-2005-0329. *In Re Kansas City Power & Light Co.*, 13 Mo. P.S.C. 3d 568, 242 P.U. R.4th 492 (July 28,