

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

APPLICATION OF BIG RIVERS)
ELECTRIC CORPORATION, INC.)
FOR AN ADJUSTMENT OF RATES) Case No. 2011-00036

ATTORNEY GENERAL'S POST-HEARING BRIEF

On March 2, 2011, Big Rivers Electric Corporation ("Big Rivers") filed the instant application for a general increase in its base rates. The following parties filed motions for intervention, all of which were granted: The Attorney General of the Commonwealth of Kentucky ("Attorney General"); Kentucky Industrial Utility Customers ("KIUC"), representing Alcan Primary Products Corporation and Century Aluminum of Kentucky General Partnership (hereinafter jointly referred to as "the Smelters"); Jackson Purchase Energy, and Kenergy. Big Rivers filed pre-filed written direct testimony with its petition, and subsequently filed rebuttal testimony. Kenergy filed rebuttal testimony, and KIUC filed testimony and sur-rebuttal testimony. An evidentiary hearing was held on this matter from July 26-28, 2011, during which witnesses from all parties which filed testimony were offered for cross-examination.

Background

Following Big Rivers' bankruptcy in the 1990s, the Commission issued an order transferring the control of Big Rivers' electric generating units to Western

Kentucky Electric Corp., a subsidiary of Louisville Gas & Electric Co. Big Rivers emerged from bankruptcy in 1998. In Case No. 2007-00455 (the “Unwind Case”), the Commission approved a joint petition filed by, *inter alia*, Big Rivers, Western Kentucky Electric Corp., and the Smelters, which sought approval of a plan to re-transfer control of Big Rivers’ electric generating units to Big Rivers, thus allowing Big Rivers to regain its status as a functioning utility under Kentucky law. The Commission approved the petition pursuant to its Order dated March 6, 2009.

The Smelters operate two aluminum smelting facilities located within Big Rivers’ service territory which, by the very nature of their operations, consume massive amounts of electricity – in fact, the two Smelters combined consume approximately 70% of Big Rivers’ generation.¹ The Smelters have remained at their current location because there they have enjoyed some of the lowest electricity rates in the nation. It is undisputed that the Smelters have an enormous positive impact on the economy of western Kentucky and indeed the Commonwealth as a whole. Together, the smelters employ 1,300 employees in high-paying jobs, and support over 4700 other jobs among other satellite companies which provide services to or transact other business with the Smelters.²

¹ The two smelters combined consume 7.3 billion kWh annually. Fayne testimony, pp. 5-6. Big Rivers’ testimony states that 68% of the company’s generation is sold to the Smelters. Seelye testimony, p. 10.

² Fayne testimony, p. 6.

Based on the evidence adduced during the course of the Unwind Case, one could reasonably infer that Big Rivers was dependent on the two Smelters for its survival, and *vice versa*. In the instant matter, however, the extent of any such co-dependent relationship has at least partially been called into question. To illustrate this point, Big Rivers submitted lengthy testimony describing the detailed measures it has taken to be able to sell its excess generating capacity on the open market, in the event one or both Smelters should leave the Commonwealth.³

The records in both the instant matter and other matters in which both Big Rivers and the Smelters were parties clearly reveal that the relationship between Big Rivers and the two Smelters has been strained, if not contentious, almost from the very start.⁴ Despite this fact, it is also abundantly clear that it remains in the best interests of the Smelters and Big Rivers to pursue mutually satisfactory resolutions to their unique and complex problems in order to maintain rate stability for the ratepayers at the least cost available.

³ See generally Seelye Rebuttal Testimony, pp. 9-17. Those measures include, *inter alia*, joining Midwest Independent Transmission System Operator, Inc. ("MISO"); construction of multiple transmission facilities, plant, and interconnection points with neighboring utilities; and exploring other means of marketing any excess generation. Moreover, MISO on June 28, 2011 released preliminary results of a study (the final results of which are still pending) indicating that MISO could absorb 1100 MW of Big River's generation, thus easily taking in all of the load the smelters currently take.

⁴ See, e.g., Fayne testimony, p. 15.

Summary of Pertinent Evidence

Big Rivers seeks new revenues of approximately \$39.3 million.⁵ Under the company's proposal, the wholesale electric demand charge for the rural class⁶ would increase from the current \$7.37 /kW per month to \$10.1890 / kW per month, while the energy charge would decrease slightly from the current 0.020400 to 0.019524.⁷ The company estimates that when the rate increase is passed on to its three member cooperatives, average rural retail rates will increase by \$6.70 / mo., or 6.8% (based on 1300 kWh / mo. consumption).⁸ The company's filing also seeks \$1 million for a suite of unspecified DSM programs; however, it cannot provide any details, capital expenditures or expenses because only short term pilot programs are currently in effect.⁹

Big Rivers' testimony indicated that the revenue increase is required because the economic downturn has reduced its off-system sales.¹⁰ Further, without the increased revenue, it is in danger of not being able to meet the minimum 1.24 TIER, and a 1.10 Margins for Interest Ratio (MFIR) necessary to maintain its investment-grade rating.¹¹ The company further testified that

⁵ Wolfram hearing cross examination, July 27, 2011 V.R. beginning at 11:17:12.

⁶ The Big Rivers' wholesale rural class includes residential and commercial.

⁷ Big Rivers' Notice to Member Cooperatives for a General Adjustment in Rates, dated Feb. 28, 2011.

⁸ The retail percentage increase is expected to vary by individual distribution cooperative member depending upon its individual sales characteristics.

⁹ See Big Rivers' response to KIUC 2-1.

¹⁰ See, e.g., Blackburn rebuttal testimony p. 8. Blackburn and other Big Rivers witnesses testified that the off-system sales market nationwide is significantly reduced due to the economic downturn.

¹¹ Bailey rebuttal testimony, pp. 3-4. However, Mr. Bailey acknowledged during hearing cross examination that based on Big Rivers' Indenture to U.S. Bank National Association, p. 2, the

maintaining its investment grade rating is crucial to its survival.¹² Company testimony also indicated that the rating agencies have placed Big Rivers at the lowest ranking of all G & Ts due to the increased risks it faces.¹³ For that reason, Big Rivers needs to demonstrate a higher level of financial protection than other G & Ts.¹⁴ Big Rivers also states that KIUC's proposal would place the company in "a financially unsound situation."¹⁵

KIUC filed extensive direct testimony indicating, *inter alia*, that the company's revenue requirement instead was only \$18.68 million¹⁶ KIUC's revenue requirements witness, Kollen developed several major adjustments to Big Rivers' revenue requirements, including, *inter alia*: (a) reducing annualized depreciation expenses by \$6.9 million; (b) recognizing the Smelters' TIER Adjustment Charge payments of \$7.1 million; (c) annualizing interest on long-term debt in the sum of \$2.53 million; and (d) eliminating the company's proposed \$1 mil. DSM program.¹⁷ In addition, KIUC's rate design expert, Barron,

company need only collect rates "reasonably expected" to yield an MFIR of 1.10 (KIUC Hearing Exhibit 4), July 26, 2011 V.R. beginning at 10:35:45.

¹² The RUS loan contract with Big Rivers requires Big Rivers to maintain at least two investment grade ratings. Blackburn rebuttal, p. 5.

¹³ Those risks include: (a) Big Rivers' prior bankruptcy; (b) the company's extreme reliance on two large industrial clients, and that the agencies consider the contractual agreements with the Smelters to be weak; (c) uncertainties created by concerns over Kentucky Public Service Commission rate regulation [this is due to the fact that most other G&Ts are not subject to rate regulation, and obtaining timely & adequate rate relief can be challenging, despite the pass-through mechanisms which help to mitigate the risk]; (d) BREC and HMPL are currently in litigation over a provision in the contract governing their relationship; and (e) environmental risks associated with older coal-based generation. Spen direct testimony, pp. 12-13; *see also* Bailey rebuttal testimony, p. 8.

¹⁴ Spen rebuttal testimony, p. 4.

¹⁵ Bailey rebuttal testimony, p. 8.

¹⁶ Kollen testimony, p. 4.

¹⁷ *See* KIUC Hearing Exhibit 3.

testified that most of the revenue increase (\$18.7 million, or 16.7%,¹⁸ prior to other adjustments described *infra*)¹⁹ should be allocated to the rural class because the Smelters are and have been subsidizing the rural class, and that it was time for that subsidy to end.

Additionally, and quite significantly, KIUC called for the end of three (3) subsidies which the Smelters have been paying since the date the final order was issued in the Unwind Case. These charges payable by the Smelters benefit all customer classes except the Smelters. Big Rivers' rebuttal testimony asserts that the KIUC proposal would economically nullify the benefit of those payments to the Rural customer rate class.

Those subsidies were worked out by and between the Smelters and Big Rivers and were an integral part of the underlying financial model approved by the Commission in the Unwind Case. As was pointed out in both direct testimony and during the hearing in the instant case,²⁰ the negotiations surrounding the agreement and the attendant surcharges reached in that case spanned five (5) years. Those surcharges include: (a) the TIER Adjustment Charge mechanism (Smelter Agreement § 4.7.1), a mechanism by which the Smelters make additional payments that are intended to help Big Rivers achieve

¹⁸ Bailey rebuttal testimony, p. 13.

¹⁹ Fayne testimony, p. 6. KIUC further recommends that of the remaining revenue requirement, \$0.03 mil. be allocated against the Large Industrial class, and \$0.2 mil. for the smelters. *Id.*

²⁰ Fayne testimony, p. 17; *see also* July 26, 2011 V.R. beginning at 12:01:00.

a 1.24 Contract TIER each fiscal year;²¹ the Smelter surcharges (§ 4.11); and (c) the Smelters' payment of \$0.25 per MWh to the large industrial class (§ 1.1.20). Big Rivers asserts that these three built-in "subsidies," which were included as revenue in Big Rivers' cost of service study, total \$27.519 million for the test year, but KIUC asserts the Smelters paid only \$18.369 million of "subsidies" during the test year.²² Big Rivers maintains the Smelters are apparently seeking to undo the rates which they agreed to in the Unwind Case.²³

Furthermore, KIUC called for Big Rivers to annually refund patronage capital equivalent to 25% of the company's prior year's net margins.²⁴ KIUC states this would be for the benefit of all ratepayers, and would maximize the ability of the Smelters to weather any downturn in aluminum pricing.²⁵ KIUC witness, Kollen, testified that this refund would not deteriorate the company's current equity level of 32.11%.²⁶ However, Big Rivers' rebuttal testimony indicated that return of patronage would hinder Big Rivers' cash flow because

²¹ The Smelters currently are paying from the top of the bandwidth set up in this surcharge, which currently translates to a \$1.95 per MWh charge. Fayne testimony, p. 7. However, Big Rivers testified that its proposed changes in rate design will eliminate 50% of the TIER Adjustment Charge mechanism billed to the Smelters on a pro forma basis, which it states is the equivalent of moving the TIER Adjustment Charge to the middle of the bandwidth. Seelye direct testimony, pp. 6-7, 24.

²² Baron direct testimony, p. 32.

²³ Bailey cross-examination, July 26, 2011 V.R. beginning at 12:01:30.

²⁴ Kollen testimony, p. 4. The 25% figure works out to be approximately \$3 mil. *Id.* at p. 27.

²⁵ Fayne testimony, p. 6.

²⁶ Kollen testimony, at p. 27.

the company lacks sufficient cash, and it would further lead to increased borrowing, and jeopardize its investment grade credit ratings.²⁷

Finally, KIUC called for a portion of the Rural Economic Reserve²⁸ (\$4.26 million) to be used to cushion the impact of the rate increase the rural class would experience.²⁹ If allowed, the amortization from the Rural Economic Reserve would lead to an increase on the rural class which exactly matches that which Big Rivers proposed (\$14 million).³⁰ However, Big Rivers testified at the hearing that this fund was established to cushion future rate increases which the parties know will come in the years ahead.³¹ This fund was negotiated during the Unwind Case.

The company's proposed rate design would allocate \$14.172 million of the overall increase to the rural class, \$3.328 million to large industrials, and \$22.553 million to the Smelters. Big Rivers' testimony indicates that there is a difference of approximately \$11.1 million between the amount of revenues received from the rural class and the actual cost of providing service to them.³² Big Rivers'

²⁷ Hite rebuttal testimony, p. 23; Blackburn rebuttal testimony, pp. 4-5, 13; and Bailey rebuttal testimony p. 10. *See also* Bailey cross examination, July 26, 2011 V.R., beginning at 11:03:30, wherein Mr. Bailey states that the company will need "every bit" of equity it can get in order to finance costs of complying with pending EPA regulations.

²⁸ The Commission ordered EON to create this reserve in its final Order in the Unwind Case, 2007-00455. Fayne testimony, p. 17.

²⁹ Fayne testimony, p. 6.

³⁰ Fayne testimony, pp. 11-12; Baron direct testimony, p. 9.

³¹ *See also* Bailey rebuttal testimony at p. 14, stating that under the KIUC proposal the rural class "... ultimately incur[s] a greater risk of rate shock resulting from premature exhaustion of the RER funds." *See also* Bailey cross examination, July 26, 2011 V.R. beginning at 10:59:00, wherein witness Bailey testifies these funds were intended for the members' use, not for Big Rivers' operations.

³² Seelye direct testimony, pp. 18-19.

proposal reduces that difference by \$1.9 million³³ While both Big Rivers and KIUC acknowledge that the rural class is being subsidized by other classes, KIUC's rate design calls for the complete elimination of all such direct subsidies,³⁴ whereas Big Rivers suggests an approach based on gradually reducing the subsidy. KIUC states that the subsidies the Smelters are paying to the rural class on an annual basis total \$18.3 million³⁵

ARGUMENT

Although significant differences exist regarding Big Rivers' and the Smelters' views on revenue requirements, those differences are not terribly far apart from a conceptual perspective. Big Rivers needs to collect rates reasonably expected to yield an MFIR of 1.10 and TIER of 1.24. While it is difficult to determine a precise level of revenue that will yield such a result, the Attorney General believes that the company has presented a reasonable case that it needs significant new revenues as set out in its application, although not to the degree requested. However, as Big River's witness Blackburn admitted in the hearing, there is no reason why KIUC's proposed \$6.9 adjustment for depreciation rates should not be accepted because it will not affect the company's cash margins or MFIR.³⁶ The Attorney General believes it would also be appropriate to adjust Big

³³ Id. at 19.

³⁴ Baron direct testimony, p. 6. Baron further testifies that the effect of tying the large industrial class to the smelter class has the effect of giving the rural class a subsidy of \$6.2 mil. Id. at 9.

³⁵ Id. at 25.

³⁶ Blackburn cross examination, July 26, 2011 V.R. beginning at 14:54:58 through 14:55:28.

Rivers' revenue requirements by the amount of the Smelters' TIER Adjustment Charge, \$7.1 million.

The Company's proposed \$1.0 million DSM program should be denied because few, if any details were provided. The Commission has historically evaluated DSM programs very carefully to insure they are financially cost-effective. However, such cannot be the case with Big Rivers' proposal in the instant filing because few, if any, of the essential details regarding the programs' financial effectiveness were provided. The Commission should not suddenly depart from its well-chartered course regarding cost-effectiveness in DSM programs. The company should re-file these programs under a separate docket, pursuant to KRS 278.285.

KIUC's proposal to use a portion of the Rural Economic Reserve raises significant cause for concern. In the Unwind Case, the Commission carefully pointed out that by 2013, the rural class would be experiencing new rate concerns due to rising fuel costs and exhaustion of the Non-Smelter Economic Reserve.³⁷ The Attorney General agrees with the Commission's position as stated in the Unwind Case, and with Big Rivers that this fund should be used only for the purposes for which it was intended – that of mitigating the effects of rate increases which will doubtlessly occur in the next few years.

³⁷ Unwind Case, Final Order dated March 6, 2009, pp. 23-26. *See also* Bailey cross-examination, July 26, 2011 V.R. beginning at 11:02:30.

The Attorney General finds equal cause for significant concern with KIUC's proposal to use a portion of Big Rivers' patronage capital to mitigate the impact of the rate impact. Big Rivers is facing massive capital investment on a level unprecedented for the company, in order to attain compliance with pending EPA regulations. The company needs to be able to borrow capital at the lowest possible rate, and the best way to accomplish that would be to leave its patronage capital untouched.³⁸

Rate design has been heatedly contested in this case. Evidence presented by both Big Rivers and KIUC indicates the rural class is being subsidized by the Smelters. Normally, the Attorney General would agree with Big Rivers' approach which emphasizes gradually reducing those subsidies rather than removing them in their entirety, as KIUC proposes. The Attorney General believes this would also comport with established Commission precedent. However, the Attorney General is sensitive to the fact that everything reasonable should be done to keep the Smelters in the Commonwealth. While the Commission is not in a position in this case to grant the long-term measures the Smelters need to remain in the Commonwealth (e.g., economic incentives, etc.), the Attorney General believes that it should nonetheless give some consideration to KIUC's proposed allocation, as a means of relieving some of the economic pressure on these two corporations whose economic vitality is key to

³⁸ Nonetheless, the Attorney General believes the issue of the amount of Big Rivers' accumulated patronage capital may need to be re-examined in its next rate case in the event Big Rivers' financial status should change to such a degree as to warrant such a review.


the Commonwealth's well-being. For that reason, he believes the Commission should carefully consider allocating a greater portion of the revenue requirement to the rural class than might otherwise be contemplated, although not to the degree advanced by the Smelters. This deviation by the Attorney General is presented because the loss of either Smelter could very well lead to even higher rates to the rural class in the event Big Rivers is forced to wheel its electricity and not collect the same revenues it currently receives from the Smelters.

It appears that the foregoing issues are dwarfed when compared with the last remaining key issue, that of the Smelter subsidy payments. These terms were deemed essential to Big Rivers' financial health at the time of the Unwind Case. The Attorney General believes that the Commission should not be forced into a corner and have to reform key contractual terms which were five years in the making prior to the filing of the Unwind Case. Although the Smelter payments are a "rate" as that term is defined in KRS 278.010(12), the Commission likely would not have approved them had they not been in the form of contracts binding the Smelters and Big Rivers. It appears that the Smelters are now seeking to undo the rates to which they agreed in the Unwind Case -- a scant two years ago. If Big Rivers and the Smelters cannot, or perhaps will not work out their differences regarding such vital issues, there is no viable and *practical* way for the Commission to impose terms which neither of these parties are likely to accept or to find just. Absent any agreement by these two primary parties, the terms should remain unchanged as they were bargained for by the Smelters and

integral to the underlying financial model in the Unwind Case which the Commission approved.

WHEREFORE, the Attorney General submits his post-hearing brief.

Respectfully submitted,
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Certificate of Service and Filing

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