THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

Before Commissioners: Brian J. Moline, Chair
Robert E. Krehbiel
Michael C. Moffet

In the Matter of the Applications of Westar Energy, Inc. and Kansas Gas and Electric Company for Approval to Make Certain Changes in their Charges for Electric Service.) Docket No. 05-WSEE-981-RTS

BRIEF OF THE CITIZENS' UTILITY RATEPAYER BOARD

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I. Introduction

An application for a rate increase is simply that: an application, like a formal request for more money. The Commission is obligated to review the request with the level of scrutiny that the evidence demands, and render a fair verdict. Some of the scrutiny is a purely mathematical exercise, some of it entails weighing the evidence, and some of it requires choosing between competing opinions.

First and foremost, the decision to set rates at a given level should be a decision that takes into consideration the evidence the Company's management has presented, the evidence of others who have examined the Company's evidence, and should be based on currently recognized ratemaking principles. The decision should be a fair and reasoned assessment of the Company's revenues and expenses, the value of the rate base, and what would be a fair return on the shareholders' investment in light of current returns on similar investments.

The decision should not be regarded as a "referendum" on how well the Company's management has done. The decision to reduce rates, if made, should be based on sound evidence, and if so based, would not be a "punitive" decision, nor one likely to send the Company into a "downward spiral." Nor is it appropriate to scrutinize the Company's expenses and revenues, then subject the resulting conclusions to a "smell test," or a "gut check." If the Commission's scrutiny is thorough, and its assessment of the evidence is fair and reasonable, the end result will necessarily be fair and reasonable, as well: no smell test is required.

II. Summary of Conclusions

Based on the analysis of the Company's filing and other documentation in this case, CURB witness Andrea Crane concluded as follows:

1. The twelve months ending December 31, 2004, is an acceptable test year to use in this case to evaluate the reasonableness of the Company's claim.

2. Westar has a pro forma capital structure that includes 44.59% common equity, 52.41% long-term debt, 0.69% preferred stock, and 2.31% post-1970 investment tax credits ("ITCs"), as shown in Schedules ACC-2N and ACC-2S. [1]

3. The Company has a pro forma cost of equity of 8.75%, as shown in Schedules ACC-2N and ACC-2S and an overall cost of capital of 7.32%.

4. Westar North has a test year pro forma rate base of $1,014,785,586, as shown in Schedule ACC-3N.

5. Westar North has pro forma operating income at present rates of $81,765,713 as shown in Schedule ACC-11N.

6. Westar North has a test year, pro forma, revenue requirement surplus of $12,416,069 as shown on Schedule ACC-1N. This is in contrast to Westar North's claimed deficiency of $47,834,265.

7. Westar South has a test year pro forma rate base of $1,106,877,090, as shown in Schedule ACC-3S.

8. Westar South has pro forma operating income at present rates of $108,458,679 as shown in Schedule ACC-11S.

1 Schedules ACC-1, ACC-37, and ACC-38 are summary schedules, ACC-2 is a cost of capital schedule, ACC-3 to ACC-10 are rate base schedules, and ACC-11 to ACC-36 are operating income schedules. It is important to note that several of Ms. Crane's schedules were revised after her direct testimony was filed.

9. Westar South has a test year, pro forma, revenue requirement surplus of $45,545,398 as shown on Schedule ACC-1S. This is in contrast to Westar South's claimed deficiency of $36,311,462.

10. Westar's generic request for a TDC rate pass-through, based on rates approved by the Federal Energy Regulatory Commission ("FERC"), should be approved.

11. The TDC stipulation and agreement (TDC S&A) reached between Westar and Staff should be rejected.

12. Westar's request for establishment of a RECA should be rejected.

13. Westar's request to recover certain environmental expenditures between base rate case proceedings through an ECRR should be denied.

14. Westar's request for the establishment of a PBR Plan is a thinly-veiled attempt to weaken the KCC's regulatory authority and control, and should be rejected.

III. Capital Structure, Cost of Debt, Cost of Equity and Overall Return

A. Introduction

Westar is asking this Commission to ignore all of the underlying data in this case when setting Westar's allowed return. Westar has couched this case in the rhetoric of a "referendum" on the company's performance. (Lennen, Tr. Vol. 1, at 22; Ruelle, Tr. Vol. 2, 408; Greenwood, Tr. Vol. 3, at 506). Dr. Avera calls regulation the "500-pound gorilla" and puts forth the nonsensical suggestion that the return allowed in this case "is a billion dollar question." (Avera, Tr. Vol. 9 at 1901, 1904). Mr. Ruell and Mr. Greenwood also provide extensive testimony on the disaster that will befall Westar should this Commission accept any recommendation other than the Company's. Mr. Haines is even concerned that he will have been on a "fool's errand" for the last few years: he claims that CURB's recommendations "would force Westar into a struggle for mere survival." (Haines, Reb. Test., at 11, 1). This extreme rhetoric is necessary because Westar knows that if the Commission closely examines the financial data in this case, there is simply no evidentiary support for the level of return that Westar is requesting.

Dr. Avera's Exhibit WEA-4 is instructive. This exhibit shows Commission allowed Returns on Equity (ROE) compared to the Average Public Utility Bond Yield for the period 1974 - 2004. What can be gleaed from this exhibit is that while bond markets in general are efficient and move quickly when there are changes in the underlying financial markets, the Commission allowed ROEs are much slower to move in a downward direction. While Dr. Avera agrees that bond markets are generally efficient, he would not say the same about Commission decision making.2 (Tr. Vol. 9 at 1877). It is certainly understandable that there is reluctance on the part of a Commission to set an ROE that is too low. On the other hand, not recognizing, or intentionally ignoring the underlying financial data and setting ROE higher than necessary to attract capital, does a disservice to the ratepayers who supply the excess profit to the utility through rates.

A close examination of Dr. Avera's Discounted Cash Flow (DCF) model shows that Dr. Avera's DCF result is fundamentally the same as the DCF recommendation of CURB. However, while CURB relies on its DCF results in making its recommendation, Dr. Avera completely ignores his DCF result, puts forth a flawed Capital Asset Pricing Model (CAPM) result that is substantially in excess of his DCF result and pours forth the rhetoric in the hope that the

2 Dr. Avera places the blame for the problems experienced in California squarely on the regulators, stating that when investors invest in utilities now, they worry that "I can get blindsided by the regulators as happened in California." (Tr. Vol. 9, at 1900 - 1903).

Commission will ignore the underlying financial data.

CURB urges the Commission not to ignore the underlying financial data, and to ignore the rhetoric in making its decision. CURB's recommendation in this case is reasonable, and represents the level of return necessary in current markets for a utility like Westar to access capital, and is based on correct financial data and analysis.

B. Capital Structure and Cost of Debt

CURB agrees with Westar's proposed capital structure in this case. (Woolridge D. Test., at 11). Further, CURB agrees with Westar's proposed long-term debt cost of 6.1409%, as updated to reflect the June, 2005 refinancing of Westar's 7.875% first mortgage bonds. (*Id.* at 10). Dr. Woolridge uses Westar's proposed capital structure and long-term debt costs in his analysis and in the formulation of his overall recommendation in this case.

C. Cost of Equity

Based on a proper application of the DCF and the CAPM, CURB recommends the Commission set the ROE for Westar in this case at 8.75%. (Woolridge, D. Test., at 2). While there has been fervent rhetoric by Westar that CURB's recommendation in this case is unreasonable, CURB's 8.75% return is based on an appropriate group of proxy companies and utilizes appropriate DCF and CAPM results. Any thorough look at the underlying data and methodologies used in this case, regardless of witness, supports an outcome similar to Dr. Woolridge's recommendation on behalf of CURB.

Dr. Avera, on behalf of Westar uses an inappropriate group of proxy companies that result in upwardly-biased growth rates in his DCF result, a DCF result he then completely ignores. Through completely unfounded and incorrect mathematical application, Dr. Avera then creates and relies upon an excessive risk premium estimate in his CAPM analysis. Further, Dr. Avera applies a floatation cost adjustment in his analysis, as did other witnesses. Based on these flawed methodologies, and his own "judgment", Dr. Avera recommends an 11.5% ROE as appropriate for Westar. However, after correcting for Dr. Avera's mathematical errors, and eliminating TXU from his proxy group, Dr. Avera's DCF result is 8.6%, below the recommendation of CURB.

Mr. Dunn, on behalf of KIC also produces a flawed analysis in calculating his 10% ROE recommendation. Mr. Dunnutilizes the same inappropriate group of proxy companies as does Dr. Avera. Of chief concern is Mr. Dunn's use of TXU as a proxy company, incorporating Value Line's projected 31% growth rate into his analysis. This alone creates a substantial upward bias in Mr. Dunn's growth rate analysis. Mr. Dunn also exclusively uses Value Line data to produce the growth rate recommendation for his DCF calculation. Exclusive use of Value Line data upwardly biases any DCF growth forecast and results in a flawed analysis. Lastly, Mr. Dunn excludes any negative or zero growth rate data from his forecasts. Mathematically, incorporating only positives in an analysis but ignoring any negatives produces an upwardly-biased growth rate. By simply eliminating TXU from Mr. Dunn's proxy group and changing nothing else in his analysis, Mr. Dunn's DCF result supports an ROE of 8.36%, below that of CURB.

Mr. Gatewood, on behalf of Staff produces a more reasonable proxy group than that utilized by Dr. Avera and Mr. Dunn. However, Mr. Gatewood then relies exclusively on Value Line growth estimates in producing his analysis. Even though Mr. Gatewood recommends a 9.6% ROE, a closer examination shows that his Value Line growth estimates are higher than those of every other reporting service. His reliance on Value Line data, to the exclusion of all other reporting services, results in a recommendation that, like Mr. Dunn's, is upwardly biased.

Mr. Gatewood's CAPM relies on a sustained growth rate of 12.4% in calculating his risk premium. However, when asked whether he expected this level of growth in the future, Mr. Gatewood's reply was "I think the 12.4% is probably a bit high". (Tr,. Vol. 10 at 2142). In essence, Mr. Gatewood discounts the validity of the data in his own risk premium study. Taken literally, Mr. Gatewood's CAPM overstates the risk premium, and therefore overstates the return requirement of Westar.

1. Proxy Group of Electric Companies

To properly evaluate Westar's required return, a proxy group of companies with similar characteristics and risk must be used in determining the return. Dr. Avera uses a proxy group of 18 companies. Mr. Dun, on behalf of KIC uses these same 18 proxy companies. However a close examination of these 18 companies shows that many have significant unregulated or natural gas operations and at least one, Cinergy, is in the process of being acquired. As summarized in Exhibit JRW-3 to Dr. Woolridge's testimony, Centerpoint Energy derives only 17% of its revenue from electric operations, DTE Energy derives 18%, NiSource derives 16% and WPS derives 18%. Several other companies in Dr. Avera's (and Mr. Dunn's) proxy group derive less than 30% of revenue from electric operations. Clearly these are not appropriate proxy companies for Westar, which derives nearly 100% of revenue from electric operations.

The single most inappropriate company to use as a proxy for Westar that is included in Dr. Avera's proxy group is TXU Corp. TXU has only 5% common equity, far outside the range of a healthy utility and not representative of Westar's 45% common equity. TXU derives only 24% of revenues from electric operations. Dr. Avera and Mr. Dunn suggest that TXU is a good proxy for Westar. However, Value Line specifically states that TXU's revenues and growth are primarily related to the recent increase in natural gas prices:

> "TXU sells more than 200 billion cubic feet of natural gas annually. Some of this fuel is sold to other utilities, the balance supplies TXU's gas fired plants, all of which sell their output in the merchant market, free from regulatory oversight. The increase in gas prices results in the sale of power at higher prices. This translates to rising profits and a higher stock price. A word of caution: should natural gas prices in turn lower, these profits would disappear, and the stock price would fall"

(CURB Hearing Exhibit 12).

It is clear that TXU's profits are based on high natural gas prices and electric sales in an unregulated environment, and not on electric utility operations, like Westar. It is simply incorrect to include TXU in a proxy group for Westar. It is quite likely that Mr. Avera included TXU because of the extraordinarily high earnings growth forecast that TXU carries. The earnings growth forecasts for the majority of Dr. Avera's proxy companies fall in the 3 - 6% range. TXU's earnings growth forecast used by Dr. Avera falls in the 15% range. By the time Mr. Dunn drafted his testimony, Value Line had TXU's earnings growth forecasted at 31%. (Dunn, D. Test., Sch. 4, page 2 of 2). Including TXU in a proxy group and averaging in TXU's 15%-30% earnings growth forecast creates a substantial upward bias in the DCF growth estimate. In Mr. Dunn's case, TXU alone biases his earnings growth forecast upwards by nearly 165 basis points. This 165 basis point swing, from the inclusion of TXU represents close to $30 million to Westar shareholders. Clearly, the inclusion of TXU in a proxy group of companies that are suppose to have similar characteristics and risks as Westar calls into question the competence and motives of the witness presenting the analysis. CURB suggests that this fact alone would allow the Commission to dismiss Dr. Avera and Mr. Dunn's testimony outright. Short of dismissing these testimonies, the Commission should specifically exclude TXU from any proxy group.

Dr. Woolridge uses two groups of proxy electric companies. The first group, for comparison purposes, contains the same eighteen electric companies used by Dr. Avera and Mr.

Dunn. The second group used by Dr. Woolridge is a smaller subset of the first group that has been screened to include only those of Dr. Avera's eighteen companies that receive at least 50% of revenues from electric operations. Cinergy is also excluded because it is being acquired by another company. Since Westar receives nearly 100% of revenues from regulated electric operations, this second group is a closer approximation of Westar, and therefore a more appropriate proxy group on which to base a capital cost comparison. CURB recommends that the Commission use Dr. Woolridge's proxy group when setting Westar's return in this case. While Mr. Gatewood also utilized reasonable screening in choosing his proxy group, other errors in Mr. Gatewood's analysis prevent CURB from agreeing with Mr. Gatewood's results.

2. Value Line Data Issues

Mr. Gatewood and Mr. Dunn rely exclusively on Value Line data in making their return recommendations in this case. This exclusive reliance on Value Line data causes both Mr. Gatewood and Mr. Dunn's analysis to be upwardly biased. Mr. Gatewood observes that "believing that every company in the S&P 500 Index will experience positive growth is *overly optimistic and unrealistic*." (Gatewood, D. Test., at 55). And yet, Mr. Gatewood relies exclusively on Value Line, even though he notes in testimony, of the 2600 companies that Value Line follows, that Value Line forecasts negative 3 to 5- year earnings growth for only 8 companies, roughly .003% of the companies it follows. In other words, Value Line is forecasting positive earnings growth for 99.97% of the 2600 companies it follows. CURB suggests that Value Line is overly optimistic and unrealistic; Mr. Gatewood and Mr. Dunn's exclusive reliance on Value Line data is an error.

Not only is Value line overly optimistic in its growth forecasts, but mathematically, Value Line incorporates historical information in calculating future growth rates. Mathematically speaking, if a company has experienced trouble in the last few years, such that earnings growth was small in any particular year, this has the effect of lowering the historical three-year average. Beginning from a depressed historical number, any forward-looking forecast will appear high, because mathematically you start from a lower number. This can be shown by examining CURB Hearing Exhibit 12, the Value Line report for TXU. Earnings for 2002 though 2004 are $2.21, $2.04 and $0.20 respectively. Averaging the 2004 figure of $0.20 with the 2003 and 2004 earnings figures yields a historical three year earnings rate of $1.43. It is from this depressed $1.43 historical base figure that the forward looking earnings growth is calculated. As a result, forward-looking growth will be overstated, simply though the use of historical data in the calculation.

Finally, on cross-examination, Mr. Gatewood had only a vague idea who Arthur Medalie, Paul Debbas or David Reimer are, and knew nothing about these three individual's background or education. (Tr. Vol. 10, at 2137 - 2138). This is an important fact because Mr. Gatewood places 100% reliance on these three individuals' opinions and growth estimates. Arthur Medalie, Paul Debbas or David Reimer are analysts for Value Line and their names are attached to the Value Line sheets for the proxy group included in Mr. Gatewood's testimony. (Gatewood, D. Test, Sch. AHG-3). Placing complete reliance on the growth estimates of only three individuals, individuals he knows nothing about, is a flaw in Mr. Gatewood's analysis. Giving weight to the other reporting services in addition to Value Line, as do Dr. Woolridge and Dr. Avera, provides a more robust and reliable view of expected growth rates.

3. DCF Results

The Commission has historically relied primarily on the DCF model to determine the appropriate level of ROE in a rate case. The DFC model is fairly straightforward. The DCF is the combination of dividend yields plus earnings growth for a proxy group of companies.

As presented in testimony, Dr. Avera and Mr. Dunn use the same proxy group of companies, and Dr. Woolridge uses a smaller subset of this proxy group, because of the concerns discussed above. As presented in testimony, all three have somewhat similar DCF results: Dr. Woolridge's is lowest at 8.5%, and Mr. Dunn's is the highest at 10.00% to 10.75%. It is interesting to note that Dr. Avera and Mr. Dunn, using the exact same companies, arrive at different results.

	Div. Yield	Earnings Growth	DCF Result
Dr. Woolridge	3.99%	4.5%	8.5%
Dr. Avera	4.30%	5.2%	9.5%
Mr. Dunn	4.00%	6.00%-6.75%	10.00% - 10.75%

However, both Dr. Avera and Mr. Dunn include TXU in their proxy group. As detailed above, it is simply inappropriate to include TXU in a proxy group for Westar because TXU has a completely different risk profile and revenue source than Westar. Further, TXU's earnings growth forecasts are clearly excessive and out of line with other companies in the proxy group. Also, as revealed during CURB's cross-examination, Dr. Avera's testimony contained numerous calculation errors that resulted in Dr. Avera overstating the growth rates presented in his testimony. Simply recalculating the above DCF table by correcting Dr. Avera's math errors, and removing only TXU from the proxy group shows that Dr. Avera and Mr. Dunn's DCF results are in line with Dr. Woolridge's DCF result:

	Div. Yield	Earnings Growth	DCF Result
Dr. Woolridge	3.99%	4.5%	8.5%
Dr. Avera	4.30%	4.3%	8.6%
Mr. Dunn	4.00%	4.36%-5.00%	8.36%-9.0%

Mr. Gatewood's intrinsic growth DCF model also produces a result in the 9.0% range. However, based on the flawed Value Line data, Mr. Gatewood's earnings growth DCF is considerably higher at 10.92%. (Gatewood, D. Test., at 17). This result is clearly out of line with every other DCF result in the case, and shows the impact of using overly-optimistic Value Line growth estimates. The Value Line earnings growth estimates for Mr. Gatewood's Proxy group is 6.3%. (Gatewood, D. Test., Sch. AHG-6). Reviewing the earnings growth estimates of other reporting services for Mr. Gatewood's proxy group shows that Yahoo First call is 4.5%, Reuters is 4.2%, Zack's is 4.9% for an average of outside reporting services of a 4.5% earning growth forecast. (Tr. Vol. 11, at 2244). Exclusively using Value Line data in the DCF upwardly biases Mr. Gatewood's result by 150 basis points—or about $30 million dollars to Westar's shareholders. Using the average of other reporting services for Mr. Gatewood's proxy group results in a DCF in the 9% range, much more in line with the other DFC model results presented in this case.

As can be observed from the analysis above, while Westar spends considerable effort and rhetoric criticizing Dr. Woolridge's recommendation, all of the DFC results in this case, with a few appropriate corrections, are well within the range of Dr. Woolridge's recommendation. Every DCF model, when corrected for math errors, corrected to remove TXU from the proxy group or corrected to eliminate exclusive reliance on overly optimistic Value Line earnings growth forecasts, results in a DCF range between 8.3% and 9.0%, clearly in line with Dr. Woolridge's 8.75% recommendation.

With the exception of Dr. Avera, the other witnesses in this case give the DCF analysis more weight in making their recommendations than they give the CAPM analysis. The fact that all the DCF results in this case are in the 8.3% to 9.0% range should clearly indicate to the Commission that an overall ROE in this range is appropriate for Westar and is in line with current capital markets.

4. CAPM Results

In its simplest form, the CAPM model attempts to calculate the level of additional return (risk premium) that an investor requires in order to feel comfortable foregoing the relative safety of bonds to invest in stocks. While the basic concept is simple, in reality, there is considerable disagreement among analysts about the appropriate way to calculate this risk premium. (Woolridge, D. Test., at 28; Tr. Vol. 7 at 1519).

Dr. Avera relies almost exclusively on his CAPM analysis in making his overall ROE recommendation in this case. While Dr. Avera's DCF analysis is only 9.5%, even before making the appropriate adjustments above, his ROE recommendation in this case is 11.5%. Dr. Avera can only get to his 11.5% ROE recommendation by simply ignoring his DFC results and by placing almost exclusive reliance on his CAPM results. For this reason, CURB will focus mainly on the errors in Dr. Avera's CAPM analysis to explain why the Commission should disregard his results. While Dr. Woolridge and Mr. Gatewood also produce a CAPM result (7.6% and 9.63% respectively), neither places the type of wholesale reliance on his CAPM result as does Dr.

Avera.

Dr. Avera produces three separate risk premium analyses. (Avera, D. Test., Exh. WEA-4 through WEA-6). The first risk premium analysis, at Exhibit WEA-4, is a review of commission-allowed ROEs compared to the Average Public Utility Bond Yield for the period 1974 - 2004. As noted above, a close examination of this exhibit shows that commission-allowed ROEs move downward at a much slower pace than the more-efficient bond markets move interest rates downward. Dr. Avera attempts to use the data in this exhibit to suggest that investor's risk premium requirements can be derived from this relationship. However, this relationship is tenuous at best and no real conclusion should be drawn from it.

Where Dr. Avera really reaches beyond the bounds of good analysis is after subtracting bond yields from commission-allowed ROEs, he then statistically regresses the result back onto the bond yields column. Rather than CURB offering the complex and detailed explanation of why this is statistically incorrect, CURB suggests that the Commissioners ask the two Doctors of Economics on its staff why this is incorrect.

On cross-examination, Dr. Avera did admit, based on his Durbin-Watson statistics, that his model has serial correlation problems. (Tr. Vol. 9 at 1880). Again, without going into a detailed statistical explanation, a serial correlation problem invalidates the regression coefficient he uses to calculate his risk premium. Interestingly, while Dr. Avera knew about this serial correlation problem, he did not include any discussion of this issue in his regression results. No qualified statistician would ignore this flaw and present his results as statistically correct. For this reason, Dr. Avera's analysis in Exhibit WEA-4 must be disregarded.

Dr. Avera's second risk premium analysis is also flawed. At Exhibit WEA-5, Dr. Avera presents historical data from 1945-2003 on annualized returns for the Standard and Poor's (S&P)

Electric Utilities compared to annualized returns for S&P Single-A Public Utility Bonds. From this comparison he drives a historical equity risk premium of 3.87%, indicating that stock investors over time expect a 3.87% risk premium above single A-bond returns. Dr. Avera then adds this equity risk premium to the current BBB-bond yield of 6.01%, resulting in an indicated ROE of 9.87%. If Dr. Avera had added his equity risk premium result to current A-bonds, his analysis would be consistent. However, by calculating the equity risk premium based on A-bonds, and then adding the equity risk premium to current BBB-bonds, Dr. Avera has compared apples to oranges to arrive at an overstated ROE indication.

Dr. Avera admits that if we derived an equity risk premium in this same manner, but used historical data for BBB-bonds, we would expect the equity risk premium to be lower than he presents, because BBB-bonds are considered more risky, and would have a higher return over time. (Tr. Vol. 9 at 1883-1884). This higher return over time, when subtracted from S&P annualized return, would result in a lower equity risk premium and indicate a lower ROE recommendation. Via his leap in logic from apples to oranges, Dr. Avera erroneously overstates the required ROE. Dr. Avera also makes an ROE recommendation using this same format, but applying the risk premium to forecasted BBB-bond rates of 7.2%. Through this method Dr. Avera moves his indicated ROE up to 11.0%. Without dwelling on the fact that his forecasted interest rate is extremely high compared to current rates, is suffices to say that this result suffers from the same analytical flaws as does his original analysis. As such, the Commission should disregard this analysis as a poor attempt to manipulate the results.

Dr. Avera's third risk premium analysis is likewise flawed. At Exhibit WEA-6, Dr. Avera calculates a DFC market return and then subtracts the long-term Treasury bond yield from this return to get an overall "market risk premium." Dr. Avera then multiplies this "market risk premium" by the average *beta* for his proxy group. The theory is that electric utilities are generally less volatile that the overall market, with a *beta* less than one, therefore the overall market risk premium must be adjusted downward to reflect this lower level of volatility. Dr. Avera then adds back in the long-term Treasury bond yield to arrive at an "implied cost of equity" in the 12% range. As these are the only analyses presented by Dr. Avera that come close to his overall recommendation in this case of 11.5% ROE, it seems clear that Dr. Avera places great weight on this analysis. No other models or results presented by Dr. Avera come close to the ROE derived from the analysis at Exhibit WEA-6.

The flaw with Dr. Avera's analysis at Exhibit WEA-6 is his starting point; the calculation of overall market returns via the DCF methodology. Dr. Avera posits that investors expect and overall market return of 13.9% (1.8% dividend yield plus 12.1% growth rate). This is simply an unrealistic number, and his method for deriving this number is questionable at best. Dr. Avera begins by using the "average IEBS growth rate for the firms in the S&P 500," as reported by S&P. (Avera, D. Test., at Exh. WEA-6, footnote b). The actual IBES information used by Dr. Avera is presented in Mr. Gatewood's testimony at Schedule AHG-8. Mr. Gatewood notes in his testimony that in the S&P data provide by Dr. Avera, not a single company of the 500 presented has a zero or negative growth forecast. (Gatewood, D. Test., at 54 - 55). This is simply unrealistic. This excessive optimism results in an upwardly-biased growth rate of 12.1% that is the basis of Dr. Avera's analysis in Exhibit WEA-6.

A second and more fundamental flaw in Dr. Avera's 12.1% growth rate is that he uses the simple average of the IBES growth rates for the S&P companies. This has the mathematical effect of weighting every company in the S&P 500 equally at .02%. This methodology gives the same weight to the growth forecast of the largest company in the S&P 500 as it gives the smallest company. This simply makes no intuitive sense, as smaller companies can usually grow at higher rates than large companies like Exxon-Mobil, General Electric or Microsoft. Not even the S&P gives equal weight to the companies in its index. The S&P uses a market-weighted index, weighted by the capitalization of the individual companies. The 10 largest companies in the S&P 500 make up over 20% of the total weight of the S&P 500. (CURB Hearing Exh. 13).

As can be seen in Schedule AHG-8, Dr. Avera's methodology gives the same .02% weight to Exxon-Mobil's 7% growth forecast as it does to Jabil Circuit's 22% growth rate, or Transoceans's 31% growth rate. Since there is no way to accurately derive a weighted-growth forecast of the S&P, and Dr. Avera made no attempt to do so, the Commission should disregard this analysis. Even Mr. Gatewood does not expect growth in the 12% range, even though he uses it in his own CAPM analysis. (Tr,. Vol. 10 at 2142).

Dr. Avera's CAPM and risk premium methodologies are suspect at best and plainly wrong at worst. There is no question that Dr. Avera plays fast and loose with his data and methodologies with the obvious objective of arriving at a higher ROE recommendation for Westar. Where Dr. Avera places almost exclusive reliance on his CAPM and risk premium analysis to arrive at his 11.5% ROE recommendation, the Commission must conclude, based on the evidence, that Dr. Avera's analysis is neither substantial nor competent, and should not be relied on in making a ROE determination in this case. Dr. Avera's results are intentionally overstated, and the Commission must recognize this fact.

5. Floatation Costs

Dr. Avera, Mr. Dunn and Mr. Gatewood all add a floatation cost adjustment to their analysis. Floatation costs are one-time expenses that are incurred when a company sells additional stock. In this case, based on Westar's recommendations, the floatation cost adjustment adds $2 million annually to consumer rates. (Woolridge, D. Test., at 55). It is simply not appropriate to charge consumers $2 million every year in rates when Westar has not historically sold stock every year, and going forward does not intend to do so. Basic regulatory principle requires that only ongoing expenditures should be allowed in consumer rates, but one-time expenditures that are not continually incurred by the company are not appropriate for inclusion in the annual revenue requirement. Even Staff witness Mr. Gatewood questions this practice, but appears to include it simply because the Commission has historically allowed an adjustment for floatation. (Gatewood, D. Test., at 43). However, Mr. Gatewood made clear that the appropriateness of a floatation adjustment to the allowed return is questionable and that Staff "will most likely recommend against floatation costs in the future." (*Id.*).

CURB urges the Commission, given the lack of any evidence in this case that Westar will sell equity each and every year going forward, to reject the floatation cost adjustment in this case. Consumers should not be charged $2 million a year for a fictional expense.

6. Cost of Equity Summary

The Commission has historically relied on the DCF model results in arriving at its allowed ROE in rate cases. CURB recommends an 8.75% ROE in this case, based on an appropriate proxy group of companies and based on appropriate data and methodologies. It is instructive that if the Commission simply removes TXU from Mr. Dunn and Dr. Avera's analysis, and corrects Dr. Avera's mathematical errors, their analyses would also also produce a DCF analysis in line with CURB's 8.75% recommendation. Mr. Gatewood's analysis, while good, relies exclusively on overly-optimistic Value Line data. Simply examining other reporting services growth forecasts for Mr. Gatewood's proxy group clearly shows that if Mr. Gatewood had not exclusively relied on Value Line data, his results would be in line with CURB's 8.75% recommendation.

Only Dr. Avera chose to outright ignore his DCF results, relying instead on flawed CAPM methodologies and flawed data to arrive at his 11.5% ROE recommendation. Under close scrutiny by the Commission, Dr. Avera's methodologies simply fall apart, as does his recommendation of 11.5%.

It is interesting to note that in Dr. Avera's Exhibit WEA-4, it is clear that commission-allowed ROEs move downward at a much slower pace than the underlying market metrics. In this exhibit, Dr. Avera's commission-allowed ROEs are published in a report by Regulatory Research Associates. Westar's Hearing Exhibit - 9 is dated July 2005, and is a more current version of the Regulatory Research Associates Report than the January 2005 version that Dr. Avera utilized. Westar Hearing Exhibit-9 shows that the first-quarter 2005 commission-allowed ROEs are in the 10.3% to 11.0% range. However, the second-quarter commission-allowed ROEs are in the 9.63% to 10.13% range. Clearly, commission-allowed ROEs are moving downward. If the inference in Dr. Avera's testimony is correct, even these lower second-quarter ROEs lag the market to some degree.

Therefore, it is clear from the evidence in this case that the underlying market metrics do not support Westar's ROE recommendation. Rather, the market metrics support an ROE in the range that CURB recommends.. The Commission should ignore Westar's rhetoric and base its ROE decision on the evidence evinced from the current markets.

D. Overall Return

Using Westar's proposed capital structure, Westar's current long-term debt rates and Dr. Woolridge's ROE recommendation of 8.75%, CURB recommends an overall Rate of Return for Westar of 7.32%. (Woolridge D. Test., at 3). Despite Westar's rhetoric, this overall rate of return level is appropriate for Westar given current market conditions, and is supported by substantial competent evidence as presented in the testimony of Dr. Woolridge. Dr. Avera's recommendations are simply outcome-based methodologies that attempt to manipulate data and methodologies to support a rate of return far in excess of any return based on substantial competent evidence. As such, Dr. Avera's analysis must be disregarded by this Commission. CURB recommends adoption of a 8.75% rate of return on equity.

IV. <u>Depreciation</u>

A. Introduction

Depreciation issues in this case are extremely important, because they involve so much money. As CURB's depreciation witness, Michael Majoros, has said, "Depreciation expense is one of the primary cost drivers of public utility revenue requirement calculations because these companies are capital intensive. An excessive depreciation rate can unreasonably increase the utility's revenue requirement and resulting service rates; thereby unnecessarily charging millions of dollars to a utility's customers." (MJM-6, Majoros, D. Test.).

Mr. Majoros' testimony focused on two major areas of inquiry concerning Westar's depreciation claims. He addressed how Westar's witness John Spanos used an excessive future inflation factor in the calculation of future costs of removal of retired plant, which vastly overstates the probable removal costs. He recommended discounting Mr. Spanos parameters to their fair net present value.

Mr. Majoros also addressed changes in financial accounting standards that have occurred since Westar's last rate case. As a result of these changes, he recommended that the Commission recognize as a regulatory liability the costs of removal of plant when the utility has no legal obligation to remove the plant upon retirement. Otherwise, he noted, there is no guarantee that if the removal funds are not spent for their intended purpose, ratepayers will not be credited for their contributions.

CURB urges the Commission to adopt Mr. Majoros' recommendations, as described in more detail below.

B. Background: Docket No. 01-WSRE-436-RTS

The Commission in Docket No. 01-WSRE-436-RTS approved Westar's present depreciation rates. In that proceeding, Westar proposed a depreciation increase based on the testimony and exhibits of Mr. James Aikman. In that case, Mr. Aikman proposed revised (mostly shorter) life spans for Westar's fossil-fuel production power plants, revised decommissioning cost estimates for those plants, and revised service lives and net salvage factors for Westar's so-called mass property accounts. (Majoros, D. Test., at 4 -5).

The Commission largely accepted the depreciation study Mr. Majoros conducted in Docket No. 01-WSRE-436-RTS. Mr. Majoros recommended longer life spans for several of Westar's production plant units than Mr. Aikman proposed. Mr. Majoros accepted a majority of Mr. Aikman's other life proposals and all of his decommissioning and future net salvage proposals. All of Mr. Majoros' recommendations in that proceeding resulted from his comprehensive depreciation study. Mr. Majoros stated, "my acceptance of a life or net salvage parameter reflected active agreement rather than passive acquiescence." (Majoros, D. Test., at 5).

C. Westar's New Depreciation Study, Witness and Proposals

Westar's new depreciation witness, John J. Spanos, sponsors Westar's depreciation study in this proceeding. His proposals would increase annual depreciation expense by $11.5 million for Westar North and $13.4 million for Westar South, relative to current depreciation rates based on December 31, 2003 plant balances. (Majoros, D. Test., at 8). Ironically, even though Westar pursued a vigorous appeal of the Commission's acceptance of Mr. Majoros' longer life span recommendations in Docket No. 01-WSRE-436-RTS, it is now proposing even longer life spans than Mr. Majoros proposed. (Majoros, D. Test., at 7).

Before discussing any specific disagreements with Mr. Spanos, Mr. Majoros explains that he has provided an alternative version of Mr. Spanos' proposed depreciation rates. His Exhibit___(MJM-2) shows Mr. Spanos' proposed depreciation rates broken into two rates that sum to his proposed rate for each account. He shows Mr. Spanos' proposed rates relating to capital recovery and his proposed rates relating to estimated future cost of removal for each account. These separated depreciation rates do not require any changes to current accounting. Mr. Majoros provided these specifically identified depreciation rates merely to facilitate external reporting and for regulatory analysis and rate setting purposes. (Majoros, D. Test., at 8 - 9).

Although Mr. Majoros disagrees with certain aspects of Mr. Spanos' proposals, he states that "should the KCC disagree with everything [Mr. Majoros] has to say ... and approve Mr. Spanos' proposals in their entirety, [he] still recommends that Westar be required to apply the separated depreciation capital recovery and cost of removal rates. In that way, ratepayers at least will have the ability to know how much they are paying for capital recovery versus future cost of removal." (Majoros, D. Test., at 9).

Mr. Spanos' annual accrual, based on December 31, 2003 plant balances, incorporates annual charges for future cost of removal of $24.1 million for Westar North and $19.3 million for Westar South. (MJM-2, Majoros, D. Test.). In fact, estimated future cost of removal and estimated future dismantling costs are the primary drivers of Mr. Spanos' proposed increase. This appears to be the result of Westar's decision to recapture the reduced depreciation rates approved in Docket No. 01-WSRE-436-RTS, which in turn resulted from the Commission's adoption of longer depreciation lives in that proceeding. (Majoros, D. Test., at 12, MJM-7). For this case, Westar "does not challenge longer lives," but rather "increases negative net salvage value, particularly on generating assets." (Majoros, D. Test., at 12, MJM-7; Spanos, Tr. Vol. 6, at 1135 - 1136).

Mr. Majoros disagrees with certain aspects of Mr. Spanos' proposal and rationale. Mr. Majoros asserts that Mr. Spanos' proposal results in excessive depreciation expense and charges to ratepayers. (Majoros, D. Test., at 9). Mr. Majoros also includes a discussion concerning the importance of credibility in depreciation filings and testimony because, in his opinion, based on the evidence discussed in his testimony, Westar's depreciation proposals lack credibility, not just Mr. Spanos' study, but also the very basis for the filing. (Majoros, D. Test., at 11 - 16).

Mr. Majoros bases his conclusions on his depreciation study, his analysis and his identification of new information brought to light by recent accounting pronouncements. (Majoros, D. Test., at 9). He also updated his firm's plant tour of several of Westar's production plants. Mr. William M. Zaetz, who accompanied Mr. Majoros on the original 2001 plant tour, visited three plants and conducted interviews of operating and management personnel at those plants. Mr. Zaetz is a boilermaker familiar with the construction, maintenance and life extension of production plants similar to Westar's. (Majoros, D. Test., at 10, MJM-3). Mr. Majoros also referenced the most recent updates of his firm's national studies of electric plant lives and retirements. (Majoros, D. Test., at 10, MJM-4, MJM-5).

D. Life Recommendations & LaCygne Unit 2 Life Span

For the most part, the Company extended its production plant life spans, relative to those adopted in Docket No. 01-WSRE-436-RTS. That is consistent with the trends Mr. Majoros has been observing in his firm's national studies, and is consistent with Mr. Zaetz' findings. (Majoros, D. Test., at 18). Westar did not, however, extend the life span of LaCygne Unit 2. Instead, Westar proposed the end of the lease period as the final retirement year for LaCygne Unit 2. This results in a far shorter life than expected for the unit. Mr. Majoros disagreed. Mr. Majoros stated that "just because Westar may have worked out some favorable financing deal, it should not charge excessive depreciation to its customers." He recommended the same final retirement year for Unit 2 as Westar proposed for Unit 1. (Majoros, D. Test., at 18 - 19).

In rebuttal, Westar noted that it had renegotiated the lease for LaCygne Unit 2, from 2016 to 2029. (Spanos, Rebut. Test., at 42). Mr. Spanos agreed that this new lease termination date should be used as the final retirement date for life purposes, if the Commission adopts the costs of the new lease. (Spanos, Rebut. Test., at 43). This date is close to Mr. Majoros' recommended retirement date of 2033 for LaCygne Unit 2. (MJM-13, Majoros, D. Test.).

E. Future Cost of Removal

A future cost of removal parameter is a ratio incorporated into the calculation of a depreciation rate to charge depreciation expense for estimated future cost of removal. The inclusion of future cost of removal parameters increases depreciation rates and expense for estimates of future removal costs. They result in charges to current depreciation expense for unmade and potentially never-to-be-made expenditures. The current depreciation rates include cost of removal parameters, and Mr. Spanos included future cost of removal parameters in the proposed depreciation rates. (Majoros, D. Test., at 19).

Mr. Majoros objects to the level of Mr. Spanos' future cost of removal proposals because Mr. Spanos is proposing inflated cost of removal parameters. Exhibit___(MJM-7), filed with Mr. Majoros' direct testimony, demonstrates that Westar filed a depreciation study that would make increases to future cost of removal parameters the primary depreciation issue in this proceeding. Mr. Spanos implemented Westar's policy by proposing vastly inflated cost of removal and dismantlement parameters. (Majoros, D. Test., at 19 - 20).

Even if one accepts the proposition that Westar will actually make these future expenditures, Mr. Majoros objects to Mr. Spanos' inflated cost of removal parameters. The estimated cost must be measured at the fair net present value, not the future inflated value. (Majoros, D. Test., at 20).

Westar's nuclear decommissioning cost charges are based on the fair net present value of the estimated future decommissioning costs. It is notable that Westar actually has a legal obligation to incur nuclear decommissioning costs relating to its Wolf Creek plant. (Majoros, D. Test., at 20).

Westar does not have any legal obligation to spend any money to remove any of its non-nuclear plant. Thus, it is only reasonable, from a comparative standpoint, to assume that future non-nuclear removal expenditures are less likely than future nuclear removal expenditures. Notwithstanding that assumption, it is clearly inappropriate to give special treatment to the non-nuclear estimates by allowing them to be inflated, but not discounted back to their fair net present value. (Majoros, D. Test., at 20).

Such special treatment results in charging future inflation to current ratepayers. Not only is this unfair, it is unnecessary by virtue of Westar's use of the remaining life depreciation technique, which is based on the concept of full capital recovery, including all actual cost of removal expenditures, and also by virtue of this Company's ability to file depreciation studies with updated estimates on a regular basis. (Majoros, D. Test., at 20 -21).

As explained earlier, Exhibit___(MJM-2) (Majoros, D. Test.) reveals that Mr. Spanos has incorporated $43.3 million of annual cost of removal charges in his proposed depreciation rates, based on December 31, 2003 plant balances. However, over the five years ending 2003, Westar only experienced $14.3 million in cost of removal on average, as summarized directly from Westar's depreciation study. (Majoros, D. Test., at 21).

To understand why Westar's cost of removal request exceeds its actual experience to such a large degree, one must only remember that Westar's basic strategy is to increase negative net salvage estimates to replace the lower depreciation rates resulting from its acknowledged longer lives. Mr. Spanos increased the production plant dismantlement estimates by extraordinary amounts of future inflation. In the previous study, Mr. Aikman used the net present value of his estimated per KW cost of dismantlement for production plant. Mr. Majoros and the Commission accepted these estimates. (Majoros, D. Test., at 21 - 22).

Mr. Spanos increased the mass property cost of removal ratios by virtue of the

Traditional Inflated Future Cost Approach, which Mr. Majoros refers to as "TIFCA." Mr. Aikman also used TIFCA for Westar's transmission, distribution and general plant functions in the last study. Mr. Majoros explains that even though he alluded to a possible disagreement, he did not object to Mr. Aikman's TIFCA proposals at the time, because it seemed clear to Mr. Majoros that Mr. Aikman had judgmentally reduced his cost of removal proposals, which in effect reduced the future inflation component. As a result, there was not a wide disparity between his proposals and actual annual cost of removal Westar was incurring at the time. Exhibit___(MJM-11) explains and provides examples of how TIFCA results in inflated cost of removal ratios. (Majoros, D. Test., at 21 - 22).

Westar controls much of the negative net salvage activity it records. Westar is not at the mercy of the market for a majority of the annual cost of removal it incurs. A majority of Westar's retirements result from asset replacements. Westar incurs replacement project costs and then "*allocates*" a portion of the replacement project cost to cost of removal. This allocation is typically a relatively small portion of the overall replacement project cost. Westar could just as easily capitalize 100 percent of the replacement cost to plant in service and depreciate it, with no allocation to cost of removal. Although Westar may indeed incur some actual cost of removal in the future, the massive amounts that Mr. Spanos proposes to collect are, for the most part, a fiction. (Majoros, D. Test., at 22 - 23).

F. Mr. Majoros' Recommended Approach

As Mr. Majoros explains, there are alternatives to TIFCA. There is a "cash basis" alternative (expensing), and two "accrual basis" alternatives (normalized net salvage allowance and the net present value approach). There are probably more alternatives. (Majoros, D. Test., at 23).

Mr. Majoros recommends the net present value approach. The net present value approach merely discounts Westar's future net salvage estimates, using the average remaining lives, back to 2003 values using the 3 percent inflation factor that Westar used for its inflation to the dismantlement cost estimates. In other words the net present value approach essentially takes the "I", or inflation, out of TIFCA. Assuming the validity of Westar's claim that it will actually spend the money it collects for future negative net salvage on future negative net salvage, the NPV approach resolves the concerns regarding future inflation. The NPV approach is consistent with the Commission's depreciation rules, and is consistent with GAAP. (Majoros, D. Test., at 23-24).

If the Commission does not adopt the NPV approach, or one of the other alternatives, the regulatory liability resulting from TIFCA will immediately jump by over $43 million and will continue to grow by more than $43 million, less actual cost of removal, per year. In the near future, that decision will result in liabilities to ratepayers in the hundreds of millions of dollars. (Majoros, D. Test., at 24).

Exhibit___(MJM-12) calculates the net present values of Westar's proposed future net salvage values. (Majoros, D. Test., at 24). Mr. Majoros' recommended depreciation rates are included in Exhibit___(MJM-13). (Majoros, D. Test., at 25).

These exhibits were updated to reflect Mr. Majoros' acceptance of recommendations made by Staff Witness Larry Holloway. Mr. Majoros accepts Mr. Holloway's recommendations to remove terminal net salvage costs for non-nuclear steam production plant, and to combine the depreciation rates for Westar Energy's North and South transmission and distribution plant. (Majoros, Rev. to Schedules at 1). Exhibit___(MJM-15) is a revised version of

Exhibit___(MJM-12), reflecting the removal of terminal net salvage from the cost of removal ratios for steam production plant, before discounting those ratios using a 3% discount rate. (Majoros, Rev. to Schedules at 1). Exhibit___(MJM-16) is a revised version of Exhibit___(MJM-13), Mr. Majoros' recommended rates. It does not reflect the combined rates for transmission and distribution. (Majoros, Rev. to Schedules at 2). Exhibit___(MJM-17) shows Mr. Majoros' recommended rates for transmission and distribution plant combined for Westar North and Westar South. (Majoros, Rev. to Schedules at 2).

Mr. Majoros has provided both his original recommendations and his revised recommendations in two formats. The first is on a single rate per-account basis, and the other shows the rates separated between capital recovery and cost of removal for each account. The two rates sum to the single rate. (MJM-13, MJM-16, MJM-17, Majoros, D. Test.).

G. New Information and New Issues

The Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standard No. 143 ("SFAS No. 143") addresses asset retirement obligations ("AROs") associated with long-lived plant. The Federal Energy Regulatory Commission's ("FERC") Order No. 631 is that agency's implementation of SFAS No. 143 for regulatory purposes. (Majoros, D. Test., at 25).

When a company has a legal ARO, SFAS No. 143 requires that the discounted fair value of the liability be capitalized and depreciated as a component of the original asset's cost. If it is determined that the utility has collected too much past depreciation relating to the ARO, the excess is to be reported as a regulatory liability. Also, if a utility has collected for future cost of removal in its depreciation rates, but does not have a legal obligation to spend the money, SFAS

No. 143 requires these excesses to be reported as a regulatory liability. (Majoros, D. Test., at 25-26).

FERC identified these latter amounts as "non-legal" asset retirement obligations, meaning that utilities do not have actual legal obligations and liabilities to incur these costs in the future. This is consistent with the SFAS No. 143 requirement to report excessive accumulated depreciation associated with legal AROs as a regulatory liability. (Majoros, D. Test., at 26).

Westar's 2004 Annual Report to Shareholders reports the following regarding regulatory liabilities in compliance with SFAS No. 143:

> We have recovered amounts in rates to provide for recovery of the probable costs of removing utility plant assets, but which do not represent legal retirement obligations. At December 31, 2004, Westar Energy [KPL] had $1.3 million in removal costs classified as a regulatory asset and KGE had $2.6 million in removal costs classified as a regulatory liability. At December 31, 2003 we had $6.6 million in removal costs classified as a regulatory asset. The net amount related to non-legal retirement costs can fluctuate based on amounts related to removal costs recovered compared to removal costs incurred.
>
> (Majoros, D. Test., at 26).

Westar explains why it reported a regulatory asset for both companies in 2003, but only for KPL in 2004. Paragraph 20 of SFAS No. 143 states, in part:

> An additional recognition timing difference may exist when the costs related to the retirement of long-lived assets are included in amounts charged to customers but liabilities are not recognized in the financial statements. If the requirements of Statement 71 are met, a regulated entity also shall recognize a regulatory asset or liability for differences in the timing of recognition of the period costs associated with asset retirement obligations for financial reporting pursuant to this Statement and rate-making purposes.

(Majoros, D. Test., at 26 - 27).

Reporting the cost of removal amounts as a regulatory asset indicates that the Company has incurred more for cost of removal than it has accrued, and that it considered that amount to be a timing difference resulting in a regulatory asset, i.e., an amount it could collect from ratepayers. In 2003, Westar North (KPL) had a regulatory asset of $4.5 million and Westar South (KGE) had a regulatory asset of $2.1 million (a total of $6.6 million as reported in the Annual Report). This means that as of 2003, Westar calculated that it had spent $6.6 million more on cost of removal than it had accrued in its rates. (Majoros, D. Test., at 27).

Westar is no longer spending more on cost of removal than it is collecting. Between 2003 and 2004, the regulatory asset for KPL decreased from $4.5 million to $1.3 million, a reduction of $3.2 million. Although there is still a gap between what has been expended and what has been accrued, that gap is narrowing. KGE's gap narrowed and then moved the other way. The $2.1 million regulatory asset in 2003 has become a $2.6 million regulatory liability in 2004, a difference of $4.7 million. On a combined basis, Westar now has a regulatory liability of $1.3 million. (Majoros, D. Test., at 27).

The change from a regulatory asset to a regulatory liability is due to more cost of removal being collected than expended as a result of the depreciation rates approved in the last rate case. These are cumulative amounts. While old depreciation rates may have not included enough provision for cost of removal, it is clear that the current rates include more than enough. Otherwise, the regulatory asset would remain the same, or grow larger. (Majoros, D. Test., at 28).

The regulatory liability is relatively small because according to Westar's calculations, it experienced more actual cost of removal than it collected prior to the adoption of the current depreciation rates in Docket No. 01-WSRE-436-RTS. Since then, cost of removal recovery has exceeded Westar's actual annual experience. Thus, even at current levels the regulatory liability will continue to grow. (Majoros, D. Test., at 28).

Mr. Spanos' cost of removal factors will increase this growth to an exorbitant level each year. As explained earlier, that is because Mr. Spanos' use of TIFCA results in the incorporation of high levels of future inflation in depreciation rates, applied thereafter to ever-expanding depreciable plant balances. The resulting accruals vastly exceed, year-by-year, the money Westar will actually spend or even allocate to cost of removal. SFAS No. 143 and FERC Order No. 631 have recognized and highlighted the excess collections, and SFAS No. 143 requires reporting them as a regulatory liability for GAAP purposes. (Majoros, D. Test., at 28).

There are two new issues that result from this new information provided by SFAS No. 143 and FERC Order No. 631. The most important new issue is for the Kansas Corporation Commission specifically to recognize the regulatory liability for regulatory and ratemaking purposes. From there, the Commission should require separate identification and reporting of these amounts. (Majoros, D. Test., at 29).

H. The KCC Should Specifically Recognize the SFAS No. 143 Regulatory Liability

SFAS No. 71—Accounting for the Effects of Certain Types of Regulation— defines regulatory liabilities from a GAAP perspective. Paragraph 11, which is summarized below, defines a regulatory liability. Of particular importance to the issues under discussion are paragraphs 11 and 11. b.

SFAS No. 71 – Regulatory Liabilities

> 11. Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers. The following are the usual ways in which liabilities can be imposed and the resulting accounting:
>
> a. A regulator may require refunds to customers . . . .

> b. A regulator can provide current rates intended to recover costs that are expected to be incurred in the future with the understanding that if those costs are not incurred future rates will be reduced by corresponding amounts. If current rates are intended to recover such costs and the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the enterprise shall not recognize as revenues amounts charged pursuant to such rates. Those amounts shall be recognized as liabilities and taken to income only when associated costs are incurred.
>
> c. A regulator can require that a gain or other reduction of net allowable costs be given to customers over future periods . . . . (Majoros, D. Test., at 29 - 30).

Westar properly reports these as a net regulatory liability in its Form 1 reports. However, Westar is silent on the matter in its rate case filing. Furthermore, Westar has not, in its depreciation study, specifically identified these amounts in separate sub-accounts of depreciation expense and accumulated depreciation. (Majoros, D. Test., at 30).

The KCC must recognize specifically the regulatory liability, because Westar believes the amounts in the regulatory liability account belongs to its shareholders, even if it does not spend the money for cost of removal. CURB Data Request No. 239, [Majoros, D. Test., Appendix, Exhibit___(MJM-14)] asked Westar the following:

> a. Does Westar agree that the amounts in the cited regulatory liability account are refundable obligations to ratepayers until they are spent on their intended purpose? If not, why not?
>
> b. Does Westar believe that amounts recorded in accumulated depreciation represent capital recovery? If not, why not?
>
> c. Whose capital is reflected in accumulated depreciation – shareholders' or ratepayers'?
>
> Westar's response, as prepared by Dick Rohlfs, was as follows:
>
> a. No.
>
> b. Yes.

c. Accumulated Depreciation is the return of invested capital over time. The invested capital was made by shareholders.

(Majoros, D. Test., at 30-31).

Other electric utilities have treated these amounts as their own money and taken past collections of cost of removal into income when their production plants were deregulated. For example, American Electric Power, which had several of its production plants deregulated, immediately took $473 million from accumulated depreciation and transferred it into income relating to those deregulated plants. (Majoros, D. Test., at 31).

In another example, Tucson Electric Power Company ("TEP") stated:

> TEP had accrued $113 million for final decommissioning of its generating facilities . . . . this amount was reversed for 2002 and included as part of the cumulative effect adjustment of accounting adjustment when FAS 143 was adopted on January 1, 2003.

This means that TEP took non-legal AROs into income. (Majoros, D. Test., at 31).

TEP applied SFAS No. 71 - Accounting for the Effects of Certain Types of Regulation - to its regulated operations, which include the transmission and distribution portions of its business. As a result TEP recorded the cost of removal collected for regulated non-legal AROs as a regulatory liability. According to TEP's December 31, 2004 10K Report,

> As of December 31, 2004, TEP had accrued $67 million for the net cost of removal of the interim retirements from its transmission, distribution and general plant. As of December 31, 2003, TEP had accrued $60 million for these removal costs. The amount is recorded as a regulatory liability.

However, also according to TEP's December 31, 2004, 10K Report:

> If TEP stopped applying FAS 71 to its remaining regulated operations, it would write off the related balances of its regulatory assets as an expense and its regulatory liabilities as income on its income statement.

(Majoros, D. Test., at 32).

Other previously-regulated industries have taken non-legal ARO amounts into income. While regulated, the telephone industry collected substantial amounts of future cost of removal through depreciation, just as Westar is proposing here. Upon deregulation and the adoption of SFAS No. 143, the major telephone companies took $11.5 billion from accumulated depreciation into net income. (Majoros, D. Test., at 32).

FERC Order No. 631 reflects FERC's adoption of SFAS No. 143. However, FERC does not require classification and reporting of non-legal AROs as regulatory liabilities. Although the FERC has recognized and identified the amounts involved and requires separate accounting for those amounts, the FERC has deferred to the states regarding recognition of the regulatory liability. FERC Order No. 631 requires jurisdictional entities to:

> . . . maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes. Therefore, the Commission [amended] the instructions of accounts 108 ... in Parts 101 ... to require jurisdictional entities to maintain separate records for the purposes of identifying the amount of specific allowances collected in rates for non-legal retirement obligations included in the depreciation accruals.

(Majoros, D. Test., at 32 - 33).

It is necessary, therefore, for the KCC to recognize a regulatory liability for the non-legal cost of removal and dismantlement amounts. Although FERC Order No. 631 provides a new transparency by requiring identification of the amounts and maintenance of separate subsidiary records for regulatory analysis and rate setting purposes, it did not establish a regulatory liability for non-legal asset retirement obligations. Therefore, there is no regulatory recognition of such a liability and there is no provision for a refund to ratepayers if the amounts they have paid are not spent on cost of removal or dismantlement. (Majoros, D. Test., at 33).

In other words, nothing holds Westar directly accountable for these excess collections from a regulatory standpoint. Note that regardless of the transparency provided by FERC, Westar did not address the issue in its depreciation study or its rate case filing in general. Experience indicates that it is highly unlikely that these amounts will be spent for cost of removal in the magnitude that they have been collected. Nevertheless, even if it was highly probable that this money will all be spent for cost of removal, it is fair and reasonable for the KCC to specifically recognize the ratepayers' security interest in these monies until they are actually spent on their intended purpose. Unless they are explicitly identified as "subject to refund," they are a hidden potential source of income for Westar. (Majoros, D. Test., at 34).

I. KCC Should Require Separate Identification and Regulatory Reporting

The KCC should require that Westar explicitly identify and report this regulatory liability and all related activity in all future reports, rate cases, and depreciation studies that it files with the KCC. Furthermore, the KCC's explicit recognition of this amount as a regulatory liability should be prominently disclosed in Westar's Form 1 reports. (Majoros, D. Test., at 34).

It would not be sufficient to report the item as a "deferred credit" of some sort. Treatment as a deferred credit would defeat the purpose. Westar could easily assert in the future that ratepayers have no claim to a deferred credit. In other words, Westar could claim that a deferred credit is the Company's money, not ratepayer's money. The item must be recognized by the KCC, and Westar must report a regulatory liability for regulatory and ratemaking purposes. (Majoros, D. Test., at 34 - 35).

J. Existing Regulatory Liability Treatment

Once recognized and protected as a regulatory liability, it should be used to develop an ongoing remaining life cost of removal depreciation rate, which is reported separately. That is how Mr. Majoros treated the regulatory liability in his depreciation study. (Majoros, D. Test., at 35).

K. Summary of Recommendations

CURB urges the Commission to adopt all of Mr. Majoros' recommendations. Mr. Majoros recommends that the Commission require that Westar provide a better explanation of the timing underlying its "appeal adjustment" and more documentation for the number; the adjustment should be part of the depreciation study rather than as a separate amortization.

Mr. Majoros recommends the same final retirement year for LaCygne Unit 2 as Westar proposed for LaCygne Unit 1.

He also recommends that all of Mr. Spanos' dismantling and future cost of removal parameters be discounted to their fair net present value using a 3 percent inflation factor. He recommends that depreciation rates be split into separate capital recovery and cost of removal components.

Finally, he recommends that the KCC specifically recognize the refundable regulatory liability resulting from Westar's collection of excessive non-legal ARO charges. The KCC should recognize this as a regulatory liability for regulatory reporting, regulatory analysis, and ratemaking purposes in Kansas. (Majoros, D. Test., at 35 - 36).

V. Transmission Delivery Charge Stipulation and Agreement (TDC S&A)

A. The TDC S&A Represents A Radical Departure From The Filed Positions Of Both Staff And Westar And Shifts $13.3 Million Of Revenue Responsibility From Wholesale To Jurisdictional Ratepayers.

The purpose of the TDC is to allow Westar to recover the jurisdictional portion of its transmission-related revenue requirement from retail customers pursuant to FERC-approved transmission rates. Staff and Westar originally proposed distinct methodologies for determining the proper level of the TDC. (*See,* Oakes, D. Test., at 10; Seelye, D. Test., at 6; *generally,* Doljac D. Test.). However, on October 25, 2005, Staff and Westar entered into an S&A to resolve all TDC issues using a previously unsupported TDC methodology. (Doljac, Supp. Test, at 1 - 4).

CURB witness Brian Kalcic identified two (2) major differences between the methodology used in the TDC S&A for determining the jurisdictional portion of Westar's claimed TDC revenue requirement, and that employed in the Company's filed case. The first change involves a reallocation of the Company's claimed TDC revenue requirement of $81.571 million between jurisdictional and non-jurisdictional customers. This reallocation is necessitated by the fact that the TDC S&A removes *all* wholesale demand contributions from the Company's total 12 monthly coincident peak ("12-CP") transmission demand to determine the retail transmission demand contributions of each operating division. In contrast, only a portion of such wholesale demand was removed from the reported "retail" transmission demand of each operating division in the Company's filed case. (Kalcic, Supp. Test, at 1 - 2).

The second change is an accounting adjustment pertaining to the level of wholesale transmission revenues to be removed from Westar's retail cost of service. Mr. Kalcic testified that this accounting adjustment is a by-product of the previously identified change in jurisdictional TDC cost responsibility. Consistent with the removal of all wholesale transmission loads (i.e., costs), the TDC S&A seeks to remove all wholesale transmission revenues from the base rate portion of Westar's retail cost of service. In the Company's filed case, a portion of wholesale transmission revenues remained in Westar's claimed cost of service, acting as a credit to retail base rates. (Kalcic, Supp. Test, at 2).

Mr. Kalcic summarized the net effect of the above changes in TDC methodology in Table 1 of his supplemental testimony, which is reproduced for convenience as Table BK-1 below: (Kalcic, Supp. Test., at 2 - 3).

Table BK-1

	Westar Filed Case	*Proposed TDC S&A*	*Difference*
	(1)	(2)	(3)
Jurisdictional TDC Allocation	$71,676,528 a/	$62,509,409 b/	($9,167,119)
Wholesales Transmission Revenues Removed	$4,206,064	$26,624,312	$22,418,248
Net Retail COS Adjustment			$13,251,129

Source: a/ As filed, 87.87% of $81.571 million.
b/ Per TDC S&A, 76.60% of $81.571 million.

If the TDC S&A were to be approved, the net impact on jurisdictional customers would be an increase in total revenue responsibility of $13.251 million over that reflected in the Company's filed case.[3]

3 The net increase of $13.251 million is comprised of two (2) components: 1) a reduction in jurisdictional revenue responsibility of $9.167 million due to a reduction in the applicable jurisdictional allocation factor from 87.87% to 76.60%; and 2) an increase in jurisdictional revenue responsibility of $22.418 million due to an increase in the amount of wholesale transmission revenues (i.e., credits) to be removed from Westar's retail cost of service.

B. The TDC S&A Fails To Unbundle Account 447 (Sales For Resale) Revenues Properly.

Conceptually, Mr. Kalcic agreed that if 100% of wholesale transmission cost is removed from retail cost of service, as proposed in the TDC S&A, then 100% of wholesale transmission revenues should also be removed. (Kalcic, Supp. Test., at 3). However, not all of Westar's wholesale transmission revenue is readily identified on the Company's books. In particular, wholesale transmission revenues are booked to two accounts: a) Account 456 – Other Electric Revenues; and b) Account 447 – Sales for Resale. However, revenues booked to Account 447 – Sales for Resale is derived largely from bundled wholesale contracts that cover *both* transmission- and production-related costs. (Oakes, Rebut. Test., at 9). As a result, the TDC S&A must "impute" a certain level of transmission revenues to wholesale customers from Account 447 before such revenue can be removed from the Company's retail cost of service. (TDC S&A, ¶ 3).

As Mr. Kalcic explained, the proposed TDC S&A methodology for unbundling Account 447 revenues is deficient on two (2) levels. As a result, the TDC S&A removes too much wholesale revenue from Westar's claimed retail cost of service, to the detriment of jurisdictional customers. (Kalcic, Supp. Test., at 3 - 4).

First, the methodology employs the Company's *proposed* FERC transmission rate to unbundled *present* (i.e., test year) Account 447 revenues. In doing so, the TDC S&A gives wholesale customers credit for paying Westar's proposed FERC transmission rate during the test year, even though the Company's proposed FERC transmission rates will not have gone into effect until December 1, 2005. (Tr. Vol. 11, at 2313). This mismatch clearly imputes too great a level of transmission revenues to the bundled Account 447 revenues derived from Westar's existing wholesale contracts. (Kalcic, Supp. Test, at 4).

Second, by applying a FERC transmission rate to Westar's wholesale billing determinants, the TDC S&A derives not only an unbundled (i.e., imputed) wholesale transmission revenue level, but an implicit wholesale generation revenue level as well. This imputed wholesale generation revenue level is simply the *residual* revenue level that remains in Account 447, or $41,013,158 per Exhibit__MD-1, Schedule B. Unfortunately, while the TDC S&A unbundling methodology assures that Westar will recover its wholesale transmission costs, it cannot insure that the residual generation-related revenues are sufficient to cover Westar wholesale generation costs. This outcome leaves jurisdictional customers at risk for any unrecovered wholesale generation costs. (Kalcic, Supp. Test., at 5-6).

Stated differently, if the TDC S&A had unbundled Account 447 revenues in a direct manner that first assured that retail customers were made whole for the generation costs associated with Westar's wholesale contracts, with the residual Account 447 revenue deemed transmission related, there is no assurance that such residual transmission revenues would be a positive amount, much less the $7,958,607 shown in the TDC S&A. (Kalcic Supp. Test., at 6-7).

The full extent of the deficiencies inherent in the TDC S&A unbundling methodology is illustrated in Table BK-1 above. If the TDC S&A were to be approved, wholesale customers would be assigned $19.062 million of the Company's total claimed TDC revenue requirement of $81.571 million. (Subtracting the TDC S&A's jurisdictional allocation of $62.509 from $81.571 million results in a wholesale assignment of $19.062 million). At the same time, the TDC S&A would remove $26.624 million of alleged wholesale transmission revenue from Weatar's retail cost of service. (See column 2 of Table BK-1). Accordingly, the TDC S&A *deems* wholesale customers to be paying Westar $7.562 million too much for transmission service, i.e., $26.624 million in transmission revenues minus $19.062 million in assigned TDC costs, under their current Westar contracts. Given the grandfathered nature of many of these contracts, such an outcome is both surprising and unintuitive, and underscores the need for the Commission to modify the TDC S&A methodology for unbundling Account 447 revenues.

C. At A Minimum, The Commission Should Order Westar To Use Its Current FERC Transmission Rates To Unbundled Account 447 Revenues.

The Company's present FERC transmission rate for point-to-point service is $1.3925 per KW-mo, including SPP Administrative Fees and Related Assessments. (Kalcic, Supp. Test., Schedule BK-3S). Mr. Kalcic demonstrated that using this present FERC rate in place of the $1.7234 per KW-mo that appears in Exhibit__MD-1, Schedule B would result in unbundled Account 447 transmission revenues totaling $6,335,597.[4] Carrying this revision through to completion, the total amount of transmission revenue to be removed from Westar's retail cost of service would become $17,716,025, rather than the $19,094,238 shown in Exhibt__MD-1, Schedule B, which would represent, all else equal, a total savings to jurisdictional customers of $1,378,213.

If the Commission were to adopt this modification to the TDC S&A unbundling methodology, wholesale customers would still be assigned $19.062 million of the Company's total claimed TDC revenue requirement of $81.571 million. However, the modified TDC S&A would remove only $25.246 million of alleged wholesale transmission revenue from Westar's retail cost of service. (Subtracting $1.378 million from the $26.624 million shown in Table BK-

4 Per Schedule BK-3S. Unlike the proposed TDC S&A, Schedule BK-3S also treats *all* Account 456 revenues as transmission related, consistent with Mr. Oakes' representation on page 10 of his Rebuttal Testimony that no portion of such revenue is generation-related.

1 results in \$25.246 million of transmission revenue to be removed from Westar's retail cost of service). Accordingly, this modification to the TDC S&A would reduce the amount by which transmission customers were deemed to be overpaying Westar for transmission service under their current Westar contracts from \$7.562 million to \$6.184 million, or \$1.378 million.

D. The Commission Should Treat 100% Of Account 447 Revenues As Generation Related To Safeguard The Interests Of Jurisdictional Ratepayers.

The Commission no longer has jurisdiction over Westar's transmission-related revenue requirement. Instead, FERC will determine Westar's transmission revenue requirement, the jurisdictional portion of which will automatically be passed along to retail customers via future changes in the TDC. As such, it is particularly important that the Commission approves a TDC mechanism that does not penalize jurisdictional customers. (Kalcic, Supp. Test., at 7).

Absent a detailed analysis of Westar's bundled wholesale contracts, which would assure an appropriate unbundling outcome for Account 447, the Commission should give jurisdictional customers the benefit of the doubt regarding the unbundling of Account 447 revenues by treating 100% of such revenues as generation related. This approach would retain \$7.958 million of Account 447 revenue as a credit to Westar's retail cost of service, and reduce the net impact of the proposed TDC S&A on retail customers that is shown in Table BK-1 by a like amount.

VI. Ancillary Service Revenue Credits

A. The TDC Revenue Requirement Does Not Reflect The Cost Of Westar's Transmission-Related Ancillary Services.

Westar has not unbundled all of its transmission-related costs in deriving its proposed

TDC revenue requirement. In particular, the TDC revenue requirement does not reflect the cost associated with any of the following transmission-related ancillary services: a) Schedule 1 – Scheduling System Control and Dispatch Service; b) Schedule 2 - Reactive Supply and Voltage Control Service; c) Schedule 3 - Regulation and Frequency Response Service; d) Schedule 4 - Energy Imbalance Service; e) Schedule 5 - Operating Reserves and Spinning Reserves Service; and f) Schedule 6 - Operating Reserves and Supplemental Reserves Service. Instead, Westar recovers the costs of the above ancillary services via its base rates. (Oakes, Rebut. Test., at 3-4).

B. Westar's Ancillary Service Revenue Credit Should Be Based Upon The Final Ancillary Service Rates Approved By FERC.

Consistent with the fact that the Company recovers the cost of ancillary services in its base rates, Westar presently credits the revenues collected under its ancillary service schedules to KCC-jurisdictional customers. (Oakes, Rebut. Test., at 4). Upon cross-examination by CURB, Mr. Oakes agreed that the test-year level of ancillary service revenue credited to KCC-jurisdictional in the Company's filed case is $6,596,661. (Tr. Vol. 11, at 2316). Mr. Oakes also agreed that the test-year credit of $6,596,661 does not reflect the Westar's proposed ancillary service charge increases in FERC Docket No. ER05-925. (Tr. Vol. 11, at 2320 - 21).

Since ancillary services have not been unbundled via the TDC revenue requirement, Westar will continue to provide ancillary services to non-jurisdictional customers using bundled, i.e., base rate, resources. As such, it is appropriate that Westar should credit the ancillary service charge revenues received from non-jurisdictional customers toward the base rate revenue requirement of its retail customers. However, given the Company's requested increase in ancillary service charges in FERC Docket No. ER05-925, it is also appropriate that Westar update its test-year ancillary service charge credit of $6.59 million, based upon the final ancillary service rates approved by FERC, in order to determine Westar's required base rate revenue adjustment in this proceeding. (Kalcic, D. Test., at 8).

C. Updating The Company's Ancillary Service Revenue Credit Need Not Subject Westar's Base Rates To Potential Refund.

Westar disagrees with CURB's recommendation to update the ancillary service revenue credit. Westar states that unlike its FERC formula rate transmission revenue requirement, the Company's ancillary service rates are not updated on an annual basis, and would not be recovered through the TDC. Westar also states that absent a settlement, Westar's ancillary service rates will go into effect subject to refund on December 1, 2005, and will remain subject to refund until FERC approves permanent rates. Mr. Oakes argues that should the Commission adopt CURB's recommendation to update the ancillary service revenue credit, the Company's base rates would be subject to potential refund and change for an indefinite period of time. Instead, Mr. Oakes argues that the Commission should limit the ancillary service revenue credit to the test-year level included in the Company's filed case. (Oakes, Rebut. Test., at 6 - 7).

The Commission should reject Westar's concerns about base rate revenue uncertainty, and adopt CURB's recommendation to update the Company's ancillary service revenue credit. In the event that FERC issues an order approving final ancillary service charges that differ from the Company's proposed charges, the Commission could direct the Company to reconcile any resulting change in the ancillary service revenue credit in a manner that does not affect the Company's base rates. For example, Mr. Oakes agreed on cross-examination that it would be possible to reconcile the ancillary service revenue credit within the Company's proposed Retail Energy Cost Adjustment (RECA). (Oakes, Tr. Vol. 11, at 2322 - 2323). Reconciling the ancillary service revenue credit, if necessary, within the RECA would satisfy the Company's *sole* objection to CURB's proposal, i.e., that it would introduce base rate revenue uncertainty, and would allow jurisdictional customers to be fully compensated for the base rate resources that are used by non-jurisdictional customers when taking transmission service.

VII. Rate Design And Class Cost of Service

A. Westar And CURB Have Narrowed Their Differences With Respect To Residential Rate Structure.

CURB recognizes that the final revenue requirement levels awarded to Westar North and Westar South in this proceeding will differ from those requested by the Company. Similarly, CURB is aware that the Commission may decide to implement a class revenue distribution that assigns different degrees of revenue responsibility to individual rate classes than that proposed by Westar. Nevertheless, CURB utilized Westar's claimed revenue requirement levels to illustrate its residential rate structure recommendations, and to develop the rate design principles that should be used to develop final rates at the conclusion of this proceeding. (Kalcic, D. Test., at 15 - 16).

Westar seeks to implement a number of changes to its residential rate structure, including: a) establishing equal customer charge levels in both rate areas; b) creating the same energy rate block levels across all residential rate schedules; and c) implementing the same approach for qualifying customers for conservation service. CURB is not opposed to the goal of aligning the residential rate structures in Westar North and Westar South. However, as discussed below, this goal would be best addressed by implementing CURB's recommended residential rate structure at the conclusion of this proceeding. (Kalcic, D. Test., at 10 - 11).

Upon reviewing Westar's proposed residential rate structure, Mr. Kalcic accepted the Company's proposals with respect to establishing identical customer charges and conservation use service criteria across Westar North and Westar South, and to switch June to a summer billing month. However, Mr. Kalcic rejected the Company's proposals to implement declining block winter energy charges for its non-heating service classes, and to implement a third summer rate block. (Kalcic, D. Test., at 11 - 12). Mr. Kalcic utilized the Company's proposed residential revenue requirement levels in Westar North and South to illustrate his recommended residential rate structure, as shown in Schedules BK-2 through BK-5.

Westar responded to Mr. Kalcic's residential rate structure proposals in Mr. Rohlfs' rebuttal testimony. Mr. Rohlfs testified that "CURB has recommended that the summer rate blocks be limited to two inclining steps and . . . [we] can agree with it in principle. The rate blocks, however, may need to be modified slightly." (Rohlfs, Rebut. Test., at 26).

However, Westar does not accept CURB's recommendation that the winter energy charge for non-heating residential customers remain flat. (Rohlfs, Rebut. Test., at 26). Inasmuch as the Company continues to propose that declining block winter energy charges apply to non-heating customers, which CURB cannot accept, this issue remains unresolved and is briefed in detail below.

B. The Commission Should Reject Westar's Proposal To Implement Declining Block Winter Energy Charges For Non-Heating Residential Customers.

Westar currently maintains a flat winter energy block rate structure for *all* of its non-heating residential service classes in Westar North and South. Moreover, Westar offers two (2) rate schedules for heating customers in Westar South, but no heating rate schedule in Westar North. The Company's proposal to implement a declining block winter energy charge would allow it to consolidate its Space Heating and Apartment Heating rate schedules with its Standard Service rate in Westar South.[5] However, that outcome, in and of itself, does not provide sufficient reason to implement declining winter rates for *all* non-heating customers.[6] It is common practice for utilities to maintain separate heating and non-heating service schedules for residential customers, and that practice should be maintained on Westar's system. CURB's recommended rate structure would allow Westar to consolidate its two residential heating rate schedules on one heating schedule, while maintaining separate rates for heating and non-heating customers. (Kalcic, D. Test., at 12 - 13).

If Westar's proposal were to be approved, all non-heating residential customers would face a declining winter energy block rate, which would encourage additional consumption in the October through May (i.e., "winter") months. (Rohlfs, Tr. Vol. 6, at 1314 - 1316). Rather than encouraging its customers to consume more energy, Westar should be encouraging conservation. The Commission can and should promote conservation in this instance by rejecting the Company's proposed declining winter energy block rate structure for non-heating customers.

C. Westar And CURB Have Resolved Their Differences With Respect To The Company's Small General Service ("SGS") Rate Structure.

Westar maintains an SGS rate schedule in each rate area. Each rate schedule contains a customer charge, a seasonally differentiated demand charge and a seasonally differentiated, declining block energy charge. However, the Company's SGS energy blocks have different break points, i.e., a 1,650 kWh breakpoint in Westar North and a 1,000 kWh breakpoint in

5 More accurately, in order to consolidate its heating and non-heating rate schedules in Westar South, the Company *had* to introduce a declining block winter energy charge for non-heating customers.

6 Having decided to eliminate its separate residential heating rate schedules in Westar South via the introduction of a declining block winter energy charge for non-heating customers, the Company was "forced" to introduce a declining block winter energy charge in Westar North, just to maintain "uniformity" in its residential rate structures.

Westar South. In addition, SGS billing demand is measured during a thirty-minute interval in Westar North, but during a fifteen-minute interval in Westar South. Westar proposes to establish a common SGS energy charge breakpoint at 1,200 kWh, and to measure billing demand during fifteen-minute intervals in both rate areas. CURB accepts both of these proposed changes. (Kalcic, D. Test., at 16 - 17).

However, under Westar's original rate design proposal, SGS energy charges (inclusive of the proposed TDC) would have declined by 1.5% to 2.0% in Westar North, and by 7.4% in Westar South. At the same time, SGS demand charges would have increased by 15% to 43% in Westar North, and by 41% to 50% in Westar South. Combined, these two rate level changes would have imposed significantly greater bill impacts on lower load factor SGS customers than higher load factor customers. In addition, although the current SGS customer charge is $8.50 in each rate area, Westar proposed to implement a $12.00 customer charge in Westar North, and a $15.00 customer charge in Westar South. CURB rejected the above aspects of Westar's proposed SGS rate structure. (Kalcic, D. Test., at 17).

In order to limit the range of intraclass rate increases (i.e., bill impacts) that would be experienced by Westar's SGS customers, CURB recommended that a more uniform increase be assigned to the SGS demand and energy charges. Moreover, CURB recommended that the SGS customer charge in Westar South should be set at a level no greater than $12.00. (Kalcic, D. Test., at 18). Westar indicated that it could accept both of CURB's recommendations with respect to the SGS rate structure (Rohlfs, Reb. Test., at 32 - 33), and submitted a revised SGS rate design incorporating CURB's proposals on September 29, 2005.[7] Based upon a review of Westar's revised SGS rate design, and the changes agreed to by Mr. Rohlfs on behalf of the

7 Notice of Westar Energy Inc. and Kansas Gas and Electric Company of Amended Tariff Sheet, filed September 29, 2005.

Company (Rohlfs, Tr. Vol. 6, at 1310 - 1313; CURB Exhibit 11), CURB concludes that all of its issues with the Company's SGS rate structure have been adequately resolved.

D. CURB Supports The Class Cost Of Service Methodology Presented By Staff.

CURB supports the class cost of service methodology presented by Staff in this docket, contrary to the erroneous presumption taken by Company witness William Seelye. (Seelye Rebuttal, at 80; Seelye, Tr. Vol. 12, at 2418-2427). CURB, like most state agencies, must stay within its budget and is frequently required to select which issues it can address in rate cases in light of its limited resources.

Here, CURB chose not to hire a consultant to address the Company's class cost of service methodology, but instead elected to rely upon Staff, which has traditionally addressed class cost of service methodologies in a manner consistent with the positions taken by CURB. According to the Company's own consultant, hiring a consultant to address class cost of service would have cost CURB an additional $45,000. (Seelye, Tr. Vol. 12, at 2426). As a result, CURB's failure to address the Company's class cost of service methodology with consultant testimony does not support Mr. Seelye's presumption that CURB "does not have a major objection to methodologies used in the [company's] studies." (*Id.*). As a result, Mr. Seelye's presumption is, as he admitted on cross-examination, "incorrect." (Seelye, Tr. Vol. 12, at 2427).

VIII. <u>Retail Energy Cost Adjustment Rider and Off-System Sales Adjustment Factor</u>

For ratemaking purposes, Westar proposes the establishment of a Retail Energy Cost Adjustment (RECA) Rider that would remove all fuel and purchased power expense from base rates. Under the Company's proposal, the RECA would operate as a monthly adjustment consisting of two components: a Fuel Adjustment Clause (FAC) factor to account for changes in fuel costs and an Off-System Sales Adjustment (OSSA) factor to share off-system sales margins.

Westar is proposing a monthly RECA adjustment, based on estimated fuel and purchased power costs for the current month, plus or minus a correction factor to account for differences between estimated and actual fuel and purchased power costs in the prior month.

Additionally, Westar is proposing to include $24 million of off-system sales margins in base rates. Margins between $24 million and $32 million would be shared on a 50-50 basis. Margins above $32 million would be shared 25% to ratepayers and 75% to shareholders.[8]

Finally, Westar is proposing that the OSSA be recomputed annually, based on actual margins and estimated total sales to all requirements customers. Thus, Westar is proposing the same OSSA factor for both Westar North and Westar South.

CURB is opposed to establishing the RECA rider for Westar. As Ms. Crane noted in her direct testimony, "Regulation is not, and should not be, a reimbursement system." (Crane, D. Test., at 56). Under the Company's proposal, Westar would receive dollar-for-dollar reimbursement for approximately 50% of its operating and maintenance costs. Ms. Crane also noted that

> Such treatment eliminates incentives for management to minimize these costs. While utility companies argue that regulatory commissions always have the ability to review fuel costs and to determine if such costs were prudently incurred, the fact is that regulatory commissions have routinely approved fuel adjustments and have rarely, if ever, challenged a claimed fuel cost on the basis that such costs were imprudently incurred. Part of the problem is that the staffs of regulatory commissions are generally overworked and their resources are severely limited, especially as compared with the resources available to the typical utility company. Moreover, the complexity of purchasing contracts and energy requirement forecasts make it very difficult, if not impossible, for staff members to

8 In rebuttal, Westar also expressed willingness to go along with Kroger witness Higgins' proposal to raise the base level to $32 million and alter the sharing mechanism, a proposal that CURB also opposes. (Seelye, Rebut. Test., at 58 – 61).

> appropriately evaluate the purchasing decisions made by the utility in light of options available to it at the time. If a utility knows that dollar-for-dollar recovery is assured, and that any regulatory review will be limited, then it has no incentive to reduce costs.

(*Id.*, at 57).

According to Ms. Crane, Westar does not have significant exposure to fluctuating market prices for fuel, which is another reason to deny the RECA rider. Virtually all of Westar's electricity is generated by nuclear or coal plants. According to Westar's 2004 Annual Report to Shareholders, at page 6, "We have an ideal mix of generation facilities. Although we have the capability to generate substantial electricity with natural gas and oil, almost all of our electricity is made with coal or uranium." The Annual Report states that more than 95% of the electricity generated in 2004 by Westar was produced by coal or uranium-fueled plants. The prices of these fuels are much more stable than some other fuels such as oil and natural gas. In addition, both coal and uranium are purchased pursuant to long-term contracts. Westar also has long-term contracts for transportation of the coal to its various facilities. Thus, there is much less risk of extreme volatility in the Westar fuel mix than in utilities that depend heavily on natural gas or fuel oil to generate power.

Additionally, there are several problems inherent in RECA mechanisms. First, a RECA mechanism results in single-issue ratemaking. It provides for dollar-for-dollar true-up and recovery of costs associated with only one component of the Company's overall revenue requirement. With a RECA, a utility can seek to increase rates even if it is earning well above its authorized rate of return.

Second, a RECA mechanism results in reimbursement ratemaking. Rather than providing the opportunity for a utility to earn its authorized rate of return, which is the foundation of traditional ratemaking principles, the RECA mechanism assures the utility that its overall return will not be impacted by its fuel and purchased power procurement practices.

Third, a RECA mechanism provides a disincentive to the utility to engage in hedging activities or to adopt good management practices in order to control costs. With a RECA, the utility has no incentive to minimize its fuel procurement and purchased power costs, since the utility knows that such costs will be fully recovered from ratepayers. Hedging will no doubt be of less value to Westar than to other electric and gas utilities, since Westar's generation is primarily fueled by coal and uranium that are purchased pursuant to long-term contracts. Nevertheless, a RECA will eliminate incentives for Westar to aggressively manage its fuel costs or to aggressively negotiate long-term contracts as they expire.

Fourth, a RECA mechanism results in rate uncertainty for ratepayers. This is especially true of RECA mechanisms that provide for monthly adjustments to customers' rates. These constant rate changes make it difficult for customers to anticipate their electric charges or to assess the accuracy of their monthly bills.

Fifth, given limited resources, there is no way for Commission Staff to undertake twelve thorough and comprehensive reviews each year of the purchasing decisions made by Westar. Time constraints alone will virtually guarantee that any review that Staff conducts will be largely to verify the arithmetic in the Company's RECA claims, rather than to determine whether or not appropriate purchasing decisions were made. Meaningful review is further complicated by the complexity of the fuel purchasing contracts and of the purchasing decisions that must be made. It is extremely rare for a state regulatory commission to successfully pursue a RECA disallowance based on issues regarding the prudence of the purchasing decisions.

Sixth, the Commission has not examined the impact of the RECA on the Company's overall return requirements. Any mechanism that provides for a dollar-for-dollar pass-through of actual fuel and purchased power costs will significantly reduce the Company's risk, a factor that must be considered by the KCC.

Finally, if the RECA is adopted, the Commission will find itself in the position of approving rate increases without knowing the potential magnitude of those increases. Moreover, the Commission has not examined important issues such as gradualism, rate stability, and the avoidance of rate shock, issues which should be thoroughly explored prior to implementing the adjustment mechanism proposed by Westar. Although Westar's fuel costs are not expected to be vulnerable to significant price swings, the impact of possible unforeseen price fluctuations on ratepayers should certainly be considered by the KCC.

In light of these problems, CURB recommends that the KCC reject the Company's proposal. RECA mechanisms provide a disincentive for effective utility management and they result in rate instability that is harmful to customers. They reflect poor regulatory policy because such mechanisms result in reimbursement ratemaking on a single issue. The Commission should continue to include fuel and purchased power costs in base rates. This ratemaking treatment provides the most efficient incentive for the Company to minimize these costs.

There are additional problems with the Company's proposal that ratepayers and shareholders should share off-system sales margins. When a normalized level of off-system sales margin is included in base rates, then the utility has an incentive to maximize off-system sales margins between rate cases, since it will retain all net margins above the amount included in base rates. Alternatively, the utility also has an incentive to aggressively pursue sales up to the amount included in base rates, since the utility's shareholders will be at risk for this amount.

For these reasons, including a normalized amount of off-system sales margins in base rates provides the best incentive to the utility to maximize these sales. The ratemaking treatment for off-system sales margins should be comparable to the treatment afforded fuel and purchased power expenses. Thus, CURB recommends that the Commission also include a normalized level of off-system sales margins in base rates.

CURB's recommendation provides utility management with incentives both to reduce energy costs and to maximize off-system sales. To the extent that off-system sales are higher than the pro forma sales included in Ms. Crane's revenue requirement recommendation, shareholders would benefit. If, however, the Commission adopts a RECA mechanism, then 100% of off-system sales should be flowed through that mechanism in order to provide ratepayers, who are paying 100% of the fuel and purchased power costs, with 100% of the benefit from such sales.

Moreover, this recommendation also provides the Company with an incentive to reduce fuel and purchased power costs. To the extent that fuel and purchased power costs are lower than those included in the Company's filing, shareholders would receive the benefit of these reduced costs between rate filings. In return, ratepayers receive rate stability and rate certainty.

IX. Environmental Cost Recovery Rider (ECRR)

Westar has requested an Environmental Cost Recovery Rider (ECRR) to recover the capital and operating maintenance costs associated with installing new pollution control equipment. The Company is proposing to recover the return on incremental investment, depreciation expense, related operating and maintenance costs, and income taxes through an annual ECRR filing. When new rates are established, these costs would be rolled into base rates.

CURB does not support the establishment of an ECRR for Westar. Westar's efforts in this case have concentrated on shifting as much risk and as much uncertainty as possible from shareholders to ratepayers, while reducing regulatory control and oversight. The ECRR is just one more example of the Company's attempt to increase prospective rates without the need to file a full base rate case. CURB does not believe that environmental expenditures should be treated differently in rates from any other types of capital investment. All capital investment necessary to provide safe and reliable utility service is important—environmental expenditures are no more or less important. There is no justification for treating this investment differently from other investment required to provide service.

A distinct advantage of the usual practice of the KCC to require a utility to file a base rate case in order to recover the costs associated with capital investment is that it provides a forum for the KCC, its Staff, and other interested parties to review the proposed rates and to determine whether or not they are just and reasonable. Permitting the Company to increase rates between rate cases for one class of investment is the very essence of what "arbitrary and capricious" means in the regulatory context: without the requisite balancing of all costs and revenues as is done in a base rate case, there is simply not enough evidence available to verify whether the increase is justified. This proposal could result in rate increases—even if Westar is earning its authorized rate of return. In fact, there is nothing in the proposal to prevent Westar from increasing rates even if it is overearning.

In addition, the arguments discussed above with regard to the RECA also apply here. The Company's proposal constitutes single-issue ratemaking.

Therefore, CURB recommends that the Commission deny Westar's transparent proposal proposal for an ECRR. The Company's proposal would constitute a major change in regulatory methodology, shifting considerable additional costs to ratepayers. This is another example of the Company's attempt to minimize its risk and maximize its return. Capital expenditures for pollution control equipment should be treated in the same manner as other investments in equipment that are made by Westar. CURB recommends that the KCC retain the current regulatory mechanism for reflecting incremental investment in base rates.

X. Performance Based Regulatory Plan

In addition to requesting rate increases of over $84 million in this case, the Company is also proposing to implement a Performance Based Regulatory (PBR) Plan, which it calls a "Reliability Based Sharing" proposal. This proposal is somewhat similar to the plan that was proposed in the Company's last base rate case.

Westar is proposing to establish a deadband of plus or minus 100 basis points around its requested return on equity of 11.5%. If actual returns exceed the top of the deadband, then the Company would share excess earnings 50-50 with ratepayers. Ratepayers would receive their share of any excess earnings through a rebate. If actual returns exceed the top of the deadband by more than 200 basis points, then the KCC or any party could request a rate review.

Under the Company's proposal, Westar would only be able to initiate a rate increase request if its actual return on equity is more than 100 basis points below the bottom of the deadband. The entire deadband could be moved up or down by up to 100 basis points, depending upon the results of quality of service indicators.

Westar's proposal contains five indicators that would impact the return on equity deadband: the System Average Interruption Duration Index ("SAIDI"), the System Average Interruption Frequency Index ("SAIFI"), the Equivalent Forced Outage Rate ("EFOR"), the answered call rate, and the meter read rate. Under the Company's proposal, a mean value for each of these metrics would be developed, based on 36 months of actual results, from 2002 - 2004. A distribution around the mean would be established for each metric. This distribution would contain five "Levels."

Each metric would result in a maximum adjustment to the midpoint of the deadband of plus or minus 20 basis points. Level 1 would be the lowest level of performance for each metric and would have a penalty equal to 100% of the allocated amount, or 20 basis points. Level 2 would be the second lowest performance level and would have a penalty equal to 40% of the allocated amount, or 8 basis points. Level 3 would be the deadband: neither a reward nor a penalty would be associated with performance at this level. Level 4 would be the lowest level of reward, with a 40% reward of 8 basis points. Level 5 would be the highest level of reward and would have a reward of 100% of the 20 basis points for each metric.

The deadband for each service indicator is intended to capture 50% of possible outcomes. The first reward or penalty step from the deadband (Levels 2 and 4) would capture an additional 30% of the potential occurrences under the distribution and the second reward/penalty steps (Levels 1 and 5) would capture the final 20% of the total area or potential occurrences for each metric. Based on the three most recent years of data, the actual values for each metric would be those shown below:

	SAIDI	SAIFI	EFOR	Ans. Call Rate	Meters Read
Level 1	>160.32 minutes	>1.72 outages	> 5.80%	< 92.94%	< 98.84%
Level 2	>146.79 but < = 160.32 minutes	>1.60 outages but <= 1.72 outages	>5.32% but <= 5.80%	< 93.84% but > 92.94%	< 98.91% but >= 98.84%
Level 3	127.99 minutes to 146.79 minutes	1.42 outages to 1.60 outages	4.64% to 5.32%	93.84% to 94.74%	98.91% to 99.01%
Level 4	<127.99 minutes but > = 114.46 minutes	< 1.42 outages but >= 1.30 outages	< 4.64% but >= 4.16%	>94.74% but <= 95.64%	>99.01% but <= 99.08%
Level 5	< 114.46 minutes	<1.30 outages	<4.16%	>95.64%	> 99.08%

The Company proposes that the incentive plan would remain in place for three years, or "longer if the initial trial works well." (Harrison, D. Test., at 12).

CURB does not believe that the service quality incentive mechanism proposed by the Company is appropriate. Utility companies are currently charged with the obligation to provide safe and adequate utility service at just and reasonable rates. The regulatory framework is based upon the premise that in return for the right to a monopoly service territory, the utility companies will take all reasonable measures to provide service at the lowest reasonable cost. The regulatory framework is also based upon the premise that the utility companies have an opportunity to earn their overall rate of return. This is an opportunity and not a guarantee; it is up to each company to operate efficiently in order to maximize the return for its shareholders under existing rates. The current service quality incentive mechanism would take us a step further and provide "rewards", where "rewards" are given for meeting what should be the inherent obligation of the utility.

In exchange for the exclusive right to provide service, an electric utility should be required to provide a safe and adequate level of service. It is good public policy to ensure that safe and adequate utility service is provided at the lowest reasonable cost. Furthermore, it is appropriate for the Commission to determine the level of service that meets the "safe and adequate" standard. By allowing a company to reap "rewards" for service that exceeds a certain expected standard, the Commission is sending the wrong message to the company and the resulting rates will be higher than necessary.

In a competitive market, customers can evaluate various levels of service that are available and determine if incremental service quality is "worth" a particular price. Basically, customers can conduct their own cost/benefit analyses. Therefore, if higher quality options exist that are more expensive than the "average," customers in a competitive environment can choose whether or not to spend the extra money on the higher quality service.

No such choice exists in a regulated utility. In fact, under the Company's proposal, ratepayers would pay higher costs for a service quality level that they may not need and from which they may never even benefit. All customers would pay for any "rewards," even if those customers were not impacted by the higher quality of service. For example, to a customer who never calls the service center, it makes no difference if the answered call rate is 95% or 75%. Similarly, a customer who never has estimated meter readings will not benefit from increasing the meter read rate. Customers who have not experienced any outages will not benefit from fewer outages or from outages of a shorter duration. Therefore, even if one believes that some customers are willing to pay more for a higher quality of service, forcing all customers to pay for service from which they may not derive any benefit is unreasonable and unfair.

Westar's proposal could increase rates in other ways, as well. In order to exceed the benchmarks and earn its rewards, the Company will have an incentive to add additional costs, especially if these costs can be passed along to ratepayers. For example, the Company currently balances its service center staff needs with its opportunity to earn its authorized rate of return. Under the Company's proposal, it could increase its service center staff, claim that this increased level is required in order to provide safe and adequate service, pass these increased staffing costs along to ratepayers in its next base rate case, and position itself to take advantage of further "rewards" by increasing its answered call rate.

A key assumption—that ratepayers should be willing to pay a premium for increases in service quality—has not been verified. Westar presented no evidence that ratepayers are willing to pay for a higher level of service. Westar's witness Mr. Fitzpatrick admitted he had not talked with any of Westar's customers to develop his theory about how they value service quality. (Fitzpatrick, Tr. Vol. 6, at 1233, 1235). There is no quantified linkage between the value of improved performance and what ratepayers may be willing to pay for that improvement. Mr. Fitzpatrick testified that he had no data that would reveal how much customers would pay for additional reliability. (*Id.*, at 1252). The Company simply assumes that its shareholders deserve a greater reward if service quality improves. This ignores the ways that service quality can be improved without exacting more revenues from ratepayers, such as improving productivity.

Without incurring any additional costs or taking any additional action, Westar may already be positioning itself to realize improvements in service quality relative to a three-year average. Various Company witnesses discuss recent actions taken by the Company to improve customer service and electric service reliability. For example, Ms. Williams discusses enhancements to the Company's interactive voice response system, improvements to the website, improved customer communications, introduction of systems to estimate restoration times, the introduction of Power Quality seminars, and other measures taken by Westar. Costs for these programs are included in the Company's revenue requirement claim, but any improvement in service quality may not yet be fully reflected in the proposed benchmarks. If so, then these results would translate into higher return thresholds for Westar, without any incremental benefit to ratepayers, who would already be paying the costs of such improvements.

Similarly, Mr. Sterbenz discussed improvements with regard to generation performance, many of which could result in improvements in the Company's reliability indices. To the extent that costs were incurred in order to improve generation performance, then these costs are included in the Company's test-year claim. However, the performance standards for these quality indicators are based on historic results, even though recent results are presumably superior due to the improvements cited above. Thus, it should be easier for the Company to meet or exceed its historic performance, increasing the prospect for return on equity premiums to shareholders.

There are other problems with the PBR proposal. The Company has crafted its indices in such a way that the most useful benefit of improved service quality is not included in the mechanism. For example, in measuring the SAIFI and SAIDI indices, the Company normalized the actual results experienced over the past three years. In other words, when there are major weather problems or other factors impacting reliability, the Company's performance is not included in the reliability calculation. As a result, these indices do not take into account the quality of the Company's performance during conditions when good service is most critical to customers, such as when there are widespread outages due to a winter storm. While no one realistically expects a utility to perform perfectly under such circumstances, the quality of a utility's performance during such a crisis is of great interest to its customers without power, if comments to the media after such storms are any indication. So, assuming for a moment that rapid restoration of power after a winter storm outage is the kind of service quality that means the most to the most people, then measurement of the utility's performance in that regard it should not be normalized out of the assessment of its overall service quality. However, we have no hard data indicating what kind of service means most to customers, or how much they might be willing to pay for improvements in service.

Furthermore, in normalizing the SAIFI and SAIDI indices, the Company did not use the KCC's "10% Rule", but instead utilized the "IEEE 1366-2003" normalization methodology. The KCC "10% Rule" defines a major event as "a catastrophic event caused by forces exceeding the design limits required by codes and regulations, and characterized by extensive damage to the electric power system and sustained interruptions to more than 10% of a utility's customers within a 24 hour period."(Henry, D. Test., at 9). The Company's SAIFI and SAIDI rates during such a major event would be removed from the data used to assess these performance measures.

By contrast, "IEEE 1366-2003" states that "a major day event is defined as a day in which the daily SAIDI exceeds a threshold derived statistically from the Company's historical daily SAIDI results for the prior five years." (*Id.*) In other words, if the performance of the Company on any day, for any reason, is really poor—the performance of that day is normalized out of the SAIDI and SAIFI statistics. Thus, the IEEE standard allows all poor performance below a certain historical level to be removed from the assessment of service quality.

Therefore, it is easy to understand why a company that wants to reap the rewards for improvements in service quality would prefer the IEEE standard—if the company has a very bad performing day and its service deteriorates beyond what is normal in a five-year average, that poor performance will not be included in the actual results that are measured against the benchmark.

However, the value of the benchmark is of limited value as an assessment tool if particularly poor performance can be excluded from calculated actual results used to evaluate performance. It certainly has no value as a tool to use decide whether ratepayers are enjoying improvements in service—especially if the very periods when customers are most in need of obtaining high quality service will not be included in determining the service incentive benchmark. It certainly should not be used to determine whether ratepayers should be charged higher rates for improved service so that shareholders can receive increased returns.

Westar has offered no compelling justification for such a significant change to the way in which Westar is regulated. Utility companies are charged with the obligation to provide safe and adequate utility service at just and reasonable rates. The regulatory framework is based upon the premise that in return for the right to a monopoly service territory, a utility will take all reasonable measures to provide service at the lowest reasonable cost. The regulatory framework is also based upon the premise that utility companies have an opportunity to earn an overall rate of return as determined by the regulatory body. This is not a guarantee—it is up to each company to operate efficiently in order to maximize the return for its shareholders under existing rates.

Mr. Harrison stated on page 3 of his direct testimony that the proposal will allow more timely review of the Company's operating and financial performance. But the KCC already has processes necessary to review both the financial and operating performance of Westar.

Mr. Harrison also states that the Company's proposal will provide an opportunity for customers to share in the benefits of strong financial performance, but clearly this proposal will provide far more benefits to the Company's shareholders than to its ratepayers.

Finally, Mr. Harrison states that the proposal will encourage continued improvement in reliability. But there is no reason why management, under a traditional regulatory framework, cannot assess and adopt innovative industry practices that would benefit its bottom line while improving reliability. Regulatory lag already provides the Company the opportunity to keep the profit contribution from innovations between rate cases, which can be a period of several years.

The Company's proposal is also likely to result in additional work for the KCC and its Staff—and additional cost for intervenors—while at the same time weakening the KCC's regulatory control. If the Commission adopts Westar's proposal, the Company's earnings and its performance metrics will be subject to annual review. However, at the same time, the KCC and its Staff will be limited as to what action they can take with regard to any specific financial or operational results, since their actions will be largely prescribed based on the formula proposed by Westar.

Westar's primary justification for its PBR Plan is largely a "me too" argument, stating that PBR plans are used in other jurisdictions and should therefore be adopted in Kansas. However, it is worth noting that North Dakota and Mississippi are the only states that have PBR programs that are based on return on equity. (Davies, D. Test., Exhs. GLD-4, GLD-5). In the Midwest and Great Plains regions, it is much more common for states to set quality of service targets, or just impose penalties when quality of service standards are not met. (*Id.*). Half the states in the country have no reporting requirements at all, or require reporting but have no pre-set standards to meet. (*Id.*). Therefore there should be no concern whatsoever that there is a nationwide trend moving toward PBR ratemaking mechanisms, especially those that are based on adjusting the rate of equity.

It seems clear to CURB that the only logical motivation for such proposals by utilities is a belief that they will reduce regulatory oversight and provide shareholders with greater earnings opportunities. PBR incentive proposals are generally biased in favor of utility companies and their shareholders. The pro-utility bias is founded in the ever-present problem of information asymmetry between the utilities and regulators: the utilities always have more information than the regulators. This asymmetry in information is especially pronounced under the current proposal because the Company proposes significant new regulatory activity that is to take place outside of the regular rate case environment. This is especially burdensome on intervenors that have no regular staff or budget with which to respond to ongoing regulatory review activities that can significantly alter their rates, especially when one considers that this activity will be conducted on an expedited basis.

The burdens on intervenors presented by the annual analyses required under the Company's proposal will also impact the Commission Staff. Staff normally benefits from the involvement of intevenors who propound discovery, identify issues, offer testimony and submit briefs. It is unlikely that intevenors can afford to participate fully in the annual reviews required under the Company's proposal and therefore even more effort will be required for the Staff to perform an analysis of the Company's annual filings.

The Company has another informational advantage under the PBR Plan because the Company can use its ability to judge how earnings will compare to the authorized return in deciding whether to take actions to influence the timing of events and their recognition in financial results. For example, if under the plan, the Company expects to have to make a rebate to ratepayers under the plan, then the Company may elect to undertake discretionary expenditures or take other actions that will decrease earnings. Even though there is an opportunity to review the Company's financial results each year, the KCC and other parties will always be at an informational disadvantage relative to the Company.

CURB recommends that the Commission deny Westar's request for a service quality incentive mechanism. The Commission should establish the level of service that constitutes safe and adequate service. Electric utilities should be expected to meet these standards. Routinely rewarding or penalizing companies through a formal program for service that is above or below acceptable levels is not appropriate given the monopoly position of Westar and the fact that its ratepayers have no choice but to take service from the Company. As Ms. Crane noted in her direct testimony,

> The Company's proposal is nothing more than a thinly-veiled attempt to increase its return on equity with the attendant burden being placed on ratepayers. Under the Company's proposal, shareholders would retain all earnings up to 12.5% on equity. Given that the Company's actual cost of equity is 8.75%, the Company's proposal initially results in excess earnings of up to 375 basis points. However, even if the threshold is adjusted to reflect the cost of equity of 8.75% that CURB recommends, the proposed incentive plan should still be rejected for the reasons stated above. Moreover, while the incentive plan would only share over-earnings, and at this time the Company is not proposing to collect any under-earnings, it is possible that the Company's proposal is Step 1 of a two-step process that will eventually seek to recover such amounts from ratepayers.

(Crane, D. Test., at 76).

Regulatory agencies should not approve incentive programs that permit electric utilities to consciously trade off additional earnings against adequate service quality. The Commission should have service standards, and electric utilities should be expected to provide service that meets those standards. If a utility does not meet those standards, the Commission can examine the specific reasons for the failure (e.g., extreme weather, poor management, inadequate staffing, etc.) and can take appropriate remedial action, if necessary. The Company should not be permitted to choose quality of service objectives depending upon the financial incentives that result from these actions. Accordingly, CURB recommends that the KCC reject the Company's proposed PBR Plan.

XI. Rate Base Issues

A. Utility Plant in Service

Westar developed its utility plant-in-service claim in this case by beginning with its utility plant-in-service balance at December 31, 2004. It then made several pro forma adjustments, to include construction work in progress (CWIP), to include certain environmental upgrade projects, and to eliminate property that has been sold. It also made an adjustment to unbundle certain plant related to the provision of transmission service.

Ms. Crane recommended several adjustments. She adjusted Westar's utility plant-in-service claim to allocate some projects to the FERC wholesale jurisdiction, to eliminate certain projects that were double-counted by the Company, to adjust the amount of CWIP included by Westar in its rate base claim, and to eliminate certain post-test year environmental projects from the Company's claim. (Crane, D. Test., at 10).

Regarding Ms. Crane's first adjustment, Westar did not allocate any of its intangible plant to the wholesale FERC jurisdiction. In response to KCC-65 (Crane, D. Test, Appendix C), the Company acknowledged that intangible plant was allocated between the FERC and KCC jurisdictions in the last two rate cases and that it would be appropriate to allocate a portion of intangible plant to the wholesale jurisdiction in this case. The Company stated that in the past, intangible plant was allocated based on the gross plant allocator. Intangible plant clearly serves both the wholesale and retail jurisdictions and therefore it is entirely reasonable and appropriate to allocate a portion of this plant to the wholesale jurisdiction. Therefore, at Schedules ACC-4N and ACC-4S, she has made adjustments to allocate a portion of intangible plant to the wholesale jurisdiction based on the Company's gross plant allocator. If the Commission accepts that stipulation and agreement between Staff and Westar, this adjustment would not apply.

In response to KCC-123, Westar indicated that there were certain work orders that were booked to both utility plant-in-service at December 31, 2004, and to CWIP. In some cases, additional charges were received and booked to CWIP after the project was completed and placed into service. In these cases, the fact that a work order appears in both utility plant- in-service and in CWIP does not necessarily result in an inflated rate base claim.

However, according to this response, there are other work orders that were inadvertently booked to both utility plant-in-service and to CWIP, resulting in a double- counting of investment. Specifically, there were two projects identified by CURB in its Direct Testimony, one in Westar North and one in Westar South, that were erroneously booked to utility plant-in-service but should only have been booked to CWIP. At Schedules ACC-5N and ACC-5S, Ms. Crane made adjustments to utility plant-in-service to eliminate these projects from Westar's utility plant-in-service claim, since the Company has indicated that they should have only been booked to CWIP.

During the hearing phase of this case, the Company stated that the "person who completed that data request did not answer that accurately" (TR 979, lines 10-11,) and that a supplemental response had been submitted. CURB has reviewed the supplemental response.

The response does explain that the amounts relating to Work Order A10186 in Westar North are not double-counted, since the plant-in-service amounts reflect expenditures up through December 29, 2004, with subsequent expenditures being booked to CWIP. Accordingly, CURB will withdraw its adjustment with regard to WEN.

However, the supplemental response does not explain why certain amounts associated with Work Order A09552 in Westar South appear to be double-counted. While that work order is discussed in the supplemental response, there is no explanation for why amounts should appear in utility plant-in-service as well as in CWIP. Accordingly, CURB is continuing to recommend an adjustment to remove $196,999 from Westar South's rate base claim, as shown in CURB Schedule ACC- 5S.

Westar included $18,778,345 of CWIP in its rate base claim for its Westar North operations and $23,852,013 of CWIP for its Westar South operations. CURB opposes inclusion of CWIP in rate base. As Ms. Crane noted in her direct testimony,

> I do not believe that CWIP is an appropriate rate base element. CWIP is plant that is being constructed but has not yet been completed and placed into service. Once the plant is completed and serving customers, then the plant will be booked to utility plant-in-service and the utility will begin to take depreciation expense on the plant. Inclusion of CWIP in rate base creates a mismatch among the components of the test year, since it represents plant that was not actually serving customers at any time during the test year. Moreover, CWIP does not represent plant that is used and useful. Therefore, it should be excluded from rate base until it is serving utility customers and providing them with utility service. In addition, including this plant in rate base violates the regulatory principle of intergenerational equity by requiring current ratepayers to pay a return on plant that is not providing them with utility service and that may never provide current ratepayers with utility service.

(Crane, D. Test., at 12).

Kansas statutes discourage inclusion of CWIP, but under certain circumstances may be allowed, at the discretion of the Commission. K.S.A. 66-128 (b)(1), provides for the KCC to determine the value of the property included in rate base. The statute generally requires "property of any public utility which has not been completed and dedicated to commercial service shall not be deemed to be used and required to be used in the public utility's service to the public." However, the statute does provide that public utility property "may be deemed to be completed and dedicated to commercial service" if certain conditions are met, one of which is that "[c]onstruction of the property will be commenced and completed in one year or less." The decision to include it is entirely guided by the discretion of the Commission.

The Company's filing did not provide any justification for its CWIP claim in its testimony. In CURB-81 (Crane, D. Test., Appendix C), Ms. Crane asked the Company to explain why each CWIP project should be included in rate base. In response, the Company stated that, "[e]ach of the CWIP projects included is anticipated to be completed and in service when rates set in this case go into effect. One principle of utility ratemaking is that costs should match the revenue at the time rates are established. Inclusion of CWIP projects that were started prior to the end of the test period but will be completed prior to the time rates are set accomplishes this result." Thus, the Company appears to believe that any CWIP project that goes into service during 2005 should be included in its rate base claim.

There are several flaws with this argument. First, Westar did not provide an estimated in-service date for all projects included in its CWIP claim. Thus, there are some projects that are not yet in service and for which no estimated in-service dates have been provided. Second, the inclusion of projects that are not yet complete is speculative. These projects do not represent known and measurable changes to test year results. We have no way of knowing if, in fact, these projects will go into service within the one-year time frame established in the legislation or if they will ever go into utility service. Furthermore, the CWIP legislation also requires projects to commence and be completed within one year. According to the response to KCC-61 (Crane, D. Test., Appendix C), there were numerous projects included in CWIP that began more than one year prior to their completion dates. Thus, Westar has clearly not demonstrated that its CWIP claim meets the one-year requirement contained in the statute.

Other provisions of K.S.A. 66-128 permit CWIP to be included in rate base even if the one-year requirement is not met. However, Westar did not reference any of the circumstances listed in the statute in support of its CWIP claim. Nor has the Company made any attempt to demonstrate that the projects included in CWIP meet the requirements of these additional provisions.

Ms. Crane noted in her direct testimony that the CWIP statute is a much-abused law:

> Since K.S.A. 66-128 was enacted, it has been my experience that Kansas utilities have pushed the envelope of reasonableness with regard to CWIP claims. Companies seem to believe that all CWIP claims must automatically be approved by the KCC. It should be noted that even if the conditions of the statute are met, the statute states that CWIP "may" be deemed to be completed and dedicated to commercial service. The statute does not state that the KCC must include CWIP in rate base. Moreover, the qualifying provisions of the CWIP statute are routinely ignored by Kansas utilities, who make no effort to demonstrate that their CWIP claims meet the provisions of the statute.

(Crane, D. Test., at 15).

While noting her objections to the prevailing attitude towards inclusion of CWIP, Ms. Crane recognized that the KCC has allowed some CWIP to be included in rate base in other cases. She therefore reluctantly recommended inclusion in rate base of only those projects that were actually completed by July 31, 2005: she deemed the other projects too speculative to be included. Her adjustments are shown in Schedules ACC-6N and ACC-6S.

Westar has included projected costs for the construction of a low nitrogen oxide (NOx) burner at the Jeffrey Energy Center (JEC) and the removal of the retired burner. According to the testimony of Mr. Kongs, construction is anticipated during a planned fall outage at JEC Unit 3. Therefore Westar violated the test year matching principle by including a plant project that was not in service during the test year, that was not CWIP during the test year, and that was still not in service eight months after the test year-end. The KCC uses an historic, not a forecasted, test year. There is no reason to make an exception to good ratemaking principles in this case and include this future construction program in rate base: its inclusion should be denied.

The Company has not demonstrated why this project should be given extraordinary ratemaking treatment. The low NOx burner project proposed by Westar in this case is not significant enough in scope to warrant the extraordinary ratemaking treatment being requested here. As stated in the response to KCC-302 (Crane, D. Test., Appendix C), low NOx burners are common within the industry. Accordingly, there is no rationale for deviating from good ratemaking principles and allowing this future project to be included in the Company's rate base claim in this case.

Therefore, Ms. Crane made an adjustment at Schedules ACC-7N and ACC-7S to eliminate the costs associated with the low NOx burner project from the Company's rate base. In addition, in those schedules, She also made an adjustment to eliminate Westar's proposed depreciation reserve addition associated with costs of removal and retirement of the existing burner.

B. Regulatory Assets

Westar included several items within a claim for a "net regulatory asset" in its rate base claim. Unamortized storm damage costs were identified as a regulatory asset, then were offset in part by regulatory liabilities associated with deferred cost savings resulting from a former service agreement with Protection One, a power purchase true-up for the State Line plant, and deferred gains from emission allowances and the sale of several properties. CURB recommends that the Commission exclude from rate base the regulatory asset related to deferred storm damage expense. While Westar did receive approval to defer these costs, approval for deferred accounting treatment does not guarantee any particular means of recovery.

One of the criteria for determining whether or not deferred costs should be recovered in rates is the extent to which such costs are likely to reoccur. If such deferred costs are likely to reoccur, such as storm damage costs, then recovery can be permitted over some future period. CURB is recommending a recovery over a five-year period. However, ratemaking is not a reimbursement system. It is not unusual for a regulatory commission to provide for future recovery of deferred costs, but to exclude unamortized balances from rate base. For example, the KCC has traditionally excluded unamortized balances associated with rate case costs from rate base. Similarly, CURB recommends that the KCC deny rate base treatment for the unamortized balances associated with deferred storm damage costs.

To avoid violating the prohibition against retroactive ratemaking, costs that occur periodically but not annually should be normalized rather than amortized. If costs are normalized, then there is simply no unamortized balance to include in rate base. Normalizing periodic costs provides for the inclusion of a prospective level of costs in future rates that should provide sufficient coverage for those periodic costs, while amortization provides for the recovery of previously incurred costs.

As described in Ms. Crane's testimony, if a utility incurs a cost periodically, but not necessarily annually, regulators should include an annual amount in rates that is likely to permit the utility to recover these periodic costs over a specified period: she recommended a five-year period for recovery. This is a different regulatory approach than providing for guaranteed dollar-for-dollar recovery of a previously incurred cost through prospective rates. CURB recommends that the Commission deny Westar rate base treatment for regulatory assets, and instead include in rates a level of normalized periodic costs that permits recovery over a five-year period.

C. Sale and Leaseback of LaCygne Generating Station

Westar has attempted to characterize its attempt to change the accounting of the unamortized balances of the LaCygne sale and leaseback as a "correction" of a mistake allegedly made by the Commission in 1987. This is not the Company's first attempt to challenge the 1987 decision of the Commission that the unamortized balance should be reflected as a rate base deduction during the life of the lease. The Company now argues that the cash from the gain was used to buy back debt and equity, thereby reducing the Company's cost of service, so the gain should not be used to reduce the rate base. As Ms. Crane noted in her direct testimony, "how the Company used the cash associated with this transaction is not an issue. The issue is how the transaction was recorded for ratemaking purposes." (Crane, D. Test., at 21). To revise the accounting treatment as Westar has attempted to do in its application would reduce the benefits that were clearly intended for ratepayers.

D. ADIT Associated with Merger Savings

Westar has ignored another previous Commission order in failing to deduct accumulated deferred income taxes (ADIT) associated with the recovery of merger-related savings from the rate base. In the last rate case (the "436 Docket"), the Commission found that the Company "receives a return on the present value of the deferred income tax payments," which amounts to an "interest-free loan from the ratepayers to the Applicants," which made it "necessary to decrease rate base by ADIT to avoid an unfair benefit to the Applicants." (436 Order, July 25, 2001, ¶ 67).

While CURB has consistently opposed recovery of merger-related acquisition premiums from ratepayers, the KCC made a previous decision to allow recovery of a portion of the premium associated with the merger of KG&E with KPL, so CURB has not recommended disallowance of the recovery permitted. However, the Company should not be permitted to go beyond the terms of the previous order and additionally benefit by failing to reduce rate base to account for ADIT associated with the recovery.

E. Summary of Rate Base Adjustments

CURB's rate base adjustments result in pro forma rate bases of $1,014,785,586 for Westar North and $1,106,877,090 for Westar South. These rate base recommendations reflect CURB's adjustments deducting $37,705,187 from the rate base claim of Westar North and $173,681,789 from the rate base claim of Westar South.

XII. <u>Operating Income Issues</u>

A. Pro Forma Revenue

Following the recommendations of Ms. Crane, CURB recommends an adjustment to the Company's claim for actual revenues billed, and imputation of revenue relating to the Company's economic development tariffs. The Company accepted CURB's adjustment. (Harrison, Reb. Test., at 5; *Id.*, at KBH-2).

In its filing, the Company made an adjustment to reflect actual revenues billed during the test year. Each month, as explained in Mr. Kong's Direct Testimony at page 9, Westar makes a journal entry to record "unbilled revenues," representing an estimate of the amount of energy delivered after each customer's meter is read until the end of the month. The Company made an adjustment to eliminate the net effect of these estimates. However, in quantifying this adjustment, the Company failed to include any adjustment for December 2004 revenues that were billed in January 2005.

According to the response to CURB-117 (Crane, D. Test., Appendix C), the Company did not reflect these January 2005 billings, even though they relate to usage during the test year. In that response, the Company indicated that such revenues should have been included in its adjustment. It quantified the amounts billed in January 2005 relating to test year usage. At Schedules ACC-12N and ACC-12S, Ms. Crane made an adjustment to increase operating revenue to include this test year usage.

Regarding imputation of revenue, the Company has an economic development rider tariff that provides for certain discounts to new commercial and industrial customers, or to expanding commercial and industrial customers that meet certain criteria. The discounts provided to these customers during the test year were not imputed by Westar in its filing.

Ms. Crane made an adjustment to impute revenue to reflect the difference between the revenue that would have been received at tariff rates from these customers and the actual revenue received under the rate discounts. It is appropriate to impute this revenue because captive residential and small commercial customers should not be burdened with higher rates as a result of subsidizing these large customers.

The problem inherent in any competitive discount provided by a utility is that it establishes two classes of customers: those that have competitive alternatives and those that do not. Furthermore, there is no evidence in this case to suggest that the discounts given in the test year were actually responsible for attracting new customers or for the expansion of existing customers. Nor have these discounts been shown to provide specific indirect benefits to the ratepayers that are being asked to subsidize them.

Additionally, the KCC has required imputation of revenue relating to these discounts in prior cases. The order approving the economic development rate in Westar South stated that,

> Because [Westar South's] Economic Development Rider may result in reduced revenue, provisions must be made to protect non-participating customers from any potential costs of the reduced rates. The [Westar South] shareholders must be made responsible for any shortfall in revenues due to the rider.

(Docket No. 87-KG&E-460-TAR, *Orde*r, Feb.26, 1988, at 1). Imputation was apparently not required in 1987, when the KCC approved the economic development rate for Westar North. However, Westar proposed to impute the revenue relating to the discounts to Westar North in the first rate review subsequent to the KPL/KGE merger.

Consistent with the reasoning of the Commission in the 1988 order approving the economic development rate for Westar South, CURB recommends that the Commission impute the revenue related to the discounts for the purpose of establishing Westar's revenue requirement in this case. This imputation will retain the treatment mandated by the KCC in the Westar South order, continue the treatment proposed by Westar for both companies subsequent to the merger, and eliminate any subsidization among customer classes resulting from the discount. Ms. Crane's adjustments are shown in Schedules ACC-13N and ACC-13S.

B. LaCygne Lease Expense

Westar renegotiated the terms of its lease for the LaCygne Generating Station in June 2005, subsequent to the filing of this case. The original termination date of the lease was September 2016. The lease term has now been extended to September 2029. As a result of the renegotiation, the owner of LaCygne Unit 2 refinanced the debt used to purchase the facility. Since Westar's lease payment is tied to the cost of financing for the facility, refinancing of LaCygne Unit 2 will reduce Westar South's annual lease expense by approximately $11 million. Ms. Crane therefore made an adjustment at Schedule ACC-14S to reduce the Company's lease expense consistent with the renegotiation of this lease.

C. Restricted Share Units

Restricted share units (RSUs) are stock awards made to officers pursuant to the Company's 1996 Long Term Incentive Plan. Under this plan, the RSUs vest ratably in equal installments on an annual basis over 2-year, 3-year and 4-year periods. The number of RSUs and the terms of the specific awards are determined by the Compensation Committee of the Board of Directors.

The Company's RSU claim was based on the amortization of existing grants, as well as the amortization of grants anticipated for 2005, and on the dividend payments associated with both existing and projected grants. In addition, Westar included an additional expense that would be payable if the Company's stock price reached certain price targets.

Ms. Crane recommended two adjustments to the Company's RSU claim. First, subsequent to preparing its filing, Westar granted certain RSUs in April 2005. In response to KCC-309 (Crane, D. Test., Appendix C), the Company revised its projected 2005 claim to reflect costs associated with the actual grants issued in April. Therefore, the Company's filed claim should be updated to reflect this more recent information.

Second, she recommended that the Commission disallow speculative expenses included by the Company in the event that Westar's stock reaches certain price targets. This adjustment does not represent a known and measurable change to the test year. The Company's stock has not reached these price targets and it is impossible to know when, or if, these price targets will be met.

CURB therefore recommends that the Commission adopt both of Ms. Crane's adjustments, which are shown in Schedules ACC-15N and ACC-15S for Westar North and Westar South, respectively.

D. Medical Benefit Expense

After reviewing the rebuttal testimony of the Company, Ms. Crane determined that her adjustment for prospective savings on medical benefits (Schedules ACC-16N and ACC-16S) should be withdrawn. (Tr. Vol. 4, at 791). The revised Schedules ACC-1S and ACC-1N reflect CURB's acceptance of Westar's claim for this expense.

E. Bad Debt Expense

Westar's claim for bad debt is based on a three-year average of actual net charge-offs incurred as a percentage of revenue averaged over the past three years. In addition, according to the response to KIC-164, the Company's bad debt expense claim includes bad debt expenses on its requested rate increase, even though that increase is unlikely to be granted by the KCC.

However, in the test year, the Company actually booked "$0" bad debt expense. This is because Westar sells 100% of its bad debts to a wholly-owned subsidiary, WR Receivables Corporation. According to the response to USD259-48 (Crane, D. Test., Appendix C), WR Receivables Corporation is a "special purpose entity [that] has sold and, subject to certain conditions, may from time to time sell, up to $125 million of undivided fractional ownership interest in the pool of receivables to a third party financial entity." According to the response to KIC-160 (Crane, D. Test., Appendix C), WR Receivables Corporation purchases receivables from Westar North and Westar South at a 2% discount and sells those receivables to a financial institution at book value. In 2004, WR Receivables had after-tax net income of $13.6 million, well above the bad debt expense claim included in Westar's filing.

CURB therefore recommends that the KCC deny Westar's claim for bad debt expense in this case. First of all, the Company did not book any bad debt expense in the test year. Moreover, WR Receivables Corporation recorded significant net income during 2004, net income that was significantly greater than the bad debt expense claim in this case. Finally, the Company's bad debt expense claim includes bad debt expense on a rate increase that has not been authorized and is unlikely to be authorized by the KCC. For all these reasons, Ms. Crane eliminated all bad debt expense from the Company's revenue requirement. Her adjustment is shown in Schedules ACC-17N and ACC-17S.

F. Storm Damage Expense

As discussed in Ms. Crane's direct testimony, Westar received authorization from the

KCC for deferred accounting treatment of the costs incurred as a result of two ice storms in January 2002 and January 2005. (Crane, D. Test., at 33). For the 2002 storm, Westar North received approval to defer storm costs of $4,977,314; Westar South received approval to defer storm costs of $8,047,055. The Company was also authorized to defer carrying costs on the deferred amounts, based on its currently authorized overall return. (*Id.*) The Company was also allowed to defer costs and carrying charges associated with the 2005 storm, less $4.1 million applied to those costs that came from a storm reserve account that is funded by ratepayers on an on-going basis.

However, in its application, Westar included costs in excess of the amounts that the Commission authorized for the 2002 storm. Ms. Crane, at Schedules ACC-18N and ACC-18S, made an adjustment to eliminate the excessive amounts.

Additionally, the Company proposed two different periods of recovery for ice storm costs for Westar North (three years) and Westar South (five years). Ms. Crane recommended instead that both regions' ratepayers provide recovery of the costs over five years. She noted that these are extraordinary expenses, and that the five-year recovery period creates less of a burden on ratepayers.

Finally, as previously noted above in the section addressing CURB's rate base adjustments, CURB opposes the Company's inclusion in rate base of the unamortized balances related to storm costs.

G. Discontinued Contracts

As noted in Ms. Crane's direct testimony, Kansas Gas Service terminated its shared billing and customer service agreements with Westar in September 2004. (Crane, D. Test., at

35). In its application, Westar made an adjustment to eliminate revenues and expenses associated with the termination of these shared services agreements with KGS. Additionally, Westar also discontinued providing certain services to Protection One after it was sold. Westar therefore made an additional adjustment to eliminate revenues and expenses associated with the termination of the agreement with Protection One.

However, Westar later acknowledged in response to KIC Data Request 220 (Crane, D. Test, Appendix C) that it had failed to reflect some cost savings in its adjustments relating to these discontinued agreements. Ms. Crane therefore made adjustments to the Company's revenue requirement that correspond to the updated information that the Company provided in KIC 220. Schedules ACC-19N and ACC-19S reflect the updates concerning the terminated agreement with KGS; ACC-20N and ACC-20S reflect the updates concerning the terminated agreement with Protection One. (All referenced schedules are attached).

H. Tree Trimming Costs

The Company's claim in its application was based on the year-end number of tree trimming crews, which was 111. With the test year weighted average contract price increasing by 3.4%, the Company requested a pro forma cost of $13,095 per month per crew. The Company's methodology results in a net increase of approximately 12% over the actual test year expense.

To test the validity of the Company's projected costs, Ms. Crane reviewed tree trimming expenses for the first half of 2005 in the Company's response to KIC-157 (Crane, D. Test., Appendix C). She found that the actual number of crews ranged from 102 to 106, in all cases well below the 111 included in the Company's claim. (Crane, D. Test., at 36). In addition, she found that Westar's actual costs for the first six months of 2005 were $7,225,186, or $14,450,372 on an annualized basis. This is well below the $15,584,383 incurred in the test year. Therefore, the Company's adjustment appeared to be overstated, with regard to both the number of crews utilized and the overall level of expense.

The Company's attempts to justify the increase with late-filed updates (see, e.g., CURB Exh. 2; Testimony of Doug Henry, Tr. Vol. 4, at 885 - 901) were confusing and only illustrate the problems created by having two different witnesses, Kevin Kongs and Doug Henry, filing testimony on one issue, and the problems created when attempting to circumvent traditional ratemaking with efforts to modify actual test-year data. Neither witness seemed to be able to sufficiently explain the variances in the various numbers presented as "actual," or support the pro forma numbers.

Since using the actual test-year costs would eliminate the confusion and be consistent with traditional ratemaking principles, CURB recommends that the Commission accept Ms. Crane's adjustment to bring the Company's recovery of tree trimming costs in line with its actual test-year costs. Therefore the Commission should reject any post-test year adjustment to tree trimming costs. This adjustment is shown in Schedules ACC-21N and ACC-21S.

I. Rate Case Costs

Westar requested an unprecedented amount for the costs of this rate case: $3.47 million. CURB witness Andrea Crane noted that this claim was astronomical, especially considering that the last rate case costs were only $2.3 million—and it was a much more complex and contentious case that involved issues such as a proposed merger with Public Service of New Mexico and a split-off of the unregulated businesses owned by Westar. (By comparison, the entire annual budget of CURB for fiscal year 2006 is only $746,794, which includes the salaries of five employees and the cost of consultants for the entire year.) Westar's rate case claim does not include the salaries of Westar executives who worked on the rate case, which makes the claim all the more extraordinary. It will, however, by the time all the claims are presented at the end of the case, include catered meals for Topeka-based Westar employees who worked out of Westar's "rate case headquarters" at the Residence Inn during the rate hearing in Topeka. As one example of extraordinary expenses already included in the claim, as evidenced by Exhibits KIC-29 and KIC-30, at least one consulting group for Westar billed the Company well in excess of $200,000 for the costs and services of two witnesses.

And, as Ms. Crane noted, fully a third of Westar's witnesses in the rate case were devoted to arguing for a performance-based regulatory (PBR) plan that, if adopted, would reduce regulatory oversight by the KCC—a proposition that is designed to benefit shareholders, not ratepayers. (Crane, D. Test., at 39). While it would be difficult, if not impossible, for the Commission to isolate the specific costs associated with the PBR-related testimony to ensure that only shareholders bear the costs, the Commission can and should limit the total amount that Westar is allowed to recover from ratepayers for rate case expenses to an amount reasonably related to historical costs. It would also ensure that if Westar wants to establish "rate case headquarters" at a place other than Westar's ratepayer-funded Topeka corporate headquarters, that shareholders are the ones that foot the bill, not ratepayers.

CURB therefore proposes that the Commission limit recovery from ratepayers of Westar's rate case expenses to $2.5 million, as Ms. Crane recommended in her direct testimony. (*Id.*). This represents a modest but reasonable increase over the costs of the last rate case, and will encourage Westar to hold its expenses in future rate cases to a more reasonable level if its shareholders do not want to bear a fair share of the costs. The adjustment limiting recovery is shown in Schedules ACC-22N and ACC-22S.

J. FERC Investigation Costs

Westar included in its application a claim for costs of $232,014 that were related to an investigation by the Federal Energy Regulatory Commission's (FERC) Division of Enforcement into allegations that the Company was involved in "round-trip" energy trading practices. (Loyd, Tr. Vol. 1, at 196). The legal costs were not related to regulatory costs that the Company routinely incurs at FERC, but were specifically related to the investigation into allegations of wrongful conduct by Westar. (*Id.*, at 193). The investigation was terminated by a stipulation and consent between FERC and Westar. (Loyd, Reb. Test., PSL-1). The stipulation and consent provided that although Westar neither admitted nor denied the allegations, it agreed to implement various remedies to resolve the concerns raised by the FERC investigation. As Westar witness Peggy Loyd noted, the compliance plan included requirements beyond those the Company is routinely required to meet under FERC's standards of conduct. (Loyd, Tr. Vol. 1, at 195).

CURB witness Andrea Crane argued that the legal costs associated with this investigation should not be born by ratepayers because Westar has an ongoing responsibility to comply with FERC and KCC regulations; shareholders should bear any legal costs associated with investigations into violations of FERC regulations. (Crane, D. Test., at 40).

Although Westar did not admit wrongdoing in the matter, it did not deny it, either. (Loyd, Reb. Test., PSL-1, at 13). The fact that the investigation was terminated by an agreement that imposed additional requirements on Westar that are stricter than FERC's standards of conduct strongly implies that wrongdoing was found. (*Id.*; Loyd, Tr. Vol. 1, at 195). If Westar could have established its lack of culpability, it would have had no incentive to agree to stricter standards of conduct to terminate the investigation. Ratepayers simply should not have to foot the bill for investigations triggered by dubious conduct on the part of Westar employees.

Additionally, Ms. Crane and the KCC Staff argued that the ratepayers should not bear these legal costs because they were related to a specific investigation and were not likely to reoccur, unlike those for routine compliance matters at FERC. (*Id.*, at 197; Crane, D. Test., at 41). Neither Staff nor CURB recommended denying recovery for routine FERC-related costs that were not related to the investigation. Ms. Crane's adjustments to remove only the legal costs associated with the investigation are shown at Schedules ACC-23N and ACC-23S.

K. Sarbanes-Oxley Start-up Costs

CURB recommends denial of non-recurring costs relating to Westar's efforts to address the requirements of the Sarbanes-Oxley Act. Although the Company will continue have an on-going obligation to meet the Act's requirements, it incurred substantial costs in the test year that were necessary to set up the specific processes and systems to enable the Company to begin to meet the new requirements. Although there will continue to be yearly expenses associated with compliance, the start-up costs were a one-time expense, and should not be included in the annual recovery of compliance costs.

Through discovery, Ms. Crane identified as start-up costs amounts paid to Price Waterhouse Coopers for "templates, training materials or other materials needed to address Westar's Sarbanes 404 requirements." This company's services were terminated in early 2004, underlining the non-recurring nature of this expense. (Crane, D. Test., at 41-42; KIC-171, Appendix C). She therefore recommended elimination of the amounts paid to Price Waterhouse

Coopers from the revenue requirement.

Similarly, Ms. Crane noted that Westar estimated that Sarbanes-related expenses paid to Protiviti, an information technology testing service, would decline significantly in 2005, which was evidence indicating that a substantial portion of the test year's billings from Protiviti were related to start-up costs. Ms. Crane therefore recommended allowing the inclusion in rates of an amount for Protiviti's services that corresponds to 2005 projected costs, which are more representative of probable future costs than were the costs of the test year. Her adjustments reflecting her recommendations are shown in Schedules ACC-24N and ACC-24S.

L. Civic and Charitable Donations

CURB recognizes that the KCC has generally allowed utilities to include 50% of their civic and charitable donations in rates, although it forces ratepayers to pay for the activities or organizations to which they might object, and that have no relation to the provision of electric service. Therefore, CURB has made no adjustment to the Company's base claim for donations. However, Ms. Crane identified items in the Company's claim classified as employee expenses that should have been identified as donations. (Crane, D. Test., at 43; KCC-51, Appendix C). Had they been identified correctly, only 50% of the amounts would be allowable in rates, assuming that the KCC in this case adheres to its usual policy of allowing 50% of the Company's donations.

Therefore, Ms. Crane made adjustments to eliminate 50% of these misidentified expenses, consistent with the KCC's usual treatment of donations. Her adjustment is shown in Schedules ACC-25N and ACC-25S.

M. Advertising Costs

CURB recommends that the Commission disallow costs for advertising that promotes Westar's corporate image. Although the Company excluded costs from its filing that related to corporate-image advertising, Ms. Crane identified two ads that Westar included in its claim that had no purpose other than bolstering Westar's image to its employees and to the community at large. The first was run on Labor Day, and featured the phrase, "Many Hands Make Light Work. 2,045 to be exact." (Crane, D. Test., at 45; CURB-124, Appendix C). This ad was clearly intended to "applaud" its employees for a job well done, and had no informational purpose that would serve its customers. The second ad promoted the Company's participation in the 2004 International Lineman's Rodeo & Expo, and was headlined, "Bulls & Broncos are Child's Play. Try Taming a 7200-Volt Behemoth." (*Id.*).

There was only one ad included in Westar's claim for advertising that had a purpose related to information about safety for its customers. (Crane, D. Test., CURB-124, Appendix C). It advised customers about the importance of avoiding electric lines when digging or climbing.

Ms. Crane recommended that the Commission include in rates only the costs for the safety-related ad. Her adjustment removing the cost of the corporate-image ads are found at Schedules ACC-26N and ACC-26S.

N. Membership Dues to Topeka Country Club and fitness clubs

CURB firmly opposes the inclusion of dues to country clubs and fitness clubs in rates. While the Company's concern for its executives' health and aversion to dining with the hoi-polloi is touching, these luxuries are entirely unnecessary for the provision of safe and reliable service to its customers. If Westar wants to provide its executives the means to become physically fit and to dine in style, the shareholders should pay for it, not ratepayers. Ms. Crane's adjustment to eliminate these costs from the Company's claim is found at Schedules ACC-27N and ACC-27S.

O. Edison Electric Institute Dues

Westar included in its cost of service a claim for $514,250 in dues to the Edison Electric Institute (EEI). However, a major activity of EEI is to lobby on behalf of the electric industry—lobbying that is more likely to benefit Westar's shareholders than its ratepayers. Therefore, it is inappropriate to ask ratepayers to pay for such lobbying costs. (Crane, D. Test., at 46 – 47).

Ms. Crane noted that Westar did not attempt to include its other lobbying costs in rates, and reasoned that there is no conceptual difference between lobbying costs that are paid directly to a lobbying firm and lobbying costs that are paid in the form of dues to an organization that lobbies. Neither should be included in the cost of service. Since EEI estimates that 25% of its revenues from dues are expended on lobbying, CURB recommends that the Commission remove from the cost of service 25% of Westar's costs of belonging to EEI. Ms. Crane's Schedules ACC-28N and 28S show her adjustment to remove these costs.

P. Legal Costs

CURB recommends the disallowance of legal costs related to Westar's sale of its interest in Protection One, an unregulated security company. Not only were these costs related to selling an unregulated business, but they were one-time costs that will not recur in the future. It is inappropriate to include costs related to unregulated businesses in the rates of regulated ratepayers, and it is inappropriate to include in rates costs that will not occur in the future.

Westar agreed in its response to KIC Data Request 170 that costs related to the sale of Westar's interest in Protection One "should be excluded from the cost of service in the test year." (Crane, D. Test., KIC-170, Appendix C). Therefore, Ms. Crane removed the legal costs related to the sale of the Company's interest in Protection One; her adjustments are shown at Schedules ACC-29N and ACC-29S.

However, if the Commission accepts Mr. Kongs' testimony at the hearing that he believed that a majority of these costs were already excluded from the cost of service (Kongs, Tr. Vol. 5, at 1051 – 52), then Ms. Crane's total adjustment would be $145,917 rather than $525,000, which should be allocated appropriately to Westar North and Westar South.

Q. Miscellaneous Non-Recurring Costs

In 2004, Kansas Gas Service terminated a joint billing agreement with Westar, whereby customers who received service from both companies received a single bill. As a result, beginning in September 2004, those customers began receiving separate bills from each company. In its application, Westar included costs of a direct mailing and refrigerator magnets that were designed to inform customers of the pending separation of Westar's electric billing from that of Kansas Gas Service. Since these were costs related to a one-time event, they will not recur in the future, and therefore should not be included in rates. Ms. Crane made an adjustment to remove these non-recurring costs at Schedules ACC-30N and ACC-30S.

R. Amortization of ADIT

As previously discussed, Westar was ordered in its last base rate case to reflect a rate base deduction associated with accumulated deferred income taxes related to KPL/KGE merger savings. The Commission found that this reserve should be amortized over the remaining 34.83 years of the merger savings period. Thus, the KCC reflected amortization expenses in its revenue requirement calculations for both Westar North and Westar South. Since Westar did not include the rate base reduction associated with these accumulated deferred income taxes in its filing, it similarly did not include an adjustment to reflect the associated annual expense.

Therefore, as discussed in the Rate Base section of this brief, Ms. Crane made an adjustment to deduct accumulated deferred income taxes from rate base. Therefore, it is necessary to also include an adjustment to reflect the amortization of these deferred taxes. At Schedules ACC-31N and ACC-31S, Ms. Crane made adjustments to include this amortization expense in the revenue requirements for Westar North and Westar South respectively.

S. Depreciation Expense

Westar reflected three adjustments to its actual test year booked depreciation expense. First, the Company included a depreciation reserve adjustment to reflect the fact that it delayed the implementation of lower depreciation rates ordered by the KCC in its last rate case. As a result of this delay, Westar's booked depreciation reserve was lower than it would have been had the Company complied with the KCC's Order and implemented new depreciation rates immediately. Therefore, in this case, Westar has made a depreciation reserve adjustment to reflect the depreciation reserve that would have resulted if the KCC's approved depreciation rates had been implemented in a timely manner. Since this adjustment was not incorporated into the Company's depreciation study, the Company made a corresponding depreciation expense adjustment to reflect recovery of the reserve adjustment over 10 years. The rate base and expense adjustments relating to the delay in implementing the prior approved depreciation rates is referred to as the "Difference in Depreciation" adjustment per the Company's filing.

Second, Westar made an adjustment to annualize depreciation expense based on its current rates and its utility plant in service claim in this case, which includes depreciation on the low NOx burner and CWIP.

Third, Westar made an adjustment to reflect the impact of new depreciation rates that it is requesting in this proceeding.

Ms. Crane did not recommend making an adjustment to Westar's rate base claim with regard to the "Difference in Depreciation" adjustment. However, she noted that if that rate base adjustment results in under-recovery of the investment by the Company, then Westar should have adjusted its depreciation study to update its reserve balances prior to developing proposed new depreciation rates. The use of a 10-year recovery period for this investment is arbitrary and it does not bear any relationship to the remaining useful life of the plant in question.

Ms. Crane recommended that the KCC reject Westar's arbitrary recovery period of 10 years for this investment, and instead require that the appropriate recovery, if any, should be determined pursuant to a depreciation study. CURB's depreciation witness, Michael Majoros, has agreed to update the results of his depreciation study if the Company provides the information necessary to incorporate this additional investment in the study. In the interim, at Schedules ACC- 32N and ACC-32S, Ms. Crane made an adjustment to eliminate the depreciation expense recovery over 10 years that is included in Westar's claim.

Secondly, as noted in the section of this brief addressing depreciation issues, CURB is recommending depreciation rates that are different than those requested by Westar in its filing. Mr. Majoros' recommended depreciation rates result in annual depreciation expense that is significantly different from the Company's depreciation expense claims. Therefore, Ms. Crane made adjustments to reflect the impact of Mr. Majoros's recommended depreciation rates on her recommended pro forma utility plant-in-service, as shown at Schedules ACC- 33N and ACC-33S.

Thirdly, as previously discussed, CURB recommends that the KCC disallow a portion of the Company's CWIP claim and its utility plant-in-service claim associated with the future low NOx burner project. CURB also recommends that a portion of intangible plant be allocated to the FERC jurisdiction. Therefore, it is necessary to make a corresponding adjustment to eliminate depreciation expense associated with the utility plant that Ms. Crane eliminated from rate base. At Schedules ACC- 34N and ACC-34S, she reduced the Company's depreciation expense to eliminate the annual depreciation expenses associated with the low NOx burner, the portion of CWIP that Ms. Crane recommends be disallowed, and the intangible plant allocated to the FERC jurisdiction.

T. Interest Synchronization

CURB recommends adjustments to the Company's pro forma interest expense for income tax purposes. Ms. Crane made this adjustment at Schedules ACC-35N and ACC-35S. These adjustments are consistent (synchronized) with CURB's recommended rate base, capital structure, and cost of capital recommendations. CURB is recommending a lower rate base and a lower cost of debt than the rate base and cost of debt that the Company included in its filing. CURB's recommendations result in lower pro forma interest expense for the Company. This lower interest expense, which is an income tax deduction for state and federal tax purposes, will result in an increase to the Company's income tax liability under CURB's recommendations. Therefore, CURB's recommendations result in an interest synchronization adjustment that reflects a higher income tax burden for the Company, and a decrease to pro forma income at present rates.

Ms. Crane utilized a composite income tax factor of 39.78%, which includes a state income tax rate of 7.35% and a federal income tax rate of 35%. These are the state and federal income tax rates contained in the Company's filing. Her recommendations result in a revenue multiplier of 1.66051, as shown on Schedules ACC-36N and ACC-36S.

XIII. <u>Revenue Requirement Summary</u>

For Westar North, Ms. Crane's adjustments result in a revenue requirement surplus at present rates of $12,419,069, as summarized on Schedule ACC-1N. This recommendation reflects revenue requirement adjustments of $60,250,334 to the revenue requirement increase of $47,834,265 requested by Westar North.

For Westar South, Ms. Crane's adjustments result in a revenue requirement surplus at present rates of $42,105,009, as summarized on Schedule ACC-1S. This recommendation reflects revenue requirement adjustments of $81,856,860 to the revenue requirement increase of $36,311,462 requested by Westar South.

At Schedules ACC-37N and ACC-37S, Ms. Crane has quantified the impact on Westar's revenue requirement of the rate of return, rate base, revenue and expense recommendations contained in this brief.

Additionally, Schedules ACC-38N and ACC-38S contain pro forma income statements, showing utility operating income under several scenarios, including the Company's claimed operating income at present rates, Ms. Crane's recommended operating income at present rates, and operating income under her proposed rate decreases. Her recommendations will result in an overall return on rate base of 7.32% for both Westar North and Westar South.

Respectfully submitted,

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VERIFICATION

STATE OF KANSAS)
) ss:
COUNTY OF SHAWNEE)

I, David Springe, of lawful age, being first duly sworn upon his oath states:

That he is an attorney for the above named petitioner; that he has read the above and foregoing document, and, upon information and belief, states that the matters therein appearing are true and correct.

David Springe

SUBSCRIBED AND SWORN to before me this 21st day of November, 2005.

Notary of Public

My Commission expires: 8-03-2009.

SHONDA D. TITSWORTH
Notary Public - State of Kansas
My Appt. Expires August 3, 2009

CERTIFICATE OF SERVICE

05-WSEE-981-RTS

I, the undersigned, hereby certify that a true and correct copy of the above and foregoing document was placed in the United States mail, postage prepaid, or hand-delivered this 21th day of November, 2005, to the following:

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