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STATE CORPORATION COMMISSION

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Susan Talbott Docket Room

BEFORE THE STATE CORPORATION COMMISSION

OF THE STATE OF KANSAS

DIRECT TESTIMONY

OF

JAMES HAINES

WESTAR ENERGY

DOCKET NO. 05-WSEE-981-RTS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. James Haines, 818 South Kansas Avenue, Topeka, Kansas 66612.

Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

A. Westar Energy, Inc. I am the President and CEO and also serve as a director.

Q. PLEASE DESCRIBE YOUR EDUCATION AND BUSINESS EXPERIENCE.

A. I received a B.A. degree in 1969 and a J.D. degree in 1975 from the University of Missouri - Columbia. From 1975 to 1985, I practiced law in a variety of government and private industry positions, including nearly four years on the legal staff of the Missouri Public Service Commission. In 1980, I joined the law department of Kansas Gas and Electric Company. In 1985, I advanced to Group Vice President with responsibility for finance, accounting, investor relations, and regulatory affairs. After KG&E merged with The Kansas Power and Light Company in 1992, I served as Executive Vice President and Chief Administrative Officer of the new company, then Western Resources, Inc. In 1995, I was promoted to Executive Vice President and Chief Operating Officer.

I left Western Resources in 1996 to become President and CEO of El Paso Electric Company. I retired from EPE in November 2001 to teach in the College of Business at The University of Texas at El Paso as the Skov Professor of Business Ethics.

On December 9, 2002, I started in my present position.

Q. WHAT IS THE CONTEXT FOR THIS RATE REVIEW?

A. During the past two years, Westar has revitalized itself as a pure electric utility. In doing that, we have simplified our corporate structure, implemented substantial changes in corporate governance, and restored our balance sheet to investment grade credit quality. This rate review is one of the final steps in the Debt Reduction and Restructuring Plan (the "Plan") approved by the Commission in Docket No. 01-WSRE-949-GIE in July 2003.

Over the past 10 years, companies and regulators have introduced many variations to the structure of utility companies and the extent of their regulation. A vertically integrated pure play electric utility subject to full retail regulation, such as Westar has again become, is no longer the standard model. Indeed, many knowledgeable people believe it is no longer possible for a small, pure play electric utility to succeed, financially or operationally, over the long term. Though I respect the premises of their arguments, I emphatically disagree with them. This rate review, however, is certainly a test of Westar's ability to succeed as a pure utility.

The immediate need in this review is to set the proper level of Westar's rates going forward. The long-term need is to set a foundation for Westar, as a basic utility, to build and maintain the strength necessary to deal with important issues and risks it will face in the next five to ten years. A few of these include:

- Volatile and high gas and oil prices,
- Upward pressure on delivered coal prices,
- Apparent rising capital cost trends coming off a 40-year low in interest rates,
- Capital and operating costs to comply with more stringent environmental regulations,
- Capital and maintenance costs for mid-life refurbishment of aging facilities,
- Capital costs for new generating and transmission capacity,

- Capital and operating costs to satisfy customer expectations for higher quality service, and
- The need to continue to improve credit quality.

In this rate review, we propose means to anticipate and manage those issues and risks so we do not jeopardize our back-to-basics strategy, a strategy that has been embraced by our customers, employees, and Kansas policy makers.

Q. WHAT ARE WESTAR'S PRINCIPAL OBJECTIVES IN THIS RATE REVIEW?

A. Our principal objectives are to show that:

1. We have kept our promises to restore Westar's financial health and to return Westar to being a pure utility focused on high quality customer service.
2. Our proposed rates are fair and logical and based on our cost of providing retail electric service.
3. Certain changes in our rate tariffs, e.g., a fuel adjustment clause, are specifically designed to reduce unnecessary risk by employing widely-accepted methodologies and are appropriate to more closely reflect investors' risk/reward expectations for a basic utility.
4. A rate increase is necessary because Westar's current rates do not recover its cost of service. This is of particular concern because Westar is entering a period in which, to

maintain adequate and reliable service, it will have to raise hundreds of millions of dollars to refurbish existing facilities and build new ones. A timely and adequate rate increase will send a positive signal to capital markets about the risk/reward balance of investing in a pure Kansas utility.

Q. HOW WILL WESTAR SHOW THOSE FOUR POINTS?

A. I will generally address each point. Other Westar witnesses will cover one or more of the points in detail.

Q. IS WESTAR PROPOSING TO INCREASE ITS APPROVED RATES?

A. Yes. Westar is proposing to increase rates – on average about 9.29% for Westar North and 6.34% for Westar South.

Q. WHY IS WESTAR SEEKING TO INCREASE ITS RATES?

A. Based on our 2004 test year, as adjusted for known and measurable changes after its end, our rates do not recover our cost of service. Prudent measures to improve productivity and cut costs have reduced but have not eliminated the revenue deficiency.

Q. WHAT HAS WESTAR DONE TO IMPROVE PRODUCTIVITY AND CUT COSTS?

A. Let me list just a few of the more significant examples. We have greatly reduced interest costs by substantially reducing debt and aggressively refinancing at lower rates the debt that remained. We negotiated hard to maintain a significant level of shared services with ONEOK. We have introduced new customer care technology to improve service quality without increasing labor costs. We have switched to low-sulfur, low-cost coal at our Lawrence and Tecumseh energy centers. We also have developed and maintained the capability to burn both oil and gas in many of our peaking units.

Q. **HOW HAS WESTAR KEPT ITS PROMISE TO RESTORE ITS FINANCIAL HEALTH AND RETURN TO BEING A PURE UTILITY?**

A. In his testimony, Mark Ruelle, our chief financial officer, describes in detail the specific actions we have taken to keep this promise. Notably, we have reduced consolidated debt by almost $2 billion and have disposed of virtually all non-utility, non-core assets. The bottom line is that now, with very slight exceptions, Westar is a pure electric utility and its first mortgage bonds are once again rated investment grade by all major credit rating agencies. Although we have attained financial measures consistent with investment grade, our general corporate and unsecured debt ratings remain below investment grade.

Q. **WHAT HAS WESTAR DONE TO FOCUS ON HIGH QUALITY SERVICE TO CUSTOMERS?**

A. It begins with our Mission Statement: **"Westar Energy provides safe, reliable, high quality electric energy service at a**

reasonable cost to all customers." Based on that Mission, we have set annual goals through 2008 for service quality as measured by the average number and duration of outages per customer, the answered call rate in our customer call center, and third-party surveys of customer satisfaction.

The point is that the words "high quality electric service" in our Mission Statement are more than words on paper. Through a deliberate planning process at the corporate level right down to individual employee performance plans, a focus on the action necessary to accomplish those plans, and regular assessment of results, we are giving concrete effect to those words.

Our commitment to quality service is further demonstrated by our proposal to tie financial penalties and rewards directly to our continuing ability to meet service quality standards.

Q. YOU TESTIFIED THAT WESTAR'S SECOND OBJECTIVE IN THIS RATE REVIEW IS TO SHOW THAT ITS PROPOSED RATES ARE FAIR AND LOGICAL AND BASED ON ITS COST OF PROVIDING RETAIL ELECTRIC SERVICE. ARE ANY OF THE COSTS RELATED TO LITIGATION AND OTHER MATTERS INVOLVING FORMER SENIOR MANAGEMENT INCLUDED IN WESTAR'S TEST YEAR COST OF SERVICE?

A. No. We have removed all costs associated with 1) their criminal indictments and trials; 2) the arbitration that Westar has initiated against them to recover past compensation and nullify their employment agreements; 3) the pending securities and ERISA-related litigation that challenges the accuracy and fullness of financial disclosures during their tenure; 4) losses from the disposition of aircraft previously owned or leased; and 5) other items associated with them, such as excessive costs of refurbishing executive office space.

Q. IN THE FINAL ORDER IN WESTAR'S RATE REVIEW CONCLUDED IN 2001, THE COMMISSION EXPRESSED THE EXPECTATION THAT OVER TIME WESTAR'S NORTH AND SOUTH RATES WOULD CONVERGE. DO THE RATES PROPOSED BY WESTAR IN THIS REVIEW CONTINUE THAT TREND?

A. Yes.

Q. DO THOSE TWO ITEMS *ALONE*, I.E. REMOVAL OF COSTS RELATED TO FORMER MANAGEMENT AND FURTHER CONVERGENCE OF THE NORTH AND SOUTH RATES, PROVE THAT WESTAR'S PROPOSED RATES ARE FAIR AND LOGICAL AND BASED ON ITS COST OF PROVIDING RETAIL ELECTRIC SERVICE?

A. No, but if we had not addressed those two items, particularly the first one, some might argue that our proposed rates could not possibly be fair and logical.

More to the point, our budgeting process is rigorous. Every proposed expenditure of any substance is tested against a few straightforward principles. Is it necessary to 1) protect employee or public safety; 2) provide adequate and reliable service, taking into account our service quality objectives; 3) facilitate employee development; or 4) comply with applicable laws and regulations, including financial disclosure requirements. Once we set our budget, we monitor our performance against that budget carefully and regularly. On that basis, I testify here with great confidence that the rates we have proposed reflect our costs of providing retail electric service and that those costs are reasonable.

Q. YOU TESTIFIED THAT WESTAR'S THIRD OBJECTIVE IS TO SHOW THAT CERTAIN CHANGES IN ITS TARIFFS, E.G., A FUEL ADJUSTMENT CLAUSE, ARE NECESSARY TO MORE CLOSELY REFLECT INVESTORS' RISK/REWARD EXPECTATIONS FOR A BASIC UTILITY. WHY IS THAT?

A. Investors balance their opportunity for gain against their risk of loss. The opportunity for gain in a pure utility is a regulated return. That limited opportunity can only be balanced by a low risk of loss. Fuel for generation is Westar's largest single cost – at $324.5 million, it was 27.7% of Westar's 2004 cost of retail electric service. Removing the risk of fuel price volatility from Westar's investment profile is a straightforward way to balance investors' opportunity for a limited return with exposure to less risk.

Q. WHY DO YOU DESCRIBE IT AS STRAIGHTFORWARD?

A. To my knowledge, no one disputes that customers should pay for the fuel that is prudently purchased to generate the electricity they consume. A well-designed fuel clause also sends more accurate price signals to customers. In the long run, a fuel adjustment clause will keep rates as low as possible consistent with assuring investors a reasonable opportunity to earn a fair return.

Q. AS YOU KNOW, WESTAR HAS NOT HAD A FUEL ADJUSTMENT CLAUSE SINCE 1992. DOES YOUR PRIOR ANSWER IMPLY THAT SINCE 1992 WESTAR'S RATES HAVE BEEN HIGHER THAN NECESSARY?

A. When fuel costs in rates are fixed, but actual fuel costs are not, it means that at any given time rates may be higher or lower than actual costs. It certainly implies that both Westar's customers and investors have been exposed to more risk than necessary. When fuel costs included in rates have been higher than actual fuel costs, Westar's shareholders have benefited at the expense of customers. Conversely, when such costs have been lower, customers have benefited at the expense of shareholders. Normally, the goal should be for rates to reflect as nearly as possible the actual fuel costs incurred.

Q. BUT VIRTUALLY EVERY COMPONENT OF COST OF SERVICE IS SIMPLY AN ESTIMATE THAT WILL TURN OUT TO BE HIGHER OR LOWER THAN ACTUAL. WHY SHOULD FUEL COSTS BE TREATED DIFFERENTLY?

A. As noted in an earlier answer, by a very significant margin, fuel is the largest component of Westar's cost of service and can be the most volatile as well.

Q. WILL A FUEL ADJUSTMENT CLAUSE DIMINISH WESTAR'S INCENTIVE TO MIMIMIZE FUEL COSTS?

A. It will not. First, the prudence of Westar's fuel purchases would remain subject to Commission review. Second, to the extent market pressure creates an incentive for Westar to minimize fuel costs, this is fully realized by Westar's active participation in wholesale power markets. In this regard, Westar's proposed sharing of wholesale margins works to the benefit of customers as well as shareholders – lower fuel costs lead directly to higher margins. Third, there is considerable social/political pressure on a regulated utility to minimize costs. Fourth, in the long run, there is no advantage and there are plenty of disadvantages in being a high cost producer – even in a regulated, monopoly market.

Q. WESTAR HAS ALSO REQUESTED APPROVAL OF AN ENVIRONMENTAL RIDER. DOES THE LOGIC IN FAVOR OF A

FUEL ADJUSTMENT CLAUSE APPLY EQUALLY TO AN ENVIRONMENTAL RIDER?

A. Yes, and more so. The proposed environmental rider would permit Westar to periodically adjust rates to reflect capital and O&M costs for upgrades to existing generating facilities to comply with more rigorous interpretation of existing environmental laws and regulations as well as new laws and regulations. As with prudent fuel costs, I believe it is beyond dispute that customers should pay rates that reflect the prudent cost of complying with environmental laws and regulations. What we want to find is the best, most efficient way to do it.

In my opinion, the best way to do it would be the one that assures an opportunity for investors to earn a fair return of and on the cost of the upgrades, avoids the cost and frequency of full-blown rate reviews, *and* minimizes the impact on rates. Everything else equal, it is always less costly to pay as you go. As with a fuel adjustment clause, the proposed environmental rider also would improve credit quality and balance investors' opportunity for a limited return with exposure to less risk. Finally, it would let our customers know the costs of complying with federal regulations.

Q. YOU SAID "MORE SO," WHAT IS THE ADDED REASON IN FAVOR OF APPROVING THE PROPOSED RIDER?

A. It relates directly to the fourth objective I listed at the beginning of this testimony. Kansas has benefited from decisions in the '70's to build coal and uranium fueled generating plants. Now is the time to aggressively affirm those decisions by doing what we can to protect and extend those benefits. In addition to the need to raise capital – hundreds of millions of dollars – to install these environmental upgrades over the next 5 to 10 years, in the same period Westar is very likely going to have to add peak generating capacity and be well under way with construction of a new base load generating plant. Actions taken now to improve Westar's credit quality and reduce its risk profile will work to minimize the capital cost of these future upgrades and capacity additions.

Q. YOU TESTIFIED THAT, EVERYTHING ELSE EQUAL, IT IS ALWAYS LESS COSTLY TO PAY AS YOU GO. CAN YOU GIVE AN ESTIMATE OF THE ULTIMATE RATE BASE IMPACT OF, FOR EXAMPLE, $300 MILLION INVESTED IN ENVIRONMENTAL UPGRADES OVER TEN YEARS WITH AND WITHOUT AN ENVIRONMENTAL RIDER?

A. Yes. *With* a rider, a total of $300 million would be added to rate base, in regular intervals as the money was spent. *Without* the rider and assuming rate reviews at the end of the third, sixth, and tenth years and assuming Westar's requested capital structure and cost of equity, between approximately $320.5 million and $338.5 million would be added to rate base. (The range is a function of whether or not an equity cost component is included in the AFUDC rate.) Accordingly, with the rider, rates would rise gradually and to a lower ultimate level. Without the rider, rates would go up in three abrupt steps and to a higher level.

Q. WESTAR HAS SUBMITTED A RELIABILITY-BASED SHARING PROPOSAL. WHAT IS THE REASON FOR THIS PROPOSAL?

A. From experience, I believe that the opportunity for financial gain and the risk of financial loss, within limits, can work effectively to achieve desired results – e.g., increased productivity and improved service quality. Under our Reliability-Based Sharing Proposal, for a three-year period, the benefit of reduced costs would be shared between customers and shareholders. The proposal includes service quality standards and ties the opportunity for gain and the risk of loss directly to performance against such standards.

Q. WHAT ABILITY WILL THE COMMISSION HAVE TO MONITOR THIS PROPOSAL?

A. To begin with, because it is being requested as part of a rate review, this proposal is benchmarked to a traditional determination of Westar's revenue requirement. The proposal would be in place for three years. Under the proposal, there would an annual review of operating and financial performance. On that basis, the full operation of the proposal, including the determination of any benefits to be shared with customers, would be subject to annual oversight by the Commission without the cost and complexity of a rate case. At the end of the three years, if the proposal is working well, it could be continued.

Q. WHY DOES WESTAR'S RELIABILITY-BASED SHARING PROPOSAL INCORPORATE SERVICE QUALITY STANDARDS?

A. Pairing service quality standards with the earnings sharing aspect of the proposal ensures that we balance the interests of customers and investors.

Q. HOW WILL WESTAR'S RELIABILITY-BASED SHARING PROPOSAL WORK IN CONJUNCTION WITH THE WHOLESALE MARGIN CREDITS IN WESTAR'S REQUESTED FUEL ADJUSTMENT CLAUSE?

A. To the extent that Westar's share of wholesale margins pushes its ROE above the top end of the dead-band, an additional benefit for customers is created under the Reliability-Based Sharing Proposal.

Q. HOW FAR FROM TRADITIONAL RATEMAKING IS WESTAR'S RELIABILITY-BASED SHARING PROPOSAL?

A. Part of its beauty is that it uses traditional regulatory methods. The sharing mechanism itself rests on the ratemaking formula used in Kansas for decades. We are not proposing adoption of new theories or methods of determining revenue requirements or the cost of service.

Q. TO SUPPORT WESTAR'S RELIABILITY-BASED SHARING PROPOSAL, YOU TESTIFIED THAT THE OPPORTUNITY FOR FINANCIAL GAIN AND THE RISK OF FINANCIAL LOSS, WITHIN LIMITS, CAN WORK EFFECTIVELY TO ACHIEVE DESIRED RESULTS. DOES THAT SAME LOGIC STAND AGAINST WESTAR'S REQUESTED FUEL ADJUSTMENT CLAUSE?

A. On the surface, perhaps it does. The difference is the limited extent to which effective management can control the factors that affect fuel cost. Based on current market information, we can make estimates of what fuel costs will be over the next three years. The only confidence we can realistically have in such estimates is that they will be wrong. The result is that shareholders or customers will get an accidental windfall and the value of the windfall to one is a cost paid by the other. For incentive ratemaking to be effective, i.e. to motivate desired behavior by management, the achievement of incentive targets has to be the result of deliberate, purposeful activity as opposed to a mere roll of the dice.

Q. MR. HAINES, WHILE THIS REVIEW IS FOCUSED ON THE FUTURE, IT IS NOT IRRELEVANT TO CONSIDER THE EXTREME CIRCUMSTANCES THAT LED TO A CHANGE IN MANAGEMENT AT WESTAR IN LATE 2002. WHAT HAS WESTAR DONE TO PROTECT AGAINST A RECURRENCE OF SUCH CIRCUMSTANCES?

A. The extreme circumstances you refer to are described in detail in the Report of the Special Committee to the Board of Directors (April 23, 2003). That Report is 376 pages long, with 246 exhibits. It is posted on Westar's website: www.wr.com. We have gone to extraordinary lengths to protect against a recurrence of the circumstances described in that report. Here is a list of the most notable actions we have taken:

- Named new senior management.
- Elected seven new directors.
- Of the 181 tasks necessary to implement all recommended actions in the Report, all but 8 have been completed. (Completion of those requires action by the IRS.)
- Redefined Westar's Mission to focus on being a pure utility.
- Simplified executive compensation.
- Substantially enhanced corporate governance practices.

Q. SPECIFICALLY, HOW HAS WESTAR SUBSTANTIALLY ENHANCED CORPORATE GOVERNANCE?

A. Ms. Loyd testifies about that in detail. Let me give just a summary. Corporate governance practices generally fit into three categories:

board, management, and enforcement. Westar has accomplished reform in all three areas.

With respect to board practices, Westar has focused on independence and more rigorous definition of responsibility. We have separated the position of Chairman from the positions of President and CEO. A committee of independent directors selects director candidates. All committees of the board are composed only of independent directors. All committees have formal, written charters. The audit committee is led by a financial expert who is a retired audit partner in a Big Four accounting firm. The board regularly meets in executive session without management and without me present. New directors attend orientation sessions and continuing directors participate in training conferences and seminars to augment their skill and knowledge. And the board goes through a self-evaluation process annually.

With respect to management practices, an annual planning process has been formalized. In addition to the normal output of such a process, e.g. an annual capital and O&M budget, this process results in a formal business plan that leads to individual performance plans for all officers. The business plan sets annual goals that build up to specific objectives five years out, presently to 2008. These objectives deal with safety, service reliability, customer satisfaction, and financial performance. Other practices include: 100% of officer expense accounts are audited every year, the officer of compliance and internal audit reports to the audit committee of the board as opposed to the CEO or the CFO, and virtually all management "perks" have been eliminated.

With respect to enforcement practices, we have a formal statement of values and a written Code of Business Conduct and Ethics. Importantly, we believe that such statements and codes are important only if in all aspects of our work we rigorously abide by their terms. Accordingly, we hold regular meetings with employees to discuss our values and code of conduct. For example, in about 20 meetings in January and February of this year, I and other officers met with every Westar manager and supervisor to discuss Westar's business plan and its values and code of conduct. They, in turn, met with employees under their supervision. Finally, we have an integrity "hotline" so that ethical or any other concerns can be reported on an anonymous basis to a third party, whose reports are reviewed by the audit committee of our board.

Q. WHAT ASSURANCE CAN YOU GIVE THE COMMISSION THAT WESTAR'S STRATEGIC AND GOVERNANCE REFORMS OF THE LAST TWO YEARS WILL CONTINUE?

A. As Westar's President and CEO, without qualification, I am devoted to institutionalizing within Westar 1) a well informed, engaged, and independent board; 2) transparency and integrity in every aspect of our business; and 3) a total commitment to meeting our public service obligation. Our governance reforms are being accomplished not through personal fiat but through a deliberate process that has involved the entire leadership of Westar. I am very confident that these reforms will last.

With respect to Westar's strategic reforms, i.e. its return to being a pure electric utility, I can only make a qualified commitment to those reforms. Not the only, but certainly a principal cause of Westar's mid-'90's diversification strategy was a strong trend by policy makers to transform the electric industry based on the belief that competitive wholesale ***and*** retail markets would be superior to regulated markets. Many companies, including Westar, believed it was best to be ahead of rather than behind such changes. Though Kansas policy makers considered such changes, they eventually (and wisely) rejected them.

If regulators and policy makers agree that Westar's strategic reforms should endure, two things are paramount. First, policy and regulation in Kansas must remain compatible with a back to basics strategy and it must be clear that this is a long-term commitment. Second, Westar and the Commission must remain able to work constructively together within that policy and regulatory framework. If those two conditions are met, I also am very confident that Westar's strategic reforms will last.

Certainly, the Commission and its Staff, as well as parties who customarily have been adversaries of Westar, have been constructive in their response to the Plan and Westar's need to obtain specific approval for the various parts of the Plan. The substantial progress of the past two years must not be lost as the Plan culminates in this rate review.

Finally, I believe the Commission itself has considerable authority to monitor and enforce adherence to these reforms. Indeed, as the failure of Westar's diversification strategy began to pose a perceived threat to Westar's ability to meet its public service obligation, the Commission was quick to act, forestalling any negative impact on utility rates or service quality. There is no reason to believe the Commission would be any less diligent in the future. If anything, it probably would act faster and more decisively.

Q. WESTAR HAS PROPOSED IN THIS REVIEW TO REVERSE TWO ADJUSTMENTS THAT THE COMMISSION ADOPTED IN WESTAR'S MOST RECENT RATE REVIEW. WHAT IS THE NATURE OF THESE ADJUSTMENTS?

A. One adjustment was to account for the unamortized gain on the LaCygne 2 sale/leaseback as cost-free capital. The other treated as cost-free capital an assumed level of unamortized deferred taxes related to Westar's recovery of the premium that KPL paid when it acquired KG&E in 1992. Obviously, both adjustments had the effect of reducing Westar's cost of service. Westar has not included the effect of these adjustments in its cost of service in this rate review.

Q. WHY HAS WESTAR NOT INCORPORATED THOSE ADJUSTMENTS IN THIS REVIEW?

A. The short answer is because, in our opinion, the Commission was mistaken in adopting those adjustments.

Q. AMONG OTHER ITEMS, WESTAR CHALLENGED THOSE ADJUSTMENTS IN AN APPEAL OF THE COMMISSION'S FINAL ORDER AND THE COURT AFFIRMED THE COMMISSION'S TREATMENT. IN VIEW OF THAT, WHAT IS YOUR BASIS FOR TESTIFYING THAT THE COMMISSION WAS MISTAKEN?

A. In a review of a Commission order in which findings of fact are at issue, an appellate court is supposed to affirm the Commission if there is competent evidence in the record to support such facts. That is the case even if the record contains competent evidence of facts to the contrary. As an expert administrative body, the Commission has broad discretion to "find the facts." Normally courts will not interfere with such discretion. Importantly, then, the Court of Appeals did not affirm the substance of the Commission's treatment of those adjustments. It simply ruled that there was competent evidence in the record to support the Commission's finding and the Commission did not abuse its discretion when it relied upon such evidence. That evidence is competent means only that its sponsor is qualified as an expert with respect to the subject matter; it does not mean that it is factually correct simply because its sponsor has been qualified as an expert. The fact is, in this instance, the expert sponsor for both adjustments was mistaken and those mistakes were only compounded when the Commission adopted them in its final order.

Mr. Rohlfs (LaCygne 2) and Mr. Stadler (merger premium) testify to the substance of these issues in detail. I have read their testimonies on these issues, including their conclusions. I believe their testimonies are accurate in all respects. Here, I am going to deal with these issues only in a general way.

Q. LET'S DEAL SEPARATELY WITH EACH ADJUSTMENT. FIRST, WHY WAS IT A MISTAKE TO ACCOUNT FOR THE UNAMORTIZED GAIN ON THE SALE/LEASEBACK AS COST FREE CAPITAL?

A. The LaCygne 2 sale/leaseback transaction was a step, among many, that Kansas Gas and Electric Company took to mitigate the rate impact of Wolf Creek and, as well, rebuild its financial strength. The transaction was a direct response to the Commission's explicit encouragement of KG&E to find ways to improve its financial health without increasing rates. Accordingly, in approving the transaction, the Commission noted that the benefits should flow to KG&E's customers. The principal benefit, of course, being that the transaction made it possible to include prudent Wolf Creek costs in rate base, *without increasing rates*. The Commission's decision in the last case to treat the **un**amortized gain as cost-free capital was based on the belief that that was necessary to assure that all the benefits of the transaction flowed to customers.

The key to seeing the mistake is in understanding how the gain and the cash proceeds from the transaction were used ***entirely*** to reduce KG&E's cost of service and thereby to offset KG&E's carrying cost for Wolf Creek so that more of Wolf Creek's prudent costs could be included in rate base, without increasing rates.

The amount of the book gain being amortized through KG&E's cost of service is about $11.8 million annually. This reduces KG&E's cost of service by a like amount and has the effect of offsetting carrying costs for Wolf Creek. Consequently, this amortization has enabled the Commission to put substantially more of Wolf Creek into rate base, *without increasing rates.* Westar agrees with this amortization of the gain.

With regard to the cash proceeds, in the broadest terms, KG&E had two choices. 1) It could use the cash in its regulated business to reduce its cost of service. 2) It could use the cash to diversify into unregulated businesses and hope that the success of such would offset under-performing utility operations.

Had KG&E used the cash to diversify, the only proper way for the Commission to have flowed all the benefit of the transaction to customers, i.e., to offset including more of Wolf Creek's prudent cost in rate base, would have been to annually amortize a portion of the gain to cost of service **and** treat the **un**amortized gain as cost-free capital – exactly what it did in Westar's recent rate review. **But, in fact, KG&E did not use any of the cash in a way that did not directly benefit customers.**

Instead, KG&E used the cash in its regulated business to reduce its cost of service by buying back high cost debt and 25% of its equity – thus reducing interest costs and dividend payouts. In doing that, KG&E used every cent of the cash directly to benefit customers. The cash was fully and efficiently "employed" in a way that enabled more of Wolf Creek's cost to be put in rate base *without increasing rates*. To now take the unamortized gain as cost-free capital assumes that KG&E (and by extension Westar) made some use of the gain that did not directly offset KG&E's cost of service.

In my opinion, the adjustment in the last rate review resulted in customers receiving the benefits of the transaction twice. It is not possible that KG&E could have used 100% of the cash proceeds to reduce its capital costs *and also* have the proceeds remain available as cost-free capital. That was and is not the case and I respectfully urge the Commission to correct this mistake.

Q. WHY WAS IT A BENEFIT TO CUSTOMERS TO BE ABLE TO INCLUDE MORE OF WOLF CREEK'S PRUDENT COSTS IN RATE BASE WITHOUT INCREASING RATES?

A. In the absence of such measures as the LaCygne transaction, eventually KG&E would have been able to raise rates to the level necessary to cover Wolf Creek's prudent costs being put into rate base. In fact, while one can only speculate about what the outcome might have been, the U.S. Supreme Court accepted KG&E's appeal of the Commission's treatment of Wolf Creek costs. The Court dismissed that appeal only after it found the Commission's later actions, such as approval of the LaCygne transaction, allowed such costs to be recognized in rates thereby making the appeal moot.

Q. WHAT MAKES YOU SO CERTAIN OF YOUR TESTIMONY ON THIS ISSUE?

A. Mr. Rohlfs and I were the principal architects of KG&E's rate stabilization plan of which the sale/leaseback transaction was a part. We were, so to speak, "present at the creation" of the sale/leaseback transaction and led KG&E's effort to obtain Commission approval.

Q. LET'S TURN TO THE ADJUSTMENT TO ADD TO ACCUMULATED DEFERRED INCOME TAXES THE UNAMORTIZED DEFERRED TAXES RELATED TO THE MERGER PREMIUM THAT KPL PAID WHEN IT ACQUIRED KG&E IN 1992. WHY IS SUCH AN ADJUSTMENT A MISTAKE?

A. Deferred income taxes for Westar **normally** result from the fact that when Westar depreciates an asset, the depreciation expense for tax purposes is different from the depreciation expense for ratemaking purposes. Most commonly, this is because for tax purposes an accelerated method of depreciation is used and for ratemaking purposes a straight-line method is used. The result is that in the early year's of an asset's life, the tax impact of a higher (accelerated) depreciation expense means that, everything else equal, actual taxes paid are lower than taxes calculated for ratemaking purposes, based on a straight-line method of depreciation. Of course, in the later years of an asset's life, the reverse is true and there is a "turnaround": actual taxes paid are higher than taxes calculated for ratemaking purposes.

In the early years of an asset's life, then, customers pay rates that reflect a higher level of taxes than the level of taxes actually paid. The positive difference is accounted for as deferred taxes, i.e. taxes that have been reflected in cost of service but not yet paid, and *added* to an accumulated deferred income tax account. In the later years of an asset's life, i.e. after the turnaround, customers pay rates that reflect a lower level of taxes than the level of taxes actually paid. In those later years, the negative difference is *subtracted* from the accumulated deferred income tax account. By the end of an asset's life, the additions to and subtractions from the accumulated deferred income tax account caused by these timing differences should net to zero.

The question that regulators have dealt with over the years is how to account for ratemaking purposes for positive balances of accumulated deferred income taxes. Most regulators treat normal accumulated deferred income taxes as cost-free capital or as an offset to rate base. The reasoning is that these positive balances are a direct result of customers paying rates that reflect a higher level of taxes than have actually been paid. We can debate about whether this is a loan from customers or the relevant taxing authority. What is not debatable is that there has been a cash in-flow that the company has not had to pay for, either with interest or dividend payments. Accordingly regulators have taken the position that the effect of this "free" cash should be taken into account in determining a company's cost of service.

Q. DO YOU OBJECT TO THAT LONG-ESTABLISHED PRACTICE?

A. No.

Q. ISN'T THAT EXACTLY WHAT THE COMMISSION DID WHEN IT APPROVED THE ADJUSTMENT TO WHICH YOU ARE NOW OBJECTING?

A. Superficially it appears so. And I will grant that that might be what the Commission understood it was doing. But that is absolutely not what the Commission in fact did.

Q. WHAT DID THE COMMISSION IN FACT DO?

A. To understand what the Commission in fact did, we have to first understand the nature of the deferred taxes related to the merger premium and how they are fundamentally different from deferred taxes created through accelerated depreciation. Remember that normal deferred taxes result from using an accelerated method for determining tax depreciation and a straight-line method for determining ratemaking depreciation. The result, in the early years of an asset's life, is a cost free cash in-flow.

The deferred taxes related to the merger premium did not result from a cost-free or any other cash in-flow to Westar. They resulted from a mere bookkeeping entry required by Westar's accountants. Here is what happened. KPL paid a premium for KG&E. Without going into the details (which Mr. Stadler provides in his testimony), it is enough to say that once sufficient merger savings were demonstrated the Commission permitted Westar to recover the premium amortization in rates.

The accountants looked at that and said, "Wait a minute, if the premium is, say, $100, then you will have to recover something greater than $100 in order to end up with $100, because whatever you recover will be subject to **current** income taxes." So the accountants required Westar to "gross-up" the premium: so much to account for the actual premium – which represents cash paid out – plus so much to represent the gross-up for taxes – a bookkeeping entry. The "gross-up" is accounted for as deferred taxes. As Westar recovers the premium, part of the recovery is accounted for by amortizing the premium itself and the remaining part is accounted for by amortizing the accumulated deferred taxes related to the "gross-up" of the premium. Importantly, the portion of the recovery related to the "gross-up" is immediately paid out in current taxes due. Therefore, it is not available as cost-free capital.

Unlike with plant-related deferred income taxes, this transaction and the associated accounting for it did not result in a cash in-flow to Westar, cost-free or otherwise. There was no "loan" from customers or taxing authorities or any other persons or entities. There was simply an accounting entry to reflect the "gross-up." Therefore, it was a mistake for the Commission to adopt an adjustment that treated a portion of the unamortized taxes related to the merger premium as cost-free capital and thereby reduced Westar's cost of service.

Q. IS WHAT THE COMMISSION DID THAT EASY TO UNDERSTAND?

A. No, in this case the adage is true – "nothing is ever easy." To attempt to bring some clarity to this complicated issue I have simplified the matter. As I understand the adjustment, here is in fact what the sponsoring witness did:

1) Treated the $26.5 million annual recovery of the merger premium as an annuity;
2) Calculated a net present value of that annuity;
3) Assumed the net present value was in rate base;
4) Assumed a level of deferred taxes attributable to this assumed rate base item;
5) Reduced Westar's rate base by this assumed level.

The result in this more complicated form, however, is no different than the result in my simplified example: deferred taxes related to the merger premium are mistakenly used as cost-free capital or an offset to rate base. I respectfully urge the Commission to correct this mistake as well.

Q. WHAT SIGNALS WOULD FIXING THIS MISTAKE SEND?

A. At least one signal would be encouragement for Kansas utilities to continue to look for efficient mergers/acquisitions that can benefit customers, as well as investors, and be "paid for" out of merger savings. The converse is also true.

Q. PLEASE CONCLUDE YOUR TESTIMONY.

A. To the benefit of all constituents, Westar has made considerable progress in the past two years – perhaps more than reasonably could have been expected. Maintaining that momentum is essential. Westar is entering a period in which it will be required to raise hundreds of millions of dollars to upgrade existing facilities and construct new ones. If the long-term interests of Westar's investors are adequately served, Westar will be able to serve the long-term interests of customers by continuing to provide an assured supply of adequate and reasonably priced power. Keeping that "compact" will contribute mightily to making Kansas a better place in which to live and work.

Q. THANK YOU.