160706

BEFORE THE STATE CORPORATION COMMISSION

OF THE STATE OF KANSAS

DIRECT TESTIMONY

OF

MARK A. RUELLE

WESTAR ENERGY

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Mark A. Ruelle, 818 South Kansas Avenue, Topeka, Kansas 66612.

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

A. Westar Energy, Inc. (Westar), as President and Chief Executive Officer.

Q. PLEASE DESCRIBE YOUR EDUCATION AND BUSINESS EXPERIENCE.

A. I hold bachelors and masters degrees in economics. I have worked in the utility industry for 25 years. I began my first tour with Westar (or its predecessor companies) in 1986. I worked as a Rate Economist, Manager of Financial Analysis, Director of Corporate Development, Executive Director of Corporate Finance, Vice

President of Corporate Development and Strategic Planning, and as president of an unregulated subsidiary. I resigned from Westar in early 1997.

Prior to rejoining Westar, I worked at Sierra Pacific Resources (now "NVEnergy"), a Nevada-based integrated electric utility (that also had natural gas pipeline and distribution and water treatment and distribution operations), from 1997 to 2002, first as Senior Vice President, Chief Financial Officer for the holding company and its utility operating units, and then as President of Nevada Power Company, the larger of the two operating utilities.

In January 2003, I returned to Westar as Executive Vice President and Chief Financial Officer and held that position until this past May when I became President and Chief Financial Officer. On August 1, 2011, I became Chief Executive Officer.

Q. HAVE YOU TESTIFIED BEFORE THIS OR OTHER REGULATORY BODIES IN THE PAST?

A. Yes. A few times.

II. PURPOSE AND OUTLINE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony covers two broad areas. The first is the set of policy considerations relevant to our application. The second is the cost of equity capital. With regard to the policy considerations, my testimony will:

1. Identify and discuss conditions that serve as important context for the Commission's consideration of this request, as well as our philosophy toward the issues and influences that bear on our mission to serve the interests of Kansas, our customers and our other stakeholders;

2. Discuss the merits of the various ratemaking methods the Commission uses to regulate Westar and set its prices;

3. Outline the principal reasons a rate adjustment is required;

4. Describe the effect a rate adjustment will have on our customers, including how such rates compare to other jurisdictional utilities and to other basic necessities our customers purchase; and,

5. I provide a summary of our corporate governance and also testify that there are no costs in this case related to the recently settled dispute regarding Westar's association with two former executives almost a decade ago.

With regard to the cost of equity, I provide an estimate of the cost of equity capital and a recommendation of a fair return on equity (ROE). This includes a discussion of the appropriate criteria and legal basis for establishing a fair rate of return and an assessment of how investors perceive the risks of investing in the utility industry and how our investors and future investors perceive

the risk of their investment in Westar relative to the competing options in which they can invest.

Q. ARE YOU SPONSORING ANY SCHEDULES OR EXHIBITS?

A. I am sponsoring the cost of equity capital figure that appears in Section 7 of the Minimum Filing Requirements (MFRs). Mr. Somma, Westar's CFO, will address the cost components other than the cost of equity capital and sponsor the overall cost of capital or rate of return in Section 7 of the MFRs.

III. POLICY TESTIMONY

A. *Matters for Consideration in Deciding the Appropriate Rate Adjustment.*

Q. AS THE NEW CEO OF WESTAR, CAN YOU SHARE WITH THE COMMISSION SOME INSIGHT INTO YOUR PHILOSOPHY TOWARD UTILITY REGULATION AND WESTAR'S ROLE IN SUPPORTING KANSAS?

A. Westar made the commitment nearly a decade ago to focus exclusively on being a great electric utility for the state of Kansas. I was part of the leadership team that made that commitment, and I embrace it just as strongly today. It is all we do; it is what we care about. As such, we care deeply about the interests of our state and making decisions and discussing issues openly and constructively, knowing how much is at stake.

As simple and straight-forward as our commitment is, our business is not that simple nor are the paths always well-defined.

More than ever, our industry is influenced and pressed from all sides to address critical and often conflicting expectations and priorities. Few decisions or solutions are simple, and most come with consequences, some obvious, some subtle. So, my share of that continued commitment to being an independent utility focused exclusively on the electric needs of Kansas is to raise concerns and issues – even when inconvenient and difficult – to ensure we work together in making decisions that best serve the interests of our state now and in the future.

Q. PLEASE DESCRIBE THE ENVIRONMENT IN WHICH WESTAR OPERATES AND WHY WESTAR IS REQUESTING A RATE INCREASE AT THIS TIME.

A. The last few years have been challenging economically to our nation and the people of Kansas. Uncertainty and instability have, sadly, become the norm in far too many areas of our social, economic and even political structures. As we recover from the recession, the importance of reliable infrastructure is magnified; it gives all segments of our population confidence that foundations are there and allows all of us to focus our efforts on (or limit our anxieties to) those elements of our economy that are at risk. Reliable electric power is an essential element in that broader definition of infrastructure; it is, simply, one of those things in daily life that people ought to feel they can take for granted. That is

especially true now when their confidence in so many other areas has been shaken. Protecting the reliability and affordability of our electric power "infrastructure" on behalf of our state requires an honest view of the changing nature of the industry and the costs – both the obvious and the subtle – that come with that mission. This case is centered on factors affecting reliability and long-term affordability – some obvious, some less so, but all directly relevant to a mission that is more important than ever in the current economic era.

Q. SOME ELEMENTS IN THIS CASE SEEMINGLY HAVE LITTLE TO DO WITH INVESTMENT IN PLANT AND EQUIPMENT. HOW DO THEY FACTOR INTO RELIABILITY?

A. When most people think of reliability, they think of physical equipment and engineering, but it would be a mistake to stop at the surface of that view and fail to recognize other factors. We take a broader view and approach in fulfilling our obligation to serve Kansans. First, reliability is not just about having power available. In our case, it is about having employees motivated, trained and supported in delivering that power, especially when it is needed most; it is about looking at secondary factors (like tree trimming) that have a huge impact on our ability to endure or recover from weather damage; it is about having an honest view of the life expectancy of our generating plants and equipment so we have the

flexibility to invest at the right time and in the right way for the future; and it is about making sure we are unwavering in sending the right message to our employees about our priority on safety and service. As you will see in our testimony, most of the elements of this case are required by law or guided by sound, long-established engineering or accounting practice. Honoring these dictates is part of being reliable. We would be mortgaging the future and ignoring reality if we swept these under the rug or failed to recognize their role in our mission.

Q. WHY SHOULD THE COMMISSION NOT EXPECT WESTAR SIMPLY TO FIND WAYS TO CUT CORNERS OR PRODUCE WEAKER RETURNS FOR INVESTORS, AS MANY OTHER BUSINESSES MAY HAVE TO DO?

A. Central to this entire discussion is the reality that we are simply not like other businesses. Regulated electric utilities are a unique institution, a hybrid enterprise with a mission quite unlike any other. Unlike most businesses, we do not have the flexibility of closing an operation, cherry-picking the most profitable customers, laying off employees, curtailing services, shutting down a production shift, or deferring maintenance and investment without raising risks for customers and Kansas. By design, the regulatory framework in which we operate is intended to recognize and respect that electric utilities are essential to our way of life, that our services ought to be

continually accessible to all customers willing and able to pay (a "just and reasonable, regulated price"), and that our investments must be with an eye toward the long-term public good, even as we experience short-term pressures.

In a business that must attract large amounts of capital to fulfill its basic mission, no investor would place a bet on such a peculiar set of business conditions and constraints without assurance that there was a reliable, constructive, regulatory framework that appreciates this unique arrangement for what it is. In that sense, good regulation is intended to keep electric utilities moderated from some of the volatility and violence of the market, so they are never tempted nor compelled to make expedient, compromising decisions that impair their ability to serve the public interest now or in the future.

It may be appealing to argue on the surface that any price increase by a utility is a risk to our recovering economy; in fact, the far greater risk is to yield to temptation and push these costs off to another day when seemingly it is less awkward to deal with them, only to find that the costs have now magnified and morphed into a much greater risk for our state and customers. Kansas enjoys relatively low rates compared to many places, but that does not mean that Kansans are served by keeping them artificially low, only to experience unavoidable price or reliability shocks later.

Q. IN WHAT WAYS HAS THIS COMMISSION DEMONSTRATED ITS APPRECIATION FOR THIS UNIQUE ROLE FOR WESTAR AS AN ELECTRIC UTILITY, AND HOW HAVE CUSTOMERS BENEFITTED FROM THIS?

A. One way is by predetermining the ratemaking principles to be applied to large investments thereby facilitating the financing of large projects. Another way is by allowing Westar to use interim adjustment tools, such as the Environmental Cost Recovery Rider (ECRR), the Retail Energy Cost Adjustment (RECA) and the Transmission Delivery Charge (TDC) which keep rates less volatile and ultimately lower. (I discuss some of these further starting on page 18). Other examples are by consistently applying regulatory and statutory principles, and always searching for constructive balance. They benefit customers by providing predictability in rates and avoiding volatility that makes it hard for customers to manage their energy costs.

Use of a balanced approach also influences our ability to access capital markets on reasonable terms and to make effective investment decisions.[1]

Westar customers, over the years, have benefitted from reliable electricity service at relatively low rates. We strive to

[1] *See* Docket No. 11-GIME-492-GIE, *Initial Comments and Answers of Westar Energy, Inc.*, at 93 (February 25, 2011).

preserve a relative price advantage for our customers. As reflected later in this testimony, even with the full effect of the price adjustment we have requested, our customers will continue to benefit from relatively low electricity prices. However, we have also been consistent and clear in our communications to our regulators, policy makers, and our customers that we will continue to face cost pressures that will adversely affect utility prices over the foreseeable future, and that it is best to address those pressures responsibly and in the natural course, as opposed to deferring them until they represent unnecessarily large increases later.

B. *The Foundation for Protecting the Public Interest.*

Q. WHAT IS WESTAR'S STATED MISSION?

A. As published on our website,

> Westar Energy provides safe, reliable, high quality electric energy service at a reasonable cost to all customers.

We formulated this mission in 2003 and continue to be guided by it today.

Q. HOW DO YOU BALANCE THE PROTECTIONS CUSTOMERS RECEIVE FROM REGULATION WITH THE MARKET OPPORTUNITIES THEY CAN OBTAIN FROM COMPETITIVE INFLUENCES?

A. The model under which we operate has two dimensions. The first is to garner the efficiencies of having one, closely regulated, company providing service, while shielding customers from rate

volatility and the higher costs that typically prevail in unregulated retail electricity markets. The second is selectively to use competition to bring further advantage to that traditional model. Thus, while our retail prices remain regulated by the Commission, our wholesale costs are very much a function of rigorous competition. Daily we buy and sell power in intensely competitive and volatile *wholesale* markets, then smooth and optimize that volatility to moderate the regulated price of power for our *retail* customers, and credit their rates with gains we make in the wholesale markets. Another example is how we use competitive bidding to obtain large additional increments of electricity from renewable (wind) generation. A third is where we compete multiple vendors against one another for materials and supplies.

The objective of this hybrid model is to bring the advantages of both regulation and competition to bear for customers, while shielding them from the inherent disadvantages of each approach. And Kansas has shown that this model works. Through Westar's and the KCC's efforts, our utility rates are both lower and less volatile than the national average.

This approach relates back to our basic philosophy of the electric utility as a unique institution. The benefits of more widespread competition are evident where a company has freedom to deploy or dispose of products and services based upon broad

market acceptance and is free to make capital investments that are centered purely on internal business strategies rather than the public good. Neither is the case with electric utilities.

Q. HASN'T COMPETITION AT THE ELECTRIC SERVICE RETAIL LEVEL WORKED IN OTHER STATES WHERE IT HAS BEEN INTRODUCED?

A: No, at least not if you measure success by price and reliability. Attempts at *retail electricity deregulation* in the U.S. have not yielded the hoped for advantages for customers that deregulation has had in other U.S. markets, such as telecommunications and trucking. Instead, in states having attempted to implement deregulated retail electricity markets, utility rates have increased more and become more volatile than in states having maintained more traditional rate regulation. For instance, as Figure 1 shows, rates in Texas, where retail deregulation was implemented in 2002 have increased dramatically compared to Kansas, a state that carefully considered, but subsequently rejected it.

FIGURE 1

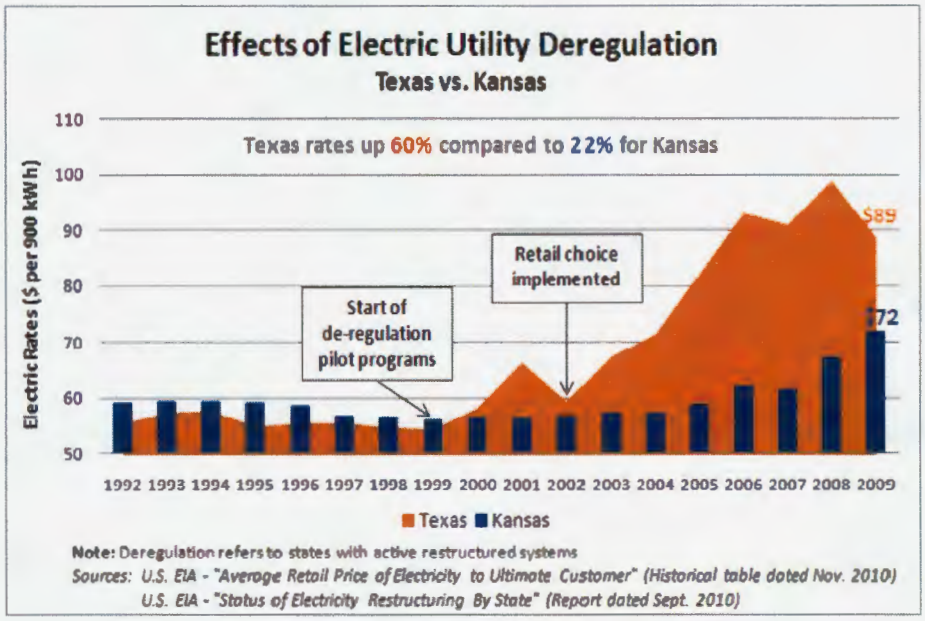
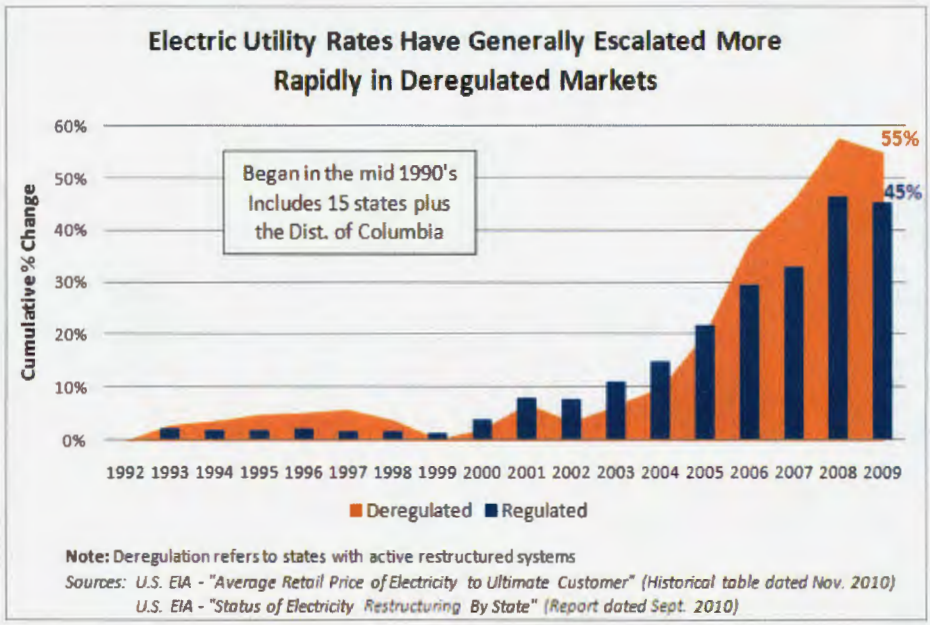


Figure 2 shows a similar story for the country as a whole.

FIGURE 2



Even beyond the philosophical debate, is a simple fact of competition; that is, that if applied consistently, all else constant,

competition will raise prices in low-cost markets and reduce prices in high-cost markets. Policy makers a few years ago I think understood that point and were not prepared to forfeit Kansas' low-energy-cost advantage to others.

Q. UNDERSTANDING THAT INTRODUCING RETAIL COMPETITION IS MOST DISRUPTIVE AT THE EARLY STAGES, DOESN'T IT SIMPLY TAKE TIME FOR COMPETITIVE MARKETS TO MATURE AND YIELD BENEFITS?

A. That has not been the experience in the U.S. In the case of California, for example, its experiment failed shortly after it was implemented, and dramatically so – as customers found themselves in the dark. Fortunately, it was not generally life threatening, as California's population centers enjoy a mostly mild climate. In other states that held the course – some for over a decade – the lights have stayed on – even if sometimes tenuously[2] – but rates have increased faster, and with more volatility, than in states that remained regulated. I believe the reason for this is that policy makers ran into some of the very aspects of our business that I have earlier mentioned. That is, the nature of the business is such that potential market failure is so consequential to the public

[2] As recently as this month Texas is again facing shortages and regional price spikes as much as 60 times normal summer prices, with a recent article noting, ". . . state officials have few tools to stimulate construction of new power plants. In ERCOT's deregulated market, regulators can't order utilities to build more power plants . . . ." *Wall Street Journal,* page A-3 (Aug 12, 2011).

interest, that in every one of these markets, some degree of continued regulation has been necessary. Unfortunately, rather than gaining the advantages of both regulated and competitive models (and avoiding the disadvantages of each), as we have in Kansas, some of these states have produced the exact opposite result; getting the disadvantages of each and the advantages of neither.

It is also important to note that the costs are rising in Kansas (and elsewhere) not because of any shortcomings in Kansas rate regulation, but principally due to federal mandates. In fact, as noted earlier, Kansas regulatory policies have actually helped control costs by allowing timely rate recovery and sending the right signals to capital markets. The greater risk for Kansas in changing its model, aside from the obvious one of potentially forfeiting its low-cost advantage, is the potential instability, disruptions, volatility and uncertainty inherent in changing a working model with one that has been shown, at best, to produce much less-desirable results; and this particularly at a time when the public is desperate for stability, certainty and reliability – especially from the "infrastructure" institutions that provide a foundation for economic recovery.

Q. YOU TESTIFY THAT RELIABLE ELECTRIC INFRASTRUCTURE IS A FOUNDATION FOR OUR STATE'S ECONOMY. CAN YOU ILLUSTRATE MORE SPECIFICALLY HOW RELIABLE

ELECTRICAL INFRASTRUCTURE ENTERS INTO THE REALM OF ECONOMIC DEVELOPMENT AND JOBS CREATION IN KANSAS?

A. Any business looking to expand or relocate to Kansas needs reliable electricity. Accordingly, we frequently work at the earliest stages with these candidate business customers, along with the Kansas Department of Commerce and local economic development authorities to respond to these inquiries. It is not overstating the case to say that virtually all of them place reliability of electric service very high on their list of considerations. Many consider it an even higher priority than price. Frequently, they go so far as to demand outage histories and to review the engineering of our electrical system for their preferred locations.

Q. HYPOTHETICALLY, CAN YOU ILLUSTRATE SOME OF THE ACTIONS THAT A FULLY COMPETITIVE RETAIL ENERGY SUPPLIER MIGHT NOT DO THAT WESTAR DOES TODAY UNDER THE COMMISSION'S FULL JURISDICTION?

A. Examples might include not acquiring renewable resources, eliminating shut-off protections for non-payment during cold weather, and promoting energy efficiency. That we undertake these activities to advance public policy and societal goals illustrates how our business differs from others in our economy.

Q. HOW WOULD YOU SUMMARIZE THIS APPLICATION?

A. Westar is a critical infrastructure provider in our state, serving the electric energy needs of most Kansans. This is our entire business. This is the only place we conduct that business. We believe this approach offers certain benefits that larger, more geographically dispersed or more diverse businesses cannot offer. Our exclusive focus is the safe, reliable, efficient delivery of utility service.

The way we go about our business is intentional and straight-forward. We operate with transparency, particularly as we comply with the many regulations – of this and other regulatory bodies. Westar and its people strive to be a positive contributor to our economy and our communities.

If the Commission finds that Westar's approach to serving Kansas remains in the public interest, it must also recognize that the cost of doing business has gone up. We can no longer meet our customers' and our state's needs when the cost of doing so is now greater than the revenues we are permitted to earn. The Commission will find as it studies this application that it has been carefully prepared and rests on a firm foundation.

It is my belief that there is more than ample evidence that stable companies with solid financial well-being serve their utility customers best. Our decision to initiate and present this case is consistent with that reality.

Q. WHAT ARE SOME OF THE PRACTICES OF KANSAS REGULATION THAT YOU BELIEVE ARE MOST IMPORTANT TO CONTINUE IN ORDER FOR INVESTORS TO CONTINUE TO VIEW WESTAR'S REGULATION AS REASONABLE, CONSTRUCTIVE, FAIR AND PREDICTABLE?

A. As a result of its 2005 rate filing (Docket No. 05-WSEE-981-RTS), Westar was allowed to implement the RECA, a TDC[3] and an ECRR. The Commission's order in that case set the groundwork that allows Westar to raise the large amounts of capital necessary to fund mandated environmental projects such as the scrubbers at Jeffrey Energy Center (JEC), and transmission line improvements that have helped accommodate renewable energy development, facilitate the economic exchange of power over long distances, and address reliability-based infrastructure requirements of the Southwest Power Pool. Westar and the Commission have also successfully completed predetermination hearings which allowed for the construction of Emporia Energy Center and our first major commitments to renewable energy.[4]

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[3] The TDC was authorized by the Kansas legislature in K.S.A. 66-1237, approved in 2003 and amended in 2005.

[4] Emporia Energy Center (EEC) and Westar's investment in its wind farms both came in under budget, saving our customers money and providing over 950 MW of nameplate generation capacity. EEC also resulted in more productive capability than anticipated, resulting in a cost per MW capability 12% lower than our original estimate.

Furthermore, that same regulatory construct of predetermination allowed us more recently to take advantage of favorable market conditions for more renewable power to meet Kansas' policy mandate.[5]

Q. HAVE THE INTERIM COST RECOVERY MECHANISMS APPROVED BY THE COMMISSION REDUCED THE NEED FOR MORE FREQUENT GENERAL RATE CASES?

A. Yes. And for that reason we were disappointed by the Commission's recent order prohibiting us from using the ECRR for the investments necessary to retrofit La Cygne. Notwithstanding our very substantial recent investments, it has been over three years since our last general rate case. That length of time between cases could not have occurred without our ability to make interim adjustments. The interim adjustment features provided by Kansas law and permitted by the Commission are constructive rate-making tools that reduce – but do not eliminate – the need for periodic general rate cases. Moreover, as the Commission is aware, general rate cases can be expensive, so decreasing their necessity saves customers money. Unfortunately, all else being constant, it

[5] In the realm of renewables, Kansas is fortunate. While adding wind energy still increases the overall cost of service, it is far less expensive than wind energy in many other states and solar energy. By way of example, NV Energy in Nevada just committed to 30 MW of solar energy at a levelized cost of $132.11 per MWh, Nevada Power Company d/b/a NV Energy, *First Amendment to the 2010-2029 Integrated Resource Plan, at* 29, Nevada Public Utilities Commission, Docket No 11-03 (March 11, 2011), compared Westar's most recent wind commitment at a cost of less than $35 per MWh.

is inevitable that general rate cases will now likely be more frequent, at least until La Cygne is completed. To reduce the costs associated with recovering its investment in the La Cygne retrofit, Westar has included in this rate application a request for authority to use the Commission's expedited ratemaking process – a less expensive process than a full-scale rate case – to update its investment in La Cygne as the retrofit progresses.

Q. WHAT PORTION OF WESTAR'S COST OF SERVICE IS COLLECTED THROUGH INTERIM ADJUSTMENT MECHANISMS?

A. In the test year, excluding the RECA, it was a little above 10%. Including fuel costs recovered through the RECA, it was about a third.

Q. WHAT CONSUMER PROTECTIONS ARE CONSIDERED IN THE COMMISSION'S USE OF INTERIM ADJUSTMENTS?

A. The Commission has established transparent, auditable annual procedures with good oversight and customer safeguards. The Commission has also been judicious in permitting such adjustments. For example, the ECRR does not include recovery of environmental operating expenses, only capital costs. Docket No. 05-WSEE-981-RTS, Order on Rate Applications, pp. 27, 29. And, although Westar is permitted to defer a portion of its higher pension expense as a regulatory asset, the deferral does not permit Westar

to record a return on that unrecovered deferral. Order Approving Application for Accounting Authority Order, Docket No. 10-WSEE-135-ACT, at 5 (September 11, 2009).

Q. DOES THE USE OF INTERIM ADJUSTMENTS ELIMINATE REGULATORY LAG, I.E., THE TIME BETWEEN WHEN WESTAR MAKES AN INVESTMENT AND WHEN IT STARTS TO REALIZE A RETURN ON THAT INVESTED CAPITAL?

A. No, and evidence of that is readily apparent in that notwithstanding our use of the ECRR, the return on those investments is just a fraction of what the Commission has authorized. Although use of interim adjustments reduces the magnitude of regulatory lag, regulatory lag for Westar continues to be a significant issue. These regulatory practices are still based on adjusting *future* rates for *costs already incurred*. Westar still has to fund the investment well in advance of adjusting prices to reflect the higher cost. As a result, even with the interim adjustments there exists significant delay between the time capital outlays are made and when investors can start realizing a return on their investment. In the intervening period shareholders suffer dilution and higher actual interest expense related to funding the capital outlays well in advance of price changes to reflect those higher costs.

Because of the design of Westar's ECRR, for example, the lag between the initial notice of an environmental project to the

Commission and the beginning of recovery in rates of even one month's worth of investment in the project is at least twelve months.

The very significant investments required to meet regulatory environmental mandates, coupled with the explicit lag until the ECRR recognizes those investments, mean that such investments have been earning returns that are a fraction of what has nominally been authorized by the Commission. For our other investments, the same general phenomena exist, but they are not as magnified due to the smaller levels of investment.

Q. DOES ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC) MITIGATE THE LAG?

A. Only to a small extent, and even then it offsets only a portion of the *accounting* cost for capital charges during construction; it provides no cash benefit to reduce lag. Moreover, AFUDC stops when the plant goes into service even if the plant is not yet in rates.

Q. CAN YOU ILLUSTRATE THE IMPACT OF REGULATORY LAG USING A SPECIFIC EXAMPLE?

A. Yes. Much of the outside capital used to fund the scrubbers at JEC had to be raised in 2007. The positions of shareholders who owned stock when we sold additional shares to raise those funds were immediately diluted because there was no accompanying increase in earnings aside from the slight accounting relief AFUDC provided. In fact, shareholders saw no return on their investment in

the JEC scrubbers until June 2008, when they started seeing a *partial* return. From an annual earnings per share perspective, investors had to wait until 2009, well after the project was complete, before we could even attempt to earn our authorized return.

In the meantime, additional capital had to be raised in 2008 and 2009 to continue funding environmental projects. This started the cycle of regulatory lag all over again. With the large number of future environmental projects on the horizon, Westar cannot reasonably earn anywhere close to the level authorized by the Commission until the cost of such projects falls to a level closer to an amount supported by Westar's cash flow from its operations; i.e., when we no longer have to raise new equity to fund construction.

Q. CAN YOU DEMONSTRATE THE MAGNITUDE OF REGULATORY LAG, WHICH YOU SAID EARLIER RESULTS IN EARNED RETURN BEING JUST A FRACTION OF AUTHORIZED RETURN?

A. Table 1 below is an estimate of earned ROE compared with the ROE authorized by the Commission for our investments required to address air quality regulations and investments covered in the ECRR. Line 4, column A shows Westar's investment of $235.4 million in environmental equipment during 2008. Keeping with the same column, line 9 shows that no revenue was received in 2008

to cover the capital charges or depreciation expense associated with the investment. Based on Westar's authorized pre-tax overall rate of return in 2008 of 10.93%, Westar would have had to collect $26.7 million in revenue to cover the capital charges and depreciation expense and provide shareholders the authorized 10.0% ROE approved by the Commission at the time. The only offset to the capital charges was in the form of AFUDC (lines 11 and 17). Line 28 indicates that AFUDC provided very modest accounting relief, but the resulting ROE of 2.47% is less than one-quarter of the 10.0% authorized by the Commission.

Similarly, even though the ECRR produced revenue in 2009 and 2010, with our obligation to invest in additional environmental controls, our experienced ROE on that investment continued to be just a fraction of our authorized ROE.

TABLE 1

Line #		A	B	C
1	*dollars in thousands*			
2		2008	2009	2010
3				
4	Rate base per ECRR filing	$ 235,400	$ 292,407	$ 396,383
5				
6				
7			Actual	
8		2008	2009	2010
9	ECRR retail revenue	$ -	$ 20,684	$ 40,785
10				
11	Equity AFUDC	4,857	700	691
12	Earnings before interest, tax, and depreciation	4,857	21,384	41,476
13	Depreciation	1,012	11,040	10,695
14	Earnings before interest and taxes	3,844	10,344	30,780
15	Interest expense			
16	Cash interest	7,789	10,200	13,440
17	Debt AFUDC	(5,539)	(660)	(954)
18	Total interest expense	2,250	9,540	12,486
19	Income before income taxes	1,595	805	18,294
20	Income tax expense	(1,292)	41	6,968
21				
22	Net income	$ 2,887	$ 763	$ 11,326
23				
24	Average common shares outstanding (000's)	103,958	109,648	111,629
25				
26	**EPS**	**$ 0.03**	**$ 0.01**	**$ 0.10**
27				
28	**Earned ROE**	**2.47%**	**0.55%**	**5.87%**
29				
30	**Authorized ROE**	10.00%	10.40%	10.40%
31				
32	**EPS Dilution**	**$ (0.08)**	**$ (0.12)**	**$ (0.08)**

As illustrated above, even with regulatory mechanisms such as the ECRR, regulatory lag remains a significant issue for investors. Even with its use, there is no financial incentive for Westar to invest in environmental controls other than, of course, the legal imperative of complying with the rule of law.

Q. IT IS CLEAR THAT INTERIM ADJUSTMENTS BENEFIT INVESTORS, BUT HOW DO THEY BENEFIT CUSTOMERS AS WELL?

A. Customers benefit from this approach because the resulting rates are lower than they would otherwise be. As the Commission has previously determined, "prompt recovery of ECRR costs, like AFUDC costs, results in lower retail costs of service for ratepayers." Docket No. 05-WSEE-981-RTS, Order on Rate Applications, at pages 29-30, ¶ 65 (December 28, 2005). The ECRR is an effective tool to avoid pushing problems off into the future and needlessly magnifying them.

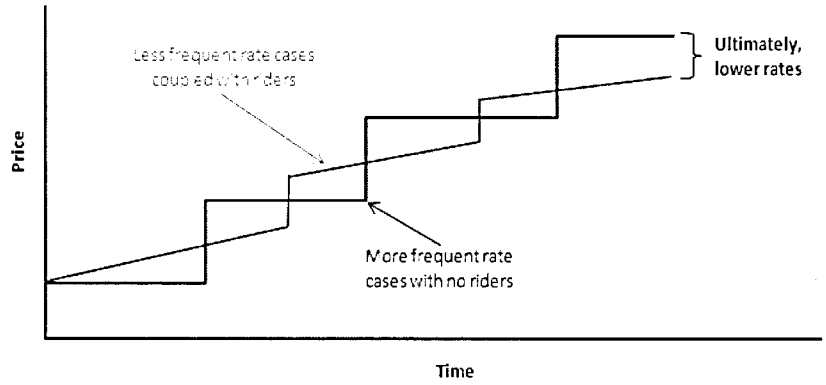
Additionally, interim adjustment tools serve to *reduce the size and frequency* of general rate cases as well as attendant rate volatility.[6] However, they do not *eliminate* the need for periodic general rate cases, nor do they eliminate regulatory lag that investors must withstand.

Figure 3 below is a diagram which we have used for some time to help investors understand the nexus of interim adjustments and general rate cases as complementary rate setting tools. It

[6] Rate cases can, of course, be very expensive. Not only are the utility's costs of pursuing a rate increase included in rates, so are the costs of the Commission and its Staff and of CURB which are assessed to the rate case docket and borne by the utility's customers.

shows how interim adjustments serve to reduce rate shock and ultimately yield lower rates.

FIGURE 3



It should go without saying that it is also in the public interest for a utility to be able to attract capital on reasonable terms. The absence of that condition would impair safe, efficient, and reliable utility service – our fundamental mission.

Q. SOME HAVE SUGGESTED THAT INTERIM COST RECOVERY MECHANISMS REDUCE A UTILITY'S NEED TO EXERCISE STRINGENT COST CONTROLS. HOW WOULD YOU RESPOND TO SUCH AN ASSERTION?

A. If they are applying that notion to Westar, then they do not know Westar. As noted earlier, because of regulatory lag, even with the use of interim adjustments under the ECRR, there is no incentive for Westar to make capital expenditures where they are not needed to comply with the law. Such investments serve to increase our costs, cannibalize output from our plants, complicate our operation and maintenance of the plants and ultimately increase prices. They

are not productive investments for us, which is obvious when one compares the huge difference between the nominal ROE we are authorized to earn and the actual ROE we are able to earn on these investments. This combination of factors also causes customers to use less energy and, as a result, we do not receive the revenues implied in the rate design approved in any particular rate review. It is in our best interests – as well as of our customers – for our installation of required environmental equipment to be performed at the lowest cost practicable, when needed, and to avoid or delay making these investments whenever possible.

Jim Haines referred to this fact when he testified in Docket No. 11-KCPE-581-PRE. Mr. Haines, testifying concerning the impacts of significant environmental investment on total earnings and earnings per share noted:

> . . . as you said, the JP Morgan person was describing it as a growth strategy, I think is a very shallow analysis and it is the worst kind of growth because this is a non-producing asset. The kind of growth that you want is growth that results from the increased productivity of your customers. You know, they are using more electricity because they are making more product, not growth that comes from an asset like this that actually probably reduces the output of the LaCygne facility because there's bound to be additional station use associated with these upgrades.

Tr. at 1064.

Q. CAN YOU PROVIDE TANGIBLE ILLUSTRATIONS OF WHERE WESTAR HAS AVOIDED OR DEFERRED MAKING THESE

KINDS OF CAPITAL INVESTMENT FOR THE REASONS YOU NOTED?

A. Yes. Mr. Sterbenz, in his testimony, shares an example of a tricky environmental problem that could be solved in a few different ways, each one with different costs and risks. If we had a perverse incentive to make capital investments to comply, we would have simply defaulted to the easiest solution; that is, we would have built a very expensive water treatment plant. Instead, our folks put on their thinking caps and developed and we are pursuing an innovative approach that has very little capital expenditures associated with it.

Another example is our ongoing challenge of Environmental Protection Agency's (EPA's) "New Source Review" allegations. If we had a perverse incentive to invest in air quality investments, we certainly would not have fought them for over six years, incurred millions in legal expenses (that were not fully built into our cost of service for rate recovery) and ultimately forced a settlement that resulted in less investment being required than EPA had sought and required much later. Instead we would have simply rolled over and done what EPA was demanding.

Q. WHAT IS WESTAR'S OVERALL PHILOSOPHICAL APPROACH TOWARD MANAGING ITS COSTS, WHETHER RELATED TO COMPLIANCE OR OTHER REASONS?

A. More philosophically, Westar has had the privilege of serving Kansans' electricity needs for almost 102 years. It is unlikely that a company inattentive to its costs and the impact that would have on its customers could have survived. The very real and appropriate concerns of our customers and our regulators about the price of electricity, means that we need to manage costs closely to the extent that doing so is consistent with maintaining safe, efficient and reliable service – and meeting state and federal policy mandates. It also means we must manage our time and our resources with the same degree of care we use to manage our checkbooks at home, a principle our executives strive to reinforce in our interactions with employees. A number of our witnesses, including Mr. Sterbenz, Westar's COO, provide illustrations of our focus on cost management.

Additionally, I remind our employees that while it is good to have engaged, energetic employees looking for ways to do more for our customers, it is also true that many of our customers simply cannot afford to pay the price it takes for all that we can envision doing to enhance their service. That means that we need to continue making improvements, not always funded with new resources, but by creatively reallocating resources to the places and things most valued by our customers, within the confines of

maintaining safe, reliable and efficient service. And while we do that, this application is evidence that that alone is insufficient.

Q. WHAT EVIDENCE DO YOU HAVE THAT ELECTRIC POWER IS SUPPORTING ECONOMIC RECOVERY IN KANSAS?

A. Generally, our retail power sales show that we are on the mend as a state. In 2010, adjusted to normal weather, energy sales were up from 2009. Industrial kilowatt-hour (kWh) sales have experienced the biggest resurgence, even if they are still slightly below pre-recession levels. Virtually all sectors of our industrial customers are showing improvement. Additionally, some of our staff have been working with state and local economic development professionals addressing numerous, significant, inquiries from companies looking to relocate or expand operations here.

Q. IS THE LEVEL OF ENERGY SALES SOLELY A FUNCTION OF ECONOMIC CONDITIONS?

A. No. In fact, the Commission and Westar have encouraged energy efficiency with appropriate cost recognition for Commission-approved efficiency initiatives. Moreover, even aside from what we have been doing, there is a general prevailing sentiment encouraging conservation. More stringent federal energy efficiency standards for heating and cooling equipment are also seemingly beginning to have an effect. Although Westar is reasonably confident in its and the Commission Staff's ability to gauge the

effect of energy efficiency initiatives, it is harder to parse the effect of general consumer trends to be more efficient and how much our customers' conservation efforts are offset by their purchases of more technology that represent new sources of electricity demand.

The trends we are seeing may in fact be far more structural than simply those associated with the business cycle. I know the Commission is aware of such trends, as they have driven patterns in natural gas utility service for the past two to three decades, and as a result, have led to rate designs and revenue models less dependent on volumetric sales.

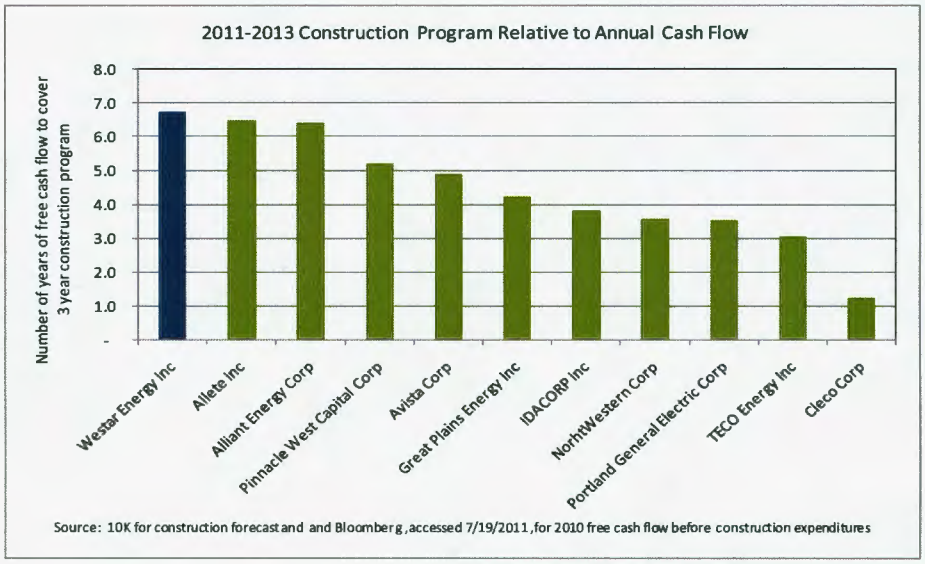
Q. GIVEN COST PRESSURES ON YOUR BUSINESS AND YOUR CUSTOMERS, WHY IS IT NOT REASONABLE SIMPLY TO HAVE SHAREHOLDERS DO WITH LESS?

A. That is a question I often get from our employees, most of whom have little opportunity for interaction with shareholders but who are passionate about taking good care of our customers. The fact is, shareholders have thousands of choices where they can invest their savings. If we are to continue to attract new capital to assure the reliability that customers demand, we must continue meeting investors' reasonable expectations for a competitive return on investment.

For a utility our size, our capital requirements are among the most demanding in our industry. Our capital investment

requirements for 2011 through 2013 are projected to be approximately $2.4 billion – about 6.7 times the cash flow produced from our operations in 2010. As Figure 4 shows our ratio of construction expenditures to cash flow is higher than that of our peers.[7]

FIGURE 4



Fortunately, we have investors' confidence. Evidence of this is that our stock price is generally in line with our peers and our bonds warrant mid-investment-grade ratings.[8] Whether investors will continue to entrust us with more of their savings by buying our

[7] In fact, while our ability to raise new equity is also dependent on a competitive dividend policy, even if Westar were not to pay a dividend, its internally-generated cash flows would still fall short of capital requirements.

[8] Last year we performed better than the median of our peer group. This year we have slightly under-performed the median of our peers. Most of that under-performance is coincident with concerns that the Commission would no longer permit the use of the ECRR.

shares and lending us money (by buying bonds) depends on their confidence that the Commission will continue to balance investor interests with those of customers and the public generally. To sustain our success in the capital markets – something essential if we are to be able to finance necessary capital projects on reasonable terms – we need to be mindful of both customer and investor interests.

Q. HOW DO YOUR PRESENT ACTUAL RETURNS COMPARE TO WHAT THE COMMISSION AUTHORIZED IN THE LAST RATE CASE?

A. Our last test year was 2007. Since then the relationship between our rates and the cost of service, even after careful cost management, has deteriorated. Our actual pro forma earned return on equity during the test year was only 7.4%. In our last rate order, the Commission cited an authorized ROE of 10.4% for AFUDC calculations and related matters, for a point of comparison.

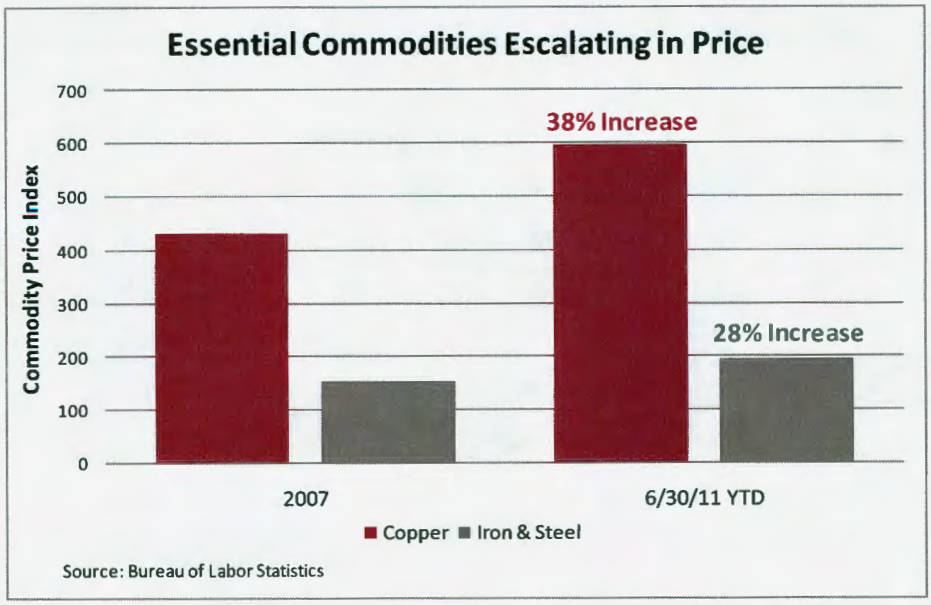
C. *Principal Reasons for the Requested Rate Adjustment.*

Q. WHAT ARE THE PRINCIPAL DRIVERS OF THE REQUIRED INCREASE IN BASE RATES?

A. Our costs today, on average, are higher than they were in 2007, which was the test year underlying our current rates. As Figure 5 shows, prices for copper and for iron and steel, for example, have increased significantly. At the same time as our costs were

increasing, we experienced a slight decrease in our normalized energy sales.

FIGURE 5



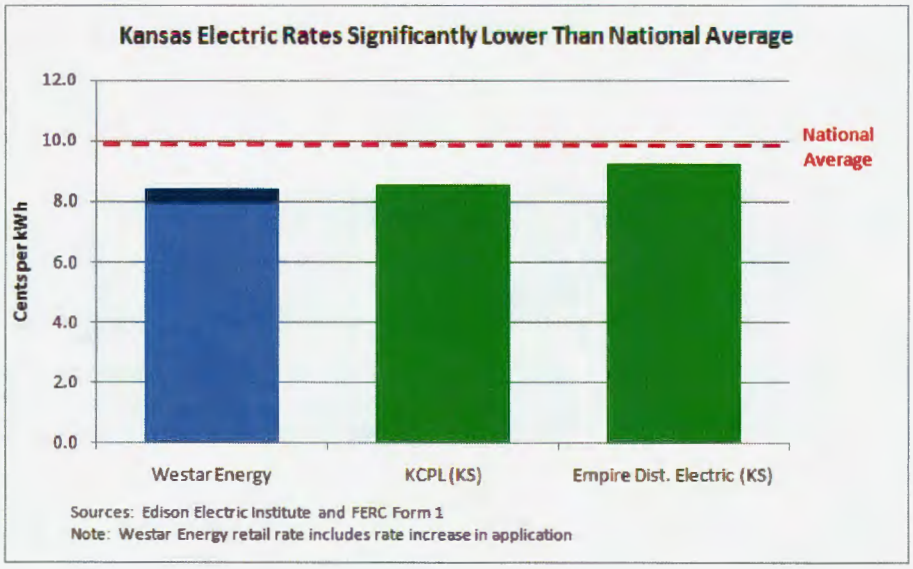
Another is that even after having reformed our pension some years ago, pension costs are still higher than they were in 2007. New capital investments, particularly for air quality controls, come with higher operating expenses, and there is no interim adjustment for those expenses permitted in the ECRR. While we negotiate our labor agreements with a firm hand, the market for skilled labor our business requires means that labor costs are higher today. Another item of note is vegetation management. Ms. Williams discusses the background, plans, costs and benefits of our proposal for an enhanced vegetation management program. There is no shirking from the fact, however, that those costs will be significant and are not now reflected in our prices.

D. *Impact of the Proposed Rate Request on Customer Rates.*

Q. WHAT WILL BE THE EFFECT ON CUSTOMER PRICES OF GRANTING YOUR RATE REQUEST?

A. On a combined basis and adjusted for inflation, Westar's average rates for electricity if our full request is granted (approximately 8.4 cents per kWh) would be approximately the same as they were almost 20 years ago, at the time of the KPL/KGE merger. As Figure 6 shows, even after considering the full effect of this proposed increase, our rates will still compare very favorably to those of other jurisdictional electric utilities. And our rates will be about 15% lower than the national average. The full effect of our request would be to increase our average retail rate by 5.85%. For the typical residential customer using 900 kWh per month, that would be an increase of $6.44 per month or about $0.21 per day.

FIGURE 6



Importantly, however, prices are just one component of a customer's electricity cost. Equally important are customers' choices about how much electricity they prefer to consume and for what purposes. Through our energy efficiency initiatives we are providing our customers the ability to use electricity more wisely and get more value from it. While we can help inform customers about their energy decisions, and provide them tools to use it efficiently, ultimately, we believe it is for them to decide how much electricity they choose to use.

Q. CAN YOU ILLUSTRATE FOR THE COMMISSION HOW WESTAR'S RATES COMPARE TO THOSE OF A FEW OTHER ESSENTIALS MANY KANSANS TYPICALLY PURCHASE?

A. We looked at prices for other items that many might consider essential to modern life. For relevant comparison, we included items that often are most economically or traditionally delivered by a single entity and, for the sake of perspective, we also included other essentials that are sold by multiple entities. Figure 7 compares cost changes in "utility essentials" including natural gas, trash collection and basic cable; cost changes in non-utility basic needs such as food and beverages, housing, transportation and medical care are displayed in Figure 8.

FIGURE 7

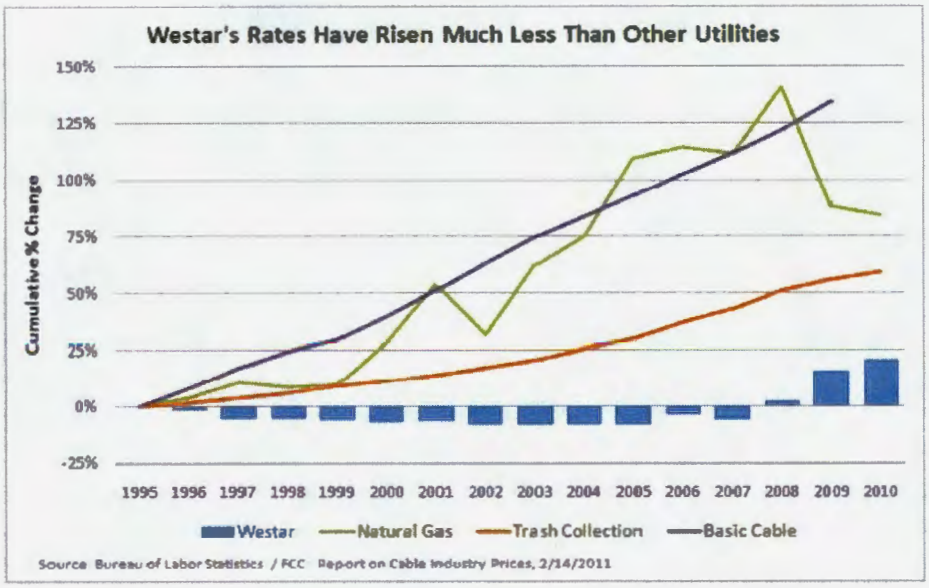
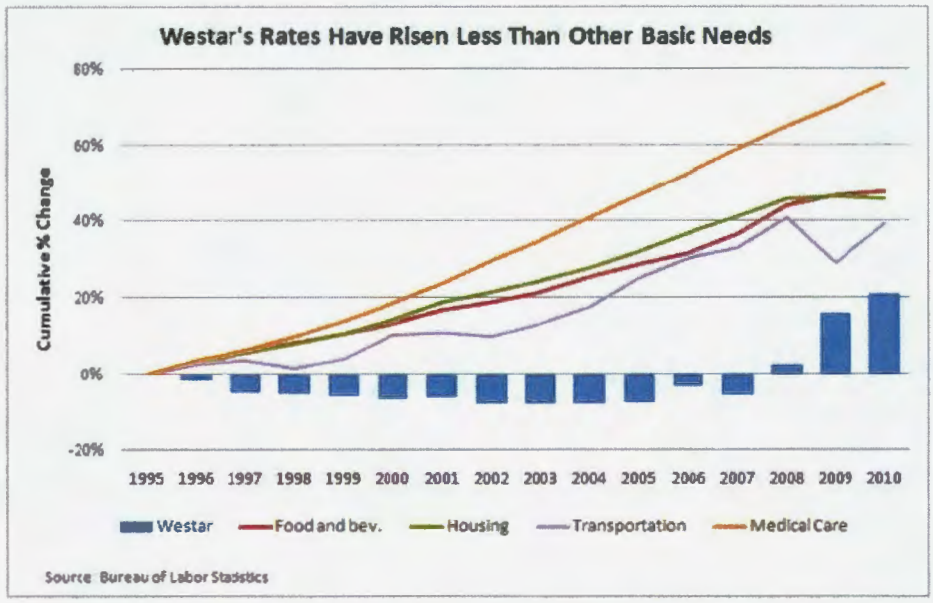


FIGURE 8



Q. IN RECENT YEARS, YOU HAVE MADE VERY LARGE INVESTMENTS IN NEW GENERATION, ENVIRONMENTAL PROJECTS, AND TRANSMISSION LINES AND HAVE ALSO IMPLEMENTED RATE INCREASES. HOW IS IT THAT WESTAR

STILL MAINTAINS A RELATIVE RATE ADVANTAGE TO MANY UTILITIES AND THE NATIONAL AVERAGE?

A. As to *relative* advantage, some of it is because, unfortunately, prices are rising elsewhere too, and for many of the same reasons. So it is, at least in part, a tide that is affecting all utilities. But giving credit where it is due, I believe the major reasons for our lower rates are commitments years ago to significant base load plant investments and, more recently, to maintain those investments with upgrades and improvements, even in the face of trends and fads that encourage otherwise. Building and maintaining a flexible and diverse energy supply portfolio, even while sometimes bucking trends to do so, continues to serve our customers well.

Another factor was cost savings from merging two of the state's major utilities in the early 1990s. That the rate advantage continues to exist today is, I believe, due in part to the general philosophy by which we manage our business for the long run. That approach includes such elements as diversity in our generation portfolio, not over-committing to a single type of investment or following fads, managing our large projects very carefully and generally taking a flexible and adaptable approach to supply planning.

This puts us in a good position to respond to the significant challenges I have described in a way that preserves our state's

competitive economic development advantages with respect to electric utility costs. We have been able to achieve this even though federal, and to a lesser extent, state, mandates conflict with customer affordability. Imagine how much more difficult it would be to address these universal cost pressures if Westar's rates were already high relative to most other places. For example, Topeka just attracted Mars Chocolate with a factory to make Snickers bars and M&M candies. Mars already has significant operations in Georgia, Illinois, Tennessee, Pennsylvania, New Jersey, and Texas. In each of these states electric rates are higher than in Topeka. Needless to say, our industrial rates, our service reliability and our access to lower-cost renewables provided an advantage in attracting this new customer, even if we should not expect always to be the lowest cost provider.

I can also say that part of our advantage is simply cultural, in that our people in many cases have learned to do more with less, and simply do without some of the expenses many other utilities find necessary. We have no stadium boxes or big advertising budgets and our general office is in the same building we constructed a half century ago. We staff our regulatory proceedings to the extent practicable with employees rather than outside counsel and consultants. And, although we benchmark our wages and salaries and compensate our employees competitively,

our executives receive no perquisites, but instead have the same benefits as our other employees. As I mentioned earlier, we have already undertaken significant pension reform. We take good care of our assets. Even our smaller, older coal plants today have similar reliability and efficiency performance metrics as our larger and younger plants.

The successful completion of the Emporia Energy Center and our initial wind farm projects at costs lower than the KCC-approved estimates in predetermination proceedings is indicative of our commitment to careful cost management.

We believe what makes for the best utility is being as passionate about managing our costs as we are about delivering safe, reliable service while providing investors a fair rate of return and employees a competitive work environment. By purposely keeping this tension among competing interests at the forefront of our decision making, I think our people have come to make better decisions about how to do things. We have room to improve, but I am confident that our approach to balancing the interests of our various constituents helps make us be a better company.

E. *Corporate Governance.*

Q. HAS WESTAR RETAINED THE CORPORATE GOVERNANCE, OWNERSHIP, ORGANIZATIONAL STRUCTURE AND FUNDAMENTAL BUSINESS THAT EXISTED AT THE TIME OF YOUR LAST RATE CASE?

A. Yes.

Q. PLEASE DESCRIBE THE PRINCIPAL FEATURES OF WESTAR'S ORGANIZATION, OWNERSHIP, CREDIT RATINGS AND CORPORATE GOVERNANCE.

A. We remain an investor-owned, publicly traded corporation. Our shares trade on the New York Stock Exchange as they have for decades. We are just one of a few publicly-traded companies headquartered in Kansas. We have no concentrated ownership positions.

For our largest shareholders, we have successfully sought out, attracted and maintained the interest of traditional utility mutual funds which in turn serve individual investors, providing them an efficient way to invest their savings. These investors we believe share with us a similar long-term perspective about our business and, therefore, are unlikely to militate for short-term interests that may not be in the best long-term interests of Kansas or our customers. As for the bulk of our retail shareholders, they are individuals that hold a relatively small number of shares each. 20,000 of our shareholders are Kansans, who hold on average just 540 shares each, reflecting individual investments of about $13,500, but in aggregate, reflecting Kansas investment in a Kansas company of over $270 million.

Our legal organizational structure remains as it has for years, although I am happy to report that we finally operate under a single rate structure, for both northern and southern parts of our service territory. Mr. Rohlfs discusses the few remaining differences in rates between our previous rate divisions.

Our corporate credit ratings remain mid-investment grade (Baa3 from Moody's, BBB from S&P, and BBB from Fitch); slightly improved since the time of our last general rate case. While respectable, these credit ratings are slightly lower than the median for our peer group, an indicator that our cash flows are strained relative to our investment obligations, with a continued strong reliance on attracting new capital.

We have 10 directors on our board. Other than me, all are independent. We have adopted a model where one of the independent directors is non-executive chairman, rather than vest the CEO with that further authority. The board maintains four standing committees: Audit, Finance, Compensation, and Nomination and Governance. As the only insider, I serve on none of these committees. Our board, our Compensation Committee and our Audit Committee regularly hold executive sessions in which neither the CEO nor any other member of management is present, including whenever our compensation is being addressed. Our board members' attendance record is almost 100%.

Our philosophical approach to management has been outlined in the Strategic Plan we first published in 2008 and subsequently updated last year. We continue to embrace those principles, including importantly: (1) avoiding over-confidence in our opinions about what the future might hold; (2) embracing uncertainty rather than assuming it away; and (3) placing a high value on flexibility and adaptability to inevitable change, which includes not getting too persuaded that any present condition (either favorable or unfavorable) in the market will necessarily persist. We believe these principles serve our customers, our state and our investors well.

Regularly we test our approach. Our executive team sets aside time to focus on our fundamental understanding of the business and possible trends and risks to which we and our customers are exposed. Although our discussions this year covered a wide range of topics, we were unanimous in our appreciation of what must hold our focus right now. We identified that there is nothing more important this year than to continue our operations with excellent execution – doing that of course with the utmost attention to safety – listening carefully to and taking care of our customers and to have regulatory success in what is shaping up to be a very busy and challenging year. A key element of the latter is presenting a compelling case to the Commission in this

application, as ultimately, we cannot perform our mission if our costs and revenues remain out of alignment.

We know that a Westar rate case is unwelcome news to customers and that there is likely to be understandable media and public interest in our regulatory plans. Accordingly, we discussed why it is of utmost importance that all of us demonstrate the value of our service for the price it takes to provide it – and not just as we ask customers to pay more for their electrical service, but at all times. We appreciate that it is easy to take electrical service for granted, and that sometimes the only reminder of it is when we ask permission to raise our prices or when lightning strikes and causes a power outage.

We appreciate and expect careful scrutiny of everything we do and acknowledge our obligation to justify every dollar it takes to do it. Many of us know that some of the largest cost drivers in our business are because of newly imposed regulations, largely, but not exclusively, coming from Washington in the form of stringent environmental regulations and new reliability requirements. Sometimes it seems there is no end to these frustrating and costly regulations. Those less familiar with them sometimes cannot imagine what is being demanded and assume that there must be some simpler solution or way around them. However, they have the full force of law and we have no choice but to comply with them,

in the same fashion that we must comply with the regulations and orders issued by this Commission.

We have endeavored to file this case with transparency. We believe a careful review of the facts will lead to a shared understanding of the important energy issues we face in Kansas and of the need for adequate rate recovery to address those issues. When undertaken in good faith, such scrutiny is a positive and essential component of the constructive and open approach to regulation that we advocate.

Q. YOU MENTION THE INCREASING COST OF COMPLYING WITH NEW REGULATIONS LARGELY ENACTED BY WASHINGTON. WHY NOT FIGHT THE NEW REGULATIONS?

A. We participate in both the legislative and regulatory process. We interact directly with our Congressional delegations through lobbyists, executives and trade association contacts. We also have filed comments with EPA and have pointed out errors in their modeling and logic. However, once legislation is enacted and regulations adopted, compliance is the appropriate, responsible, and ultimately most cost-effective course.

Q. GIVEN THE HIGH COST OF COMPLIANCE, HOW CAN IT BE THE MOST "COST-EFFECTIVE" COURSE?

A. Unless the rules are changed, compliance is the ultimate result. In addition to the imperative to obey the rule of law, resisting

compliance only runs up legal expenses without reducing the cost of ultimate compliance. Our recent experience related to compliance at JEC demonstrates the cost of fighting even when the utility believes it is in compliance.

As the Commission is aware, we were in protracted litigation challenging assertions by the EPA that we violated environmental rules at JEC. After meeting with both in-house and outside counsel, we elected to fight the notice as we believed there was a decent chance in prevailing. Unfortunately, after six years of fighting the case, spending millions of dollars, and dedicating thousands of man hours by management, we ultimately had to settle resulting in the requirement for at least one selective catalytic reduction unit (SCR) being installed at JEC, the application of monetary penalties and the requirement that we undertake other environmental remediation projects. Mr. Harrison gives a more thorough description of events in his testimony.

Q. IN ITS LAST TWO CASES WESTAR ATTESTED AND THE COMMISSION CONFIRMED THAT THE COSTS AND LEGAL FEES RELATED TO DISPUTES WITH TWO FORMER EXECUTIVES WHO LEFT PRIOR TO 2003 WERE EXCLUDED FROM YOUR RATE REQUEST. GIVEN THAT YOU HAVE RECENTLY RESOLVED THESE DISPUTES CAN YOU AGAIN

ATTEST THAT SUCH COSTS ARE EXCLUDED FROM YOUR RATE REQUEST?

A. Yes. I have personally inquired of those assembling this application to gain their assurance that none of those costs are in our rate request, and that we never seek to ask customers to pay those amounts or legal fees related to those disputes. Unfortunately, the same cannot be said of our shareholders. They incurred significant costs related to those circumstances and that is one of the reasons I am relieved to see that unfortunate chapter finally behind us.

Q. YOU SPOKE EARLIER ABOUT THE NEED FOR AN OPEN AND TRANSPARENT REGULATORY APPROACH. IN WHAT WAYS HAVE YOU ATTEMPTED TO FACILITATE SUCH AN APPROACH?

A. We have endeavored to be proactive in our regulatory affairs by openly sharing our plans and the status of projects with the Commission, the Staff and the public generally. This has taken many forms. For example, in developing our large transmission projects, we hold open houses to explain our intentions and to elicit public input. These are not statutorily-required meetings. In that same vein, we provide landowners notice of the proposed line routes more broadly than called for in the statutes. We also solicit input from interested environmental and non-governmental

organizations. In addition to being a good neighbor and recognizing that utility assets sometimes intrude in people's lives, it also reduces the likelihood of costly and time-consuming dissent and delay.

Before proceeding with new, very significant commitments, such as Emporia Energy Center, renewable energy projects, and by joining KCP&L in its request with regard to environmental retrofits to La Cygne, a jointly owned power plant, we have initiated or supported predetermination cases. The predetermination process is helpful to sound decision-making because it provides some degree of common understanding and agreement about how best to develop large and expensive projects before we commit investors and customers to such projects. Such a formal, focused process also provides *ex ante* information to our customers and to the Commission about the costs and rate implications of these projects and an opportunity for input, and even objection or protest – before we commit our customers and our company to them. It is a maxim that addressing potential problems or disagreements up front ends up being less costly than dealing with unpleasant surprises later.

In our day-to-day interactions with Commission Staff, whether responding to information requests or initiating communications about our operations and plans, our intent is to be

open, direct and forthcoming. I am hopeful that both the reality and the perception of our actions are consistent with that objective. In our last two rate cases, we kept the amount of confidential information to an absolute minimum and responded to every data request submitted to us. Consistent with that approach, there is no confidential testimony in this application and we began the process of responding to Staff data requests as we filed this application.

Finally, perhaps the most tangible evidence of our commitment to transparency has been the development and subsequent update to our Strategic Plan. The 2008 Strategic Plan and the 2010 update describe with candor factors affecting our industry generally and Westar specifically, our decision-making process, how we weigh various alternatives for meeting customer needs and investor expectations, our anticipated financing approach, and the rate and regulatory implications of our plans.

IV. COST OF EQUITY

A. *Determining an Appropriate Return on Equity Capital.*

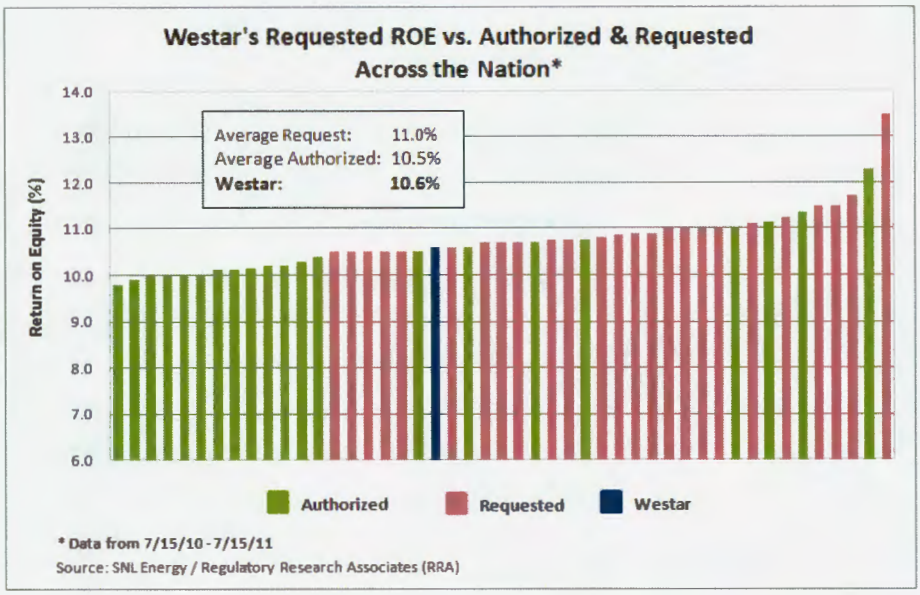
Q. IN ADDITION TO PROVIDING AN OVERALL POLICY REVIEW OF MATTERS YOU BELIEVE TO BE IMPORTANT TO THE COMMISSION'S CONSIDERATION OF YOUR RATE APPLICATION, YOU ALSO INDICATED YOU WOULD BE TESTIFYING REGARDING A REASONABLE ROE. WHAT IS YOUR RECOMMENDED ROE?

A. I recommend 10.60% as the appropriate and fair return on equity capital for Westar. I derived this figure by applying the long-established discounted cash flow (DCF) method to a group of electric utility companies with similar business characteristics and risks to Westar as well as to Westar itself. I also corroborated the reasonableness of this estimate by comparing it to other recently requested and commission authorizations for returns on equity for vertically integrated electric utilities across the nation (electric utilities with regulated generation, transmission and distribution assets).

Q. HOW DOES THE 10.6% ROE YOU ARE REQUESTING COMPARE TO WHAT OTHER UTILITIES ARE PRESENTLY SEEKING FROM THEIR REGULATORS AND WHAT REGULATORS ELSEWHERE HAVE BEEN AUTHORIZING?

A. Figure 9 below shows that compared to what others are requesting, it is modest, and if adopted in full by the Commission, would still be very close to the average of what other utilities have been granted. Purposely, we have attempted to avoid triggering a game of bidding and asking from potential extremes. Instead, just as we did in our last rate case, we have requested an allowed ROE that we believe to be a reasonable ending point for the Commission's final order.

FIGURE 9



Q. HOW WOULD THE CHANGE IN WESTAR'S REQUESTED ROE AFFECT CUSTOMERS' RATES?

A. Westar is requesting a 20 basis point increase in ROE from the current implied 10.4% ROE used for AFUDC calculations, current ECRR updates and what was used in the abbreviated rate filing in 2009. This 20 basis point increase reflects a change in our overall annual revenue requirement of only about $5.8 million, which in the context of the cost of service, reflects only a 0.35% change in rates, or about $0.41 per month on the average residential customer's bill. Although this is a relatively small part of the overall increase, it sends a strong signal which allows Westar to raise capital on favorable terms and to maintain a competitive long-run rate advantage for our state and our customers.

Q. HOW MIGHT THE COMMISSION WEIGH THIS INFORMATION IN SETTING AN ROE THAT BALANCES THE INTERESTS OF CUSTOMERS AND INVESTORS?

A. Other parties in this case will suggest Westar be authorized a lower ROE than we are requesting. There may be arguments based on ROE estimation models that the Commission has put little to no weight on in the past and there will be arguments (likely based on numerous factors) to keep rates artificially low for customers by adjusting the ROE down. While heeding such arguments might indeed result in very slightly lower rates in the short term, it would put at risk the very stability and reliability essential to meeting our customers' needs and would create a much more challenging long-term, structural problem that will not serve customers or the public interest.

The requested ROE in this application strikes the appropriate balance between Westar's customers and investors and will enable Westar to continue its mission.

B. *Criteria for a Fair Return on Investment.*

Q. WHAT CRITERIA DID YOU USE TO ESTABLISH A FAIR RATE OF RETURN?

A. I employed the economic guidelines set forth in the *Hope* (1948) and *Bluefield* (1923) cases. I interpret the language in those decisions to mean that a regulated utility should be afforded the opportunity to collect revenues sufficient to cover all legitimate

costs of providing regulated utility service, including sums sufficient to compensate investors for the use of their money tied up in the business, with the allowed return taking into consideration the risks to which that investment is exposed. This is generally referred to as the "the cost of capital."

Two standards have emerged from these cases. The first, known as the *comparable earnings* standard, is reflected in the *Bluefield* decision:

> The return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks (*Bluefield*, 262 U. S. 679, 1923).

The second is known as the *capital attraction* standard and is reflected in both decisions:

> 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 (*Bluefield*, 262 U. S. 679, 1923).
>
> 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 (*Hope*, 320 U. S. 391, 1944).

At the heart of these two standards is a single principle: if the firm can offer returns to investors commensurate with returns available on competing investments with similar risks, that firm will be paying the market cost of capital and it should be able to

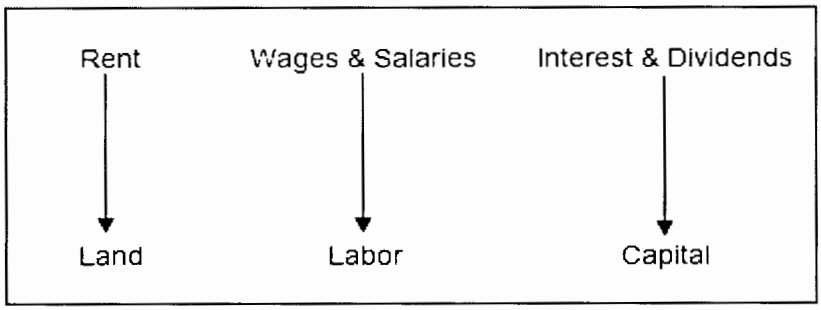
compete for, attract and hold the capital necessary to continue operations in accordance with its public utility obligations.

Q. WHAT IS THE MARKET COST OF CAPITAL?

A. The market cost of capital is the competitive price that must be paid to investors to entice them to let someone else use their money. Thus, dividends and interest paid for the use of money are not unlike the payment of rent that permits one to use another's real estate.

As Table 10 illustrates, capital is an economic resource, like land and labor. If the firm is to attract land and labor resources, it must pay the going rate for rent and wages, respectively. If the firm is to attract capital, it must pay the market price for it as well.

FIGURE 10



Q. WHAT DETERMINES THE MARKET COST OF CAPITAL?

A. The market cost of capital is based on the time value of money, the uncertainty or risk associated with the investment and the supply and demand for capital.

Q. WHAT IS WESTAR'S COST OF CAPITAL?

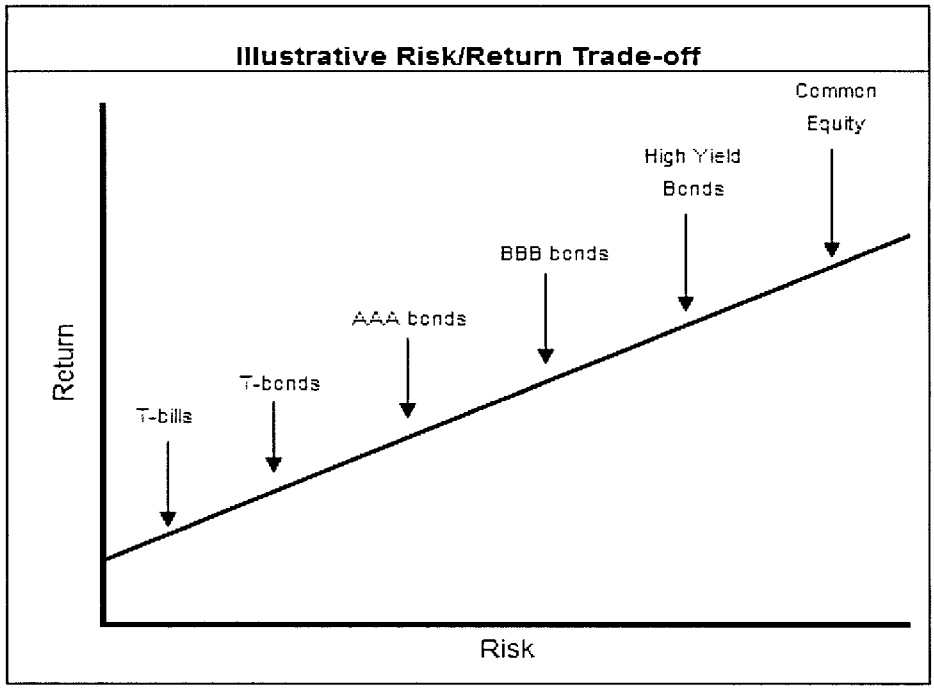
A. Westar's cost of capital is the weighted average of the three types of capital it uses to fund rate base: debt, preferred equity and common equity. Mr. Somma addresses the cost of capital items other than common equity.

C. *Westar's Cost of Common Equity (i.e., Recommended ROE).*

Q. HOW IS THE COST OF COMMON EQUITY CAPITAL DETERMINED?

A. The same time value of money and risk premium concepts apply to equity as they do to debt, but unlike debt securities, with common equity there are no underlying contractual obligations setting forth terms for paying returns. Equity returns are the residual left for shareholders after all the more senior claims of debt and preferred stockholders have been satisfied. Their subordination and the lack of contractual obligation to pay returns are the reasons that the cost of equity capital is far higher than the cost of debt. The risk-return trade off illustrated in Figure 11 below shows this relationship.

FIGURE 11



Q. IF THERE ARE NO CONTRACTUAL, DIRECT WAYS OF ASCERTAINING THE COST OF EQUITY, HOW DOES ONE DETERMINE ITS COST?

A. It has to be estimated indirectly. Because there is no single method of estimating the cost of equity capital, the process of calculating such an estimate is often controversial with different experts offering differing opinions, as I am sure will be the case in this rate review. These mathematical formulations range from the long-established and practical to the arcane and esoteric. The most practical and accepted method is called the dividend discount model or discounted cash flow (DCF) approach, the method I used to support my testimony.

Q. HAS THE DCF METHOD BEEN ACCEPTED IN UTILITY RATE PROCEEDINGS SUCH AS THIS?

A. Yes. It is the most commonly used method for determining ROE in most, if not all, U.S. utility regulatory jurisdictions, including Kansas. Both Staff and Westar experts used the DCF in Westar's last rate case.

Q. ARE THERE OTHER METHODS AND MODELS OTHER THAN THE DCF?

A. Yes. However, they are less commonly used and relied upon in regulatory proceedings. I believe they are less intuitive and can more often produce illogical results. For example, one well-known method is called the Capital Asset Pricing Model (CAPM). Even though I do not recommend it, the Commission has given some weight to it in past proceedings.

Q. WHY DIDN'T YOU USE THE CAPM?

A. For a number of reasons. But let me begin by introducing the form of the model. The CAPM model estimates the cost of equity by taking the "risk-free rate" plus a company's beta multiplied by the expected market or equity return, as demonstrated by the formula below:

$$K_e = R_f + \text{Beta } (R_p)$$

Where:

K_e = return on equity

R_f = return on the risk free security

Beta = volatility of the security relative to the volatility of the entire market

R_p = market risk premium required for investors to purchase equity securities instead of treasuries

Q. WHAT IS YOUR PRINCIPAL OBJECTION TO THE CAPM?

A. There is quite a bit of empirical evidence that the CAPM under-estimates the cost of equity capital for utility stocks similar in size and risk to Westar, or more generally, smaller stocks with beta's below 1, and stocks with lower price-to-earnings ratios.[9] Given the nature of what we are trying to do here, that is, estimate the cost of capital for a smaller utility, for this reason alone, I would caution against putting much, if any, weight in the results of the CAPM in this proceeding. I am guessing the bias in the CAPM's results will be evident if other parties testify using the CAPM to justify a lower recommendation for the ROE. It is not uncommon for example to have the CAPM produce implied cost for equity capital that is below

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[9] There are numerous empirical studies that suggest the CAPM underestimates the cost of equity capital for smaller stocks, stocks with betas below 1 and stocks with lower price-to-earnings ratios. The following studies are just a few that support these claims.

Jensen, Michael C., "The Capital Asset Pricing Model: Some Empirical Tests," *Studies in the Theory of Capital Markets* (Praeger Publishers Inc. 1972), (available http://papers.ssrn.com/sol3/papers.cfm? abstract_id=908569); Fama, Eugene F., French, Kenneth R., 2004. "The Capital Asset Pricing Model: Theory and Evidence." *CSRP Working Paper No. 550; Tuck Business School Working Paper No. 03-26* (2004), (http://papers.ssrn.com/sol3/papers.cfm? abstract_id=440920); Banz, Rolf W., "The Relationship Between Return and Market Value of Common Stocks." 9 *Journal of Financial Economics*, 3-18, (North-HollandPublishing Company 1981).

(or just slightly above) the cost of debt, which, of course, belies logic, given the significantly different risks to which bond and equity investors expose themselves.

A second reason is that U.S. Treasury securities are typically assumed to be used as a proxy for the "risk-free rate." Given that yields on U.S. Treasury securities are so subject to government intervention, especially today, thereby artificially lowering the implied risk free rate, I caution against inferring too much from those yields. Recent evidence includes negative interest rates on short-term Treasury securities.[10] Further, recent actions by S&P to downgrade ratings on U.S. Treasury securities suggests even those are not risk free.[11]

Lastly, most computations using the CAPM to estimate the cost of equity rely on historical market returns, historical market premiums, current 30-year Treasury yields and betas computed using the past three to five years of market data. In reality, stocks are priced based on *future* expectations, so analysts who apply the CAPM model would be better served to use *forecasted* 30-year

[10] On December 9, 2008, the yield on 3-month Treasuries dropped below 0% during intra-day trading. On October 25, 2010, the U.S. Treasury issued 5-year Treasury Inflation Protected Securities (TIPS) at a negative yield for the first time at a U.S. debt auction. At a more recent auction held on April 21, 2011, 5-year TIPS were once again issued with a negative yield. To note an even greater extreme, 10-year TIPS traded at a negative yield for the first time in history on August 9, 2011.

[11] Mellon Bank recently implemented a policy of charging depositors fees; effectively charging negative interest instead of paying interest. Rappaport, Liz. "New Fee to Bank Cash." *The Wall Street Journal*, http://online.wsj.com/article/SB10001424053111903366504576488123965468018.html (August 5, 2011).

Treasury yields, *forecasted* market risk premiums and even *forecasted* betas, but that of course, makes it much more analytically challenging and subject to even further debate. Consider the debate today about what the yield on Treasury bonds might be, even in the relatively near future.

For these reasons, and even with the understanding that the Commission has in the past put *some* reliance on the CAPM, I would suggest less reliance still should be in order.

Q. PLEASE DESCRIBE THE THEORY UNDERLYING THE DCF MODEL.

A. Fortunately, it is much more intuitive than the CAPM. An illustration using bonds provides a good starting point. If a company is able to issue bonds at $1,000 each with the promise to return this sum plus interest of $100 one year later, the investor must require a rate of return of 10% per annum for tying up his or her $1,000. In this example, the present value today of $1,100 to be received a year from now is $1,000 ($1,100/1.10 = $1,000). The discount rate (10%) is the rate which equates the expected *future* value of an investment to its *present* value.

Similarly, the present value of a share of common stock is well known. It is simply the trading price of the stock, which is readily obtainable any time. What is not known is the discount rate, and that is what we are after here. What the DCF seeks to show is

that, given the known stock price (i.e., present value) and certain intuitive growth assumptions about the future income stream (i.e., level of and expected growth rate of dividends), the discount rate (i.e., the required cost of equity capital) can be readily and simply calculated.

The simple DCF model expression gives the discount rate as:

$$k = D_1/P_o + g$$

where:

k = the discount rate or cost of equity

D_1 = the expected dividend

P_o = the known current stock price

D_1/P_o = the dividend yield

g = the expected growth rate in dividends

Thus, the DCF formulation shows that dividend yield plus the expected growth in dividends for a common stock will equal the rate at which investors are discounting (for the time value of money and uncertainty) the expected future income from the stock. This is the basis for intuitively estimating the cost of equity and a long-standing method for establishing an appropriate ROE in rate cases.

D. *DCF Peer Group.*

Q. SPECIFICALLY, HOW DID YOU IMPLEMENT THE DCF MODEL TO ARRIVE AT YOUR RECOMMENDED ROE FOR WESTAR?

A. I applied the DCF to a group of publicly-traded electric utilities with businesses and risks very similar to those of Westar. I also applied it to Westar directly as a further check of reasonableness.

Because Westar remains a smaller regulated electric utility with a straightforward business model and financial profile, I screened companies to identify those with similar characteristics. Specifically, I started with the universe of U.S. publicly-traded electric utilities, of which there are about 60. I then screened them to ensure they met the following requirements:

1. Markets they serve continue to be retail rate regulated and served by vertically integrated utilities, like Westar;
2. Market capitalization had to be approximately $1.0 billion to $5.0 billion (Westar's is approximately $3.0 billion);
3. The companies had to have investment grade credit ratings that fall within the BBB+ to BBB- by S&P or Baa1 to Baa3 by Moody's (Westar's are BBB/Baa3);
4. The companies must pay a common dividend and have at least a three-year continuous history of paying dividends;
5. The companies must have a similar business model, where more than 50% of revenues come from the

business of a vertically-integrated electric utility with more than 80% of assets being regulated;

This resulted in the ten companies identified in Table 2 below:

TABLE 2

	A Company	B Market Cap (Billions)	C Corp Credit Ratings (S&P/Moody's)
1	Pinnacle West Capital Corp	$4.8	BBB/Baa3
2	Alliant Energy Corp	$4.5	BBB+/Baa1
3	TECO Energy Inc	$4.0	BBB+/Baa3
4	Great Plains Energy Inc	$2.8	BBB/Baa3
5	Cleco Corp	$2.1	BBB/Baa3
6	IDACORP Inc	$2.0	BBB/Baa2
7	Portland General Electric	$1.9	BBB/Baa2
8	Allete Inc	$1.5	BBB+/Baa1
9	Avista Corp	$1.5	BBB/Baa2
10	NorthWestern Corp	$1.2	BBB/Baa1
11	Peer Group Average	$2.6	BBB/Baa2
12	Peer Group Median	$2.0	BBB/Baa2
13	Westar Energy	$3.0	BBB/Baa3
Sources: Bloomberg and Moody's Credit Rating accessed July 19, 2011			

Q. DO YOU THINK SIZE (MARKET CAPITALIZATION) IS RELEVANT?

A. Absolutely. Market capitalization is a relevant selection criterion because size implies a different level of risk. Smaller electric utilities, similar in size to Westar, offer less liquidity. They also lack geographic and regulatory diversification and they may be less able to withstand extreme financial demands. For example, Southern Company is presently undertaking the construction of two new

nuclear units. It would be unthinkable for a company Westar's size to take on such an obligation. Empirical financial studies suggest a premium is required for investments in smaller companies, regardless of industry or country, relative to their larger cap peers.[12]

Q. HOW MANY IN YOUR PEER GROUP ARE PERMITTED TO USE SOME FORM OF INTERIM RATE ADJUSTMENT MECHANISMS?

A. All of them have a fuel clause and all use one or more additional interim rate adjustment method. The use of these ratemaking tools has become commonplace.[13] Accordingly, any perceived effect on the risk/return calculus associated with such use would already be reflected in security prices and thus in my DCF analysis.

Q. WHY DIDN'T YOU ESTIMATE THE ROE BY JUST APPLYING THE MODEL TO WESTAR ALONE?

A. There are good reasons against estimating the ROE based on a sample of one firm. First, as stated in *Hope* and *Bluefield*, the basic premise in determining a fair return is that the allowed return on equity should be commensurate with returns on investments in other firms with comparable risk, hence, the need to extend the

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[12] The Ibbotson Build-Up Method, which is a widely-recognized method for determining the return on equity, includes summing the risk free rate (long-term government bonds), the long-horizon equity risk premium, and the size premium. The size premium is required since small cap stocks are riskier than blue-chip stocks which require a greater return for investors.

[13] *See*, Docket No. 11-GIME-492-GIE, *Initial Comments and Answers of Westar Energy, Inc.*, Volume 1, Table 9 (February 25, 2011).

sample to a group of similar companies. Second, the DCF is an estimation model. Statistical confidence in the reliability of the modeled ROE can be enhanced by estimating the cost of equity capital for a number of companies with similar risks instead of applying the model to a single company and relying on a single data point.

Q. HOW DID YOU DEFINE THE VARIABLES USED IN YOUR DCF ANALYSIS?

A. The expected dividend (D_1) is the sum of the expected quarterly dividends and additions to these dividends resulting from the reinvestment of the quarterly dividend stream over the annual investment period. D_1 depends on when the quarterly dividend payments are made during the period and in which calendar quarter scheduled dividend increases occur. This gives the model a bit more precision because it takes into consideration the specific time when, throughout the year, utilities actually adjust and pay their dividends. Part of the intuitive appeal of this model for this purposes is that utilities typically maintain very predictable quarterly dividend payment and dividend adjustment schedules. This makes the quarterly model all the more relevant and intuitive.

Q. HAS THIS QUARTERLY DIVIDEND FORMULATION BEEN USED IN CASES BEFORE THIS COMMISSION?

A. Yes. In fact, I was first introduced to this form of the DCF model by a former Commission Staff financial expert years ago.

Q. WHAT METHOD DID YOU USE FOR YOUR STOCK PRICE INPUTS?

A. For the price, (P_o), I used the average of the companies' stock prices for a 15-day trading period ending July 15, 2011, taking care to make sure that prices in this 15-day period were not temporarily biased by severe market distortions. The underlying theory of the DCF model, which rests on the assumed efficiency of the market, implies that a stock price on a given day may be more theoretically precise, however, given the obvious perturbations in the daily markets that we know exist, I believe using the average of a few days is reasonable. I would not, however, suggest that averaging prices over a period beyond a few days would be consistent with the underlying DCF model theory because, in fact, market sentiments do change over time and do so relatively quickly.

Q. HOW DID YOU DETERMINE THE GROWTH RATES USED IN YOUR MODEL?

A. This is really the only controversy among model inputs. Some experts suggest using more esoteric, multi-factor sub-models just to calculate projected growth. Practically speaking, any method of estimating future growth rates suffers from an inherent inability to predict the future. I used forecasted long-term earnings growth

rates published by the major investment firms and gathered by *Thomson Reuters*, a leading financial publishing firm, along with the forecasted long-term earnings growth rates published by *Value Line*, a source Staff witnesses have also relied on in the past, to offer an additional estimate. This enabled me to gather between two and eight estimates of long-term growth for each company in my peer group.

Q. WHY DID YOU USE LONG-TERM *EARNINGS* GROWTH RATES AS OPPOSED TO LONG-TERM *DIVIDEND* GROWTH RATES IN YOUR DCF MODEL?

A. For a number of reasons, mostly practical, but still intuitively logical. Most analysts typically concentrate their efforts on forecasting earnings, and only provide one or two years of dividend forecasts, but of course, the ability to pay dividends is largely a function of earnings. Given that we are estimating the ROE for regulated electric utilities that typically have an established payout ratio range, long-term earnings growth rates should indicate the same general growth rate for dividends if a company is to maintain a reasonably consistent payout ratio, which the market suggests utilities strive to do. The illustrative example in Table 3 below demonstrates this relationship.

TABLE 3

Illustrative Example: Dividend Growth Mirrors Earnings Growth						
Earnings growth rate	5%					
Payout ratio	60%					
	Yr	1	2	3	4	5
Earnings per share		$ 2.00	$ 2.10	$ 2.21	$ 2.32	$ 2.43
Dividends per share		$ 1.20	$ 1.26	$ 1.32	$ 1.39	$ 1.46
Annual dividend growth rate			5%	5%	5%	5%
Annual payout ratio		60%	60%	60%	60%	60%

Secondly, the only sources of long-term dividend projections (three to five years) are available from *Value Line* and *Bloomberg*. Using dividend projections limits the number of growth estimates to, at most, two per company.

Q. USING THE ABOVE DEFINED VARIABLES FOR YOUR DCF MODEL, WHAT WERE THE RESULTING UNADJUSTED ESTIMATES OF COST OF EQUITY?

A. My sample of ten companies yielded an average of 10.33% and a median of 10.46%. Table 4 below shows the peer group companies and resulting unadjusted DCF estimate of ROE.

TABLE 4

	A Company	B Unadjusted ROE
1	Pinnacle West Capital Corp	11.20%
2	Alliant Energy Corp	10.63%
3	TECO Energy Inc	13.91%
4	Great Plains Energy Inc	10.97%
5	Cleco Corp	7.92%
6	IDACORP Inc	7.79%
7	Portland General Electric Co	9.38%
8	Allete Inc	10.05%
9	Avista Corp	10.30%
10	NorthWestern Corp	11.13%
11	Peer Group Statistics	
12	**Peer Group Average**	**10.33%**
13	**Peer Group Median**	**10.46%**
14	Westar Energy	**12.00%**
	Sources: Bloomberg, Thomson Reuters, and Value Line.	

E. *Issuance Cost Adjustment.*

Q. DID THAT CONCLUDE YOUR ANALYSIS?

A. No. One further adjustment was required. I adjusted these preliminary results for the costs incurred while issuing stock, something the DCF model does not pick up automatically.

Q. WHAT ARE ISSUANCE COSTS?

A. When a company issues common equity, just as it does with bonds and preferred equity, it incurs costs such that the amount investors pay for the securities they purchase is greater than the net proceeds the issuing company receives after taking transaction costs into account. Issuance costs include expenses such as

underwriting, legal and printing fees, as well as the effects of price pressure.

Q. WHAT IS PRICE PRESSURE?

A. A company issuing common equity typically incurs an additional cost reflected in the depressing effect on the stock price of the new issuance. Basic supply and demand tells us that, as more shares of common stock are sold, the price for these securities should fall. This can be quantified by comparing a company's stock price before an announced offering with the stock price at the time the shares are priced, which is typically lower.

Because of issuance costs, funds available for the company to invest in plant and equipment (i.e., rate base) are less than the total amount provided by investors, but investors require a return on the total amount they invested, not just the net proceeds the company actually received and could invest in its plant.

Q. HOW DO SUCH COSTS AFFECT THE UTILITY?

A. A simple example illustrates this point. Assume that a new utility is formed which requires $10,000 of net capital to purchase the necessary assets, or rate base, to serve customers. Stock can be sold to investors to raise the money, but, in doing so, the company incurs issuance costs of $500. As a result, for the company to raise $10,000 of net proceeds it must sell $10,500 of securities to investors. Assume further that investors require a rate of return of

10.0%. If rates are set to earn 10.0% on the rate base of $10,000, investors receive income of just $1,000, which is only a 9.5% return on their total investment of $10,500. Theoretically, this means the price will fall, thereby driving up the return to 10.0%, the market cost of capital in this example. For investors to earn their required return of 10.0% on the amount they actually invested when they bought the securities, utility rates must generate a 10.0% return on total cost of the equity purchased by investors – $10,500; a return that equates to a 10.5% return on the lower net amount in this simplified example.

Q. HAVE THE COMMISSION OR STAFF EXPERT WITNESSES RECOGNIZED COMMON STOCK ISSUANCE COSTS PREVIOUSLY?

A. Yes. Staff witness typically agrees that common stock issuance costs should be recognized when estimating the cost of equity capital.

Q. EXPLAIN HOW YOU RECOGNIZED ISSUANCE COSTS IN YOUR ANALYSIS.

A. I applied an adjustment to the unadjusted DCF result to ensure that the costs of raising capital are recovered in the ratemaking process.

Q. RATHER THAN MAKING AN ADJUSTMENT TO THE RATE OF RETURN, WHY AREN'T THESE ISSUANCE COSTS SIMPLY EXPENSED WHEN THEY ARE INCURRED?

A. We would not object to the Commission treating these costs that way, but as with all costs, issuance costs generally should be borne by those customers receiving the associated benefit. If common stock issuance costs were expensed as incurred, a single generation of customers would bear the entire cost of something that benefits current, as well as future customers, because common equity has an indefinite life. Accordingly, these expenses have never been recognized on our income statement.

Q. WHY ARE COMMON STOCK ISSUANCE COSTS NOT AMORTIZED OVER TIME AS THEY ARE WITH BONDS?

A. In the case of bond financing, issuance costs are amortized over the life of the bonds, with the unamortized portion reflected in the net interest rate calculation. This ensures that those customers benefiting from the bond issue bear their share of the corresponding issuance costs. Again, we would not object to the Commission recognizing these costs in that fashion but, unlike bonds, common stock has an indefinite life and any such amortization period would be arbitrary. An appropriate means of recognizing these costs is to adjust the DCF estimate of ROE upward slightly to capture the effect of issuance costs.

Q. DID WESTAR ISSUE ANY NEW COMMON EQUITY IN THE TEST YEAR OR DOES WESTAR PLAN TO DURING THE PERIOD IN WHICH RATES WILL BE IN EFFECT?

A. Yes, both. Westar sold approximately $366 million (gross proceeds) of equity in 2010. Moreover, given the size of our construction program, we will need to issue additional equity in the near future. Nevertheless, while those are convenient facts to help illustrate the point, because common equity has a perpetual life, issuance costs should be recognized in the cost of equity whether or not the company actually issued equity in a test year.

Q. WHAT IS THE MAGNITUDE OF THE ADJUSTMENT AND HOW SHOULD IT BE APPLIED?

A. The relevant financial literature suggests that issuance costs average about 4.0% to 5.5% of gross proceeds.

As stated by Roger A. Morin, Ph.D. in *New Regulatory Finance (2006):*

> . . . empirical studies by Lee et al. (1996), Borum and Malley (1986), Logue and Jarrow (1978), Pettway (1984), Pettway and Radcliffe (1985), Excbo and Masulis (1987), Bhagat and Frost (1986), Mikkelson and Partch (1986) and Smith (1977, 1986), underwriting costs and expenses average 4.0%-5.5% of gross proceeds from utility stock offerings. The more recent study by Lee et al. (1996) finds an average flotation cost of 4.92% for utility common stock offerings . . . .[14]

Morin goes on to summarize that, for utility stocks, the costs associated with market pressure range from 0.6% up to 3.0% based on relevant studies.

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[14] Morin, Roger A., *New Regulatory Finance,* Public Utility Reports, at 323 (2006).

With the direct costs and market pressure related to issuing equity, flotation costs average above 5.0%.

In my analysis, I made the adjustment by reducing the stock price used in the DCF formula by 5.0%. This is a reasonable approach that is toward the lower end of issuance and market pressure cost estimates that is accepted in the financial literature.

Q. TO WHAT PORTION OF COMMON EQUITY IS THE ADJUSTMENT APPLIED?

A. That is a somewhat contentious point. There is disagreement as to whether an adjustment should be applied to the entire equity component or just the part that is raised directly from investors (i.e., excluding the portion attributable to retained earnings).

There are arguments that the adjustment needs to be applied to the entire common equity component, i.e., both paid-in-capital and retained earnings. The argument for this position is that it is a common but mistaken belief that because retained earnings are not raised directly from investors, no issuance costs are attributable to these funds. However, because retained earnings are sourced in the original stock investment and because this investment included flotation costs, mathematical properties cause the effects to flow through retained earnings as well. This argument holds that, without an adjustment to the entire common

equity balance (i.e., both paid-in-capital and retained earnings), shareholders will not receive an adequate return.

Others suggest that the adjustment should be applied only to the portion of equity that is raised directly from investors (i.e., excluding retained earnings). Rather than ask the Commission to engage in that academic controversy, I have taken the more conservative approach by not applying the adjustment to the retained earnings portion of equity.

Q. WHAT IS THE IMPACT OF THE ISSUANCE COST ADJUSTMENT ON YOUR DCF ESTIMATES?

A. The issuance cost adjustment increased the average DCF model result by 0.24%, from 10.33% to 10.57%, and increased the peer group median by 0.25%, from 10.46% to 10.71% (see Table 5).

TABLE 5

	A Company	B Unadjusted ROE	C Adjusted ROE	D Issuance Cost Adjustment
1	Pinnacle West Capital Corp	11.20%	11.46%	0.26%
2	Alliant Energy Corp	10.63%	10.87%	0.24%
3	TECO Energy Inc	13.91%	14.26%	0.35%
4	Great Plains Energy Inc	10.97%	11.20%	0.23%
5	Cleco Corp	7.92%	8.10%	0.18%
6	IDACORP Inc	7.79%	7.97%	0.18%
7	Portland General Electric Co	9.38%	9.61%	0.23%
8	Allete Inc	10.05%	10.30%	0.25%
9	Avista Corp	10.30%	10.55%	0.25%
10	NorthWestern Corp	11.13%	11.38%	0.25%
11	Peer Group Statistics			
12	**Peer Group Average**	**10.33%**	**10.57%**	**0.24%**
13	**Peer Group Median**	**10.46%**	**10.71%**	**0.25%**
14	Westar Energy	**12.00%**	**12.28%**	**0.28%**

The proxy group's average retained earnings to common equity is 33%, with Westar's being 18%. Table 6 shows how the adjustment was applied.

TABLE 6

	ROE Range					
	A		B		C	D
	ROE - Peer Group Adjusted AVERAGE					
			Percent of Common Equity		Peer Group Adjusted Average	
1	Paid-in-capital		67%	X	10.6%	= 7.10%
2	Retained Earnings		33%	X	10.3%	= 3.40%
3					ROE	**10.50%**
	ROE - Peer Group Adjusted MEDIAN					
			Percent of Common Equity		Peer Group Adjusted Median	
4	Paid-in-capital		67%	X	10.7%	= 7.17%
5	Retained Earnings		33%	X	10.5%	= 3.47%
6					ROE	**10.63%**

A reasonable estimate for a fair ROE, as computed in Table 6 above, is between 10.50% and 10.63%. Given the conservative issuance cost adjustment and since the stand-alone DCF results for Westar are well above the proxy group average and median, a 10.60% ROE is being supported in this rate review. A 10.60% ROE is also near the average of recently authorized ROE's for utilities with regulated generation, transmission and distribution assets as noted earlier beginning at page 51.

10.60% is a reasonable and fair ROE for Westar; it is also the basis for the revenue requirements analysis in our application.

F. *Regulatory Construct is at the Forefront of Investors Concerns Regarding Investment Risk.*

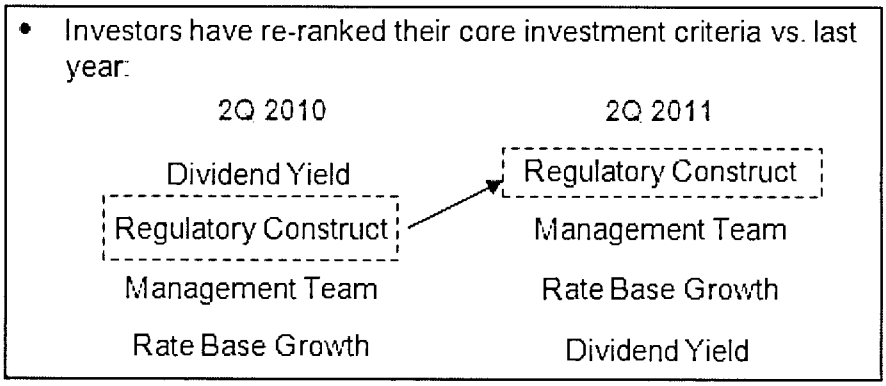
Q. WHY IS IT SO IMPORTANT THAT THE COMMISSION AUTHORIZE AN ALLOWED ROE COMPETITIVE WITH WHAT OTHER COMPANIES HAVE BEEN GRANTED?

A. There is no mystery there. If investors can get a better return for the risk to which they are exposed at other companies, they would have no reason to take the risks of investing in Westar.

Q. WHAT DO INVESTORS PERCEIVE TO BE THE GREATEST RISK FACTOR IN INVESTING IN A REGULATED UTILITY?

A. The short answer is regulation. Figure 12 below is taken from an analyst report addressing the investment in utilities.[15]

FIGURE 12



[15] Citi, *Utility Infrastructure: Planning For The Next "Dog" Year* (April 14, 2011).

With the large amount of capital expenditures forecast within the industry in order to comply with environmental mandates, meet renewable energy requirements, keep pace with the need for additional transmission, replace aging distribution infrastructures and to comply with potential mandated upgrades at existing nuclear generation facilities, investors will have many opportunities to invest in the industry. The ability to compete for investor capital on reasonable terms will be essential.

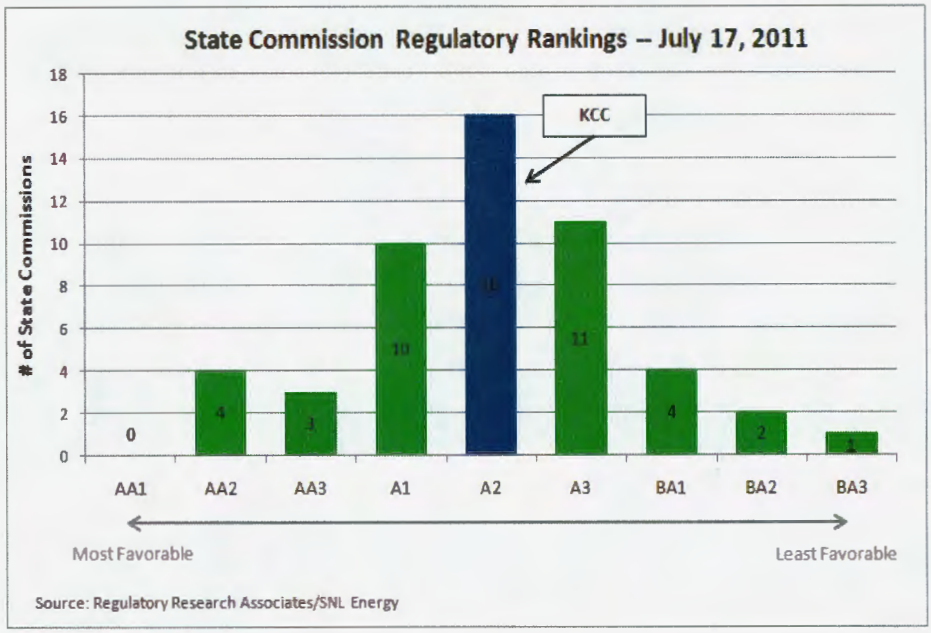
Understandably, investors follow rate proceedings and state commission rulings closely. Utilities that manage their businesses well and operate in states with balanced, fair, consistent regulation, where public policy does not surprise investors with shifting practices, will continue to attract external capital on reasonable terms. This ultimately allows utilities to invest capital more efficiently which leads to more favorable rates and the continuation of safe and reliable service.

Q. HOW DO OTHERS PERCEIVE THE REGULATORY ENVIRONMENT IN KANSAS?

A. In most of my discussions with investors, they consider it to be moderately constructive, and in the middle of the road. Regulatory Research Associates (RRA), an independent research and consultation company that specializes in electric utility securities and regulation, and which recognizes the importance of regulatory

risk to investors, endeavors to rank each state commission from an investor's point-of-view. As shown in Figure 13, RRA came to the same conclusion.

FIGURE 13



Q. HOW DOES RRA DETERMINE EACH COMMISSION'S RANKING?

A. Here is how RRA described its process:

> . . . RRA ranks the regulatory environments of the states from the perspective of the utility investor. Above Average is considered a less risky regulatory environment for investors, while a Below Average ranking is the opposite . . . . Our ranking system is a comparative system, rather than an absolute system, meaning that each state ranking is based on that state's comparison to the hypothetical average regulatory environment. RRA reviews many aspects of electric and gas utility regulation to determine a

particular state's ranking (authorized ROE, test year, fuel cost recovery, predictability, etc.).[16]

Q. GENERALLY, WHAT DO YOU DISCUSS WITH INVESTORS AND POTENTIAL INVESTORS WHEN YOU MEET WITH THEM?

A. Although regulation is top of mind for most of them, we present Westar on all fronts (operational, financial, regulatory, service territory, management, future challenges, etc.) and try to do so with consistency and candor, all within the strict securities laws that require "fair disclosure." This is evident in the investor relation materials we regularly post on our website.

Q. WHEN YOU DISCUSS REGULATION WITH INVESTORS, WHAT TOPICS ARE OF MOST INTEREST TO THEM?

A. They are interested in the methods, practices, rules and regulations by which the Commission sets our prices to cover our costs and to provide a reasonable expectation of a fair return. Timeliness and consistency are of utmost interest to them.

Q. HOW HAVE INVESTORS IN TURN RESPONDED?

A. Investors have been supportive of our investment thesis, as evidenced by our ability to attract capital on reasonable terms in varying market conditions, all while funding a very large construction program.

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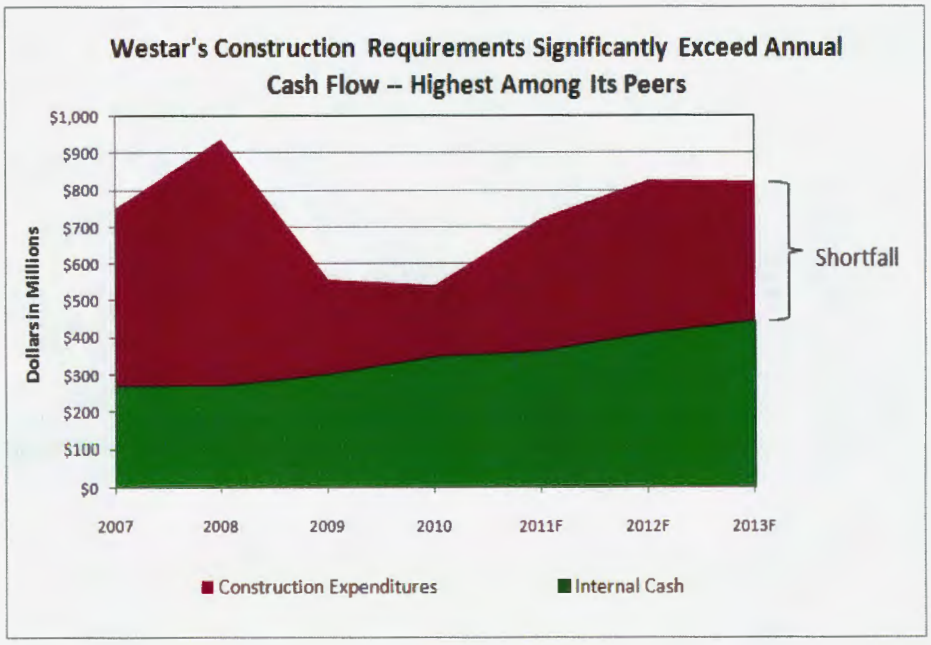
[16] SNL Financial LC. 17 https://www.snl.com/help/HelpFile.htm (August 2011).

Q. WHY IS ACCESS TO CAPITAL ON REASONABLE TERMS SO IMPORTANT?

A. The requirements of our business require far more capital investment than our business produces. As Figure 14 shows, we are in a negative cash flow position and will be for the foreseeable future. Any cash shortfall has to be made up by raising new capital.

FIGURE 14



Q. WHAT ARE SOME OF THE SPECIFIC REGULATORY SUBJECTS WESTAR'S INVESTORS ARE MOST INTERESTED IN TODAY?

A. They are currently most interested in this rate review and Dockets Nos. 11-GIME-492-GIE and 11-KCPE-581-PRE regarding the environmental requirements at the La Cygne power station. Investors are keenly aware of our large construction program, the

required deadlines to complete some of our large environmental projects, and the regulatory lag associated with them.

We would expect investors to be disappointed to learn of the Commission's decision to deny use of the ECRR for recovery of our investment in the La Cygne retrofit project. They may not be surprised, however, as the Commission's earlier actions suggested that was the course of action it was considering. I believe our investors' expectations concerning the prospects for La Cygne ECRR recovery are already indicated in the under-performance of Westar's stock price this year.

Q. WHAT HAVE INVESTORS COME TO EXPECT WITH REGARD TO THE REGULATORY CONSTRUCT IN KANSAS?

A. Investors have come to expect a regulatory environment that is constructive and fair. They do not expect generous or light-handed treatment, but they do expect predictable, consistent regulation. They have come to expect an authorized ROE that is "middle-of-the-road" compared to what other commissions might authorize, coupled with some, but not all, of the cost recovery mechanisms that have become more commonplace in the industry that assist in providing more timely recognition of their investment in the rates Westar is permitted to charge.

Q. WHAT ARE SOME OF THE CONSTRUCTIVE COST RECOVERY TOOLS WESTAR IS NOT PERMITTED TO USE THAT SOME OTHER UTILITIES ARE PERMITTED TO USE?

A. By way of example, some utilities have bad debt tracking adjustments. Some have cash tracking adjustments for construction work in progress, tree-trimming, security/safety, energy efficiency, and renewable energy costs.

Q. WHY IS TIMELINESS SO IMPORTANT?

A. Timeliness is important because regulatory lag depresses returns on investment. I have described these effects starting at page 21 in this testimony.

Q. YOU HAVE MENTIONED REGULATORY RISK IS AT THE FOREFRONT OF YOUR INVESTORS' CONCERNS. CAN YOU PROVIDE SOME SPECIFIC EXAMPLES FROM THE INVESTMENT COMMUNITY?

A. Yes, on April 19, 2011, one large investment firm downgraded Westar's stock to "sell," and on May 5, 2011, following Westar's first quarter earnings call, it reaffirmed its "sell" rating:

> In our view, WR remains a well-run regulated company, however, we maintain our Sell rating given valuation concerns regarding a negative turn in state utility regulation in Kansas.[17]

On May 5, 2011, another firm wrote:

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[17] Goldman Sachs, *First Take: 1Q2011 inline with consensus but below GS estimates.* Equity Research (May 5, 2011).

> One of the key questions for investors, in our view, remains whether Westar will be able to recover the environmental capital spending associated with its 50% stake in the La Cygne power plant (operated by neighboring utility Great Plains Energy) through the environmental cost recovery rider (ECRR). Rider recovery mitigates the impact of regulatory lag and reduces the uncertainty associated with ultimate recovery compared to a traditional rate case .... Additionally, we expect investors to continue to focus mainly on Westar's upcoming general rate case, which in our view is the single biggest driver of the company's 2012 earnings power.[18]

Q. HOW DO INVESTORS RESPOND TO NEGATIVE DEVIATIONS FROM THEIR EXPECTATIONS?

A. Investors logically would have a bias to sell Westar and invest elsewhere when the Commission changes regulatory practices investors perceive as constructive and predictable. The Commission's action in Docket No. 11-KCPE-581-PRE prohibiting Westar from using the ECRR to recover its costs in the La Cygne retrofit project is such an action as would be an order authorizing a sub-par ROE.

If, in reaction to such an action, there are more sellers than buyers, that would drive down the price of our securities until the expected yield would rise to be competitive, and that only occurs with a loss of shareholder value, which in turn signals to future investors a higher degree of risk and volatility associated with

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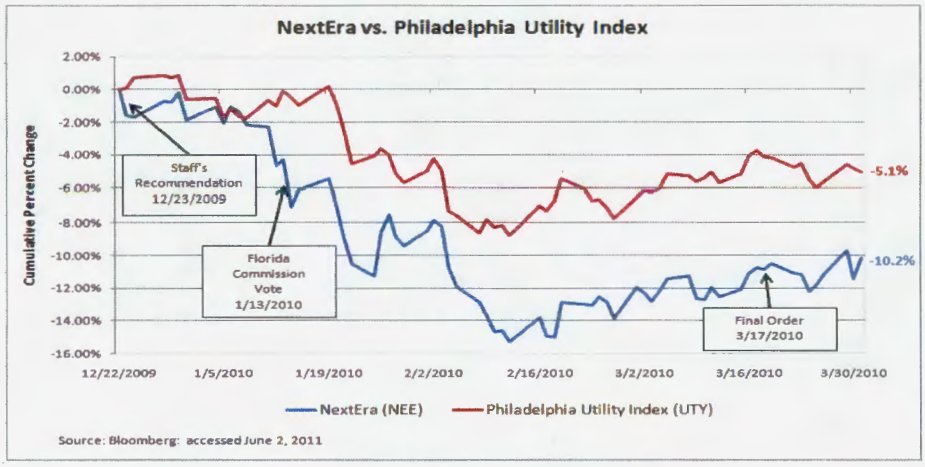
[18] J.P.Morgan, *Westar Energy Inc: Expect Neutral Stock Reaction on In-Line 1Q11 Results and Reiterated 2011 Outlook – ALERT.* North American Equity Research (May 5, 2011).

investing in Westar. In other words, short-term regulatory actions designed to keep utility rates low can sometimes lead to long-term utility rates higher than they need to be. With huge mandated investments in environmental and transmission on the horizon with intractable looming regulatory deadlines, the ability to raise capital on reasonable terms today is critical in order to fund these projects and maintain our low cost generation fleet.

Q. ARE THERE RECENT RELEVANT EXAMPLES OF HOW INVESTORS' NEGATIVE REACTIONS RESULT FROM REGULATORY SURPRISES?

A. The most notable occurrences have been related to the Florida Public Service Commission's (FPSC) rate rulings in 2010 regarding subsidiaries of Progress Energy (Florida Power Corp.) and NextEra (Florida Power and Light Co.). The FPSC authorized a 10.5% ROE for Progress Energy and a 10.0% ROE for NextEra. The 10.5% ROE granted to Progress was about the industry average for the time, while the 10.0% granted to NextEra was among lower authorized levels. As recently as April 2009, the FPSC had authorized Tampa Electric Company an 11.25% ROE. As could be expected and is shown in Figure 16, the investment community was surprised by the NextEra rate ruling and its reaction was immediately reflected in NextEra's stock performance – with the effect being sustained into the future.

FIGURE 16



In addition, NextEra had its credit ratings downgraded. Below is an excerpt from S&P's March 11, 2010 ratings action:

> FPL's credit fundamentals on its regulated utility side have been among the strongest in the U.S., due primarily to low regulatory risk and an attractive service territory with healthy economic growth and a sound business environment. Both of those pillars have been weakened in the past year as Florida, and FP&L's service territory in particular, have suffered during the recession, and regulators have responded with decisions that reflect more intense political influence over the regulatory environment. Maintaining financial strength despite regulatory setbacks and a slowly improving economy in Florida will be challenging. In addition, the balance between regulated utility operations and unregulated businesses is projected to trend in favor of the riskier merchant generation, marketing, and trading activities as lower returns and higher regulatory risk in Florida lead to changes in capital allocation decisions. This will erode FPL's business risk profile, which we now deem to be "strong" instead of "excellent."[19]

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[19] Standard and Poors, *Research Update: FPL Group Inc. Downgraded to 'A-' From 'A', Off Credit Watch; Outlook Stable*, (March 11, 2010).

V. CONCLUSION

Q. WHAT OBSERVATIONS DO YOU OFFER TO THE COMMISSION AS IT CONSIDERS YOUR APPLICATION AND STAFF'S AND OTHER PARTIES' RESPONSES TO IT?

A. As the Commission, the Staff and intervening parties examine our filing, I believe it will be evident that our request is transparent, conventional, presented in a forthright manner, and contains little, if anything, that should be characterized as controversial. I believe it will withstand the scrutiny of careful audit and verification as to completeness, accuracy and reasonableness. This should not be taken as an assertion that our direct case is infallible or that other approaches have no merit. We will readily acknowledge and correct any errors as we or other parties discover them and will be open to considering reasonable alternatives to adjustments we have proposed.

I also believe the Commission will find that our request reflects necessary, but well-managed cost increases that are consistent with: (a) our continued commitment to being an independent, basic Kansas electric utility, (b) our obligation to provide reliable service at a reasonable cost, and (c) our mutual responsibility to address evolving environmental and reliability energy policy mandates.

Q. THANK YOU.