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**PUBLIC SERVICE
COMMISSION**

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC)
RATES OF EAST KENTUCKY POWER) CASE NO. 2010-00167
COOPERATIVE , INC.)

ATTORNEY GENERAL’S POST-HEARING BRIEF

Comes now the Attorney General of the Commonwealth of Kentucky, by
counsel, and tenders the following post-hearing brief in the above-styled matter.

I. PROCEDURAL BACKGROUND

East Kentucky Power Cooperative, Inc. [“EKPC”] filed its application and pre-filed written direct testimony in this matter on or about May 27, 2010. The Attorney General and Gallatin Steel [“Gallatin”] filed motions to intervene, both of which the Commission granted. Two rounds of discovery were conducted. Gallatin filed testimony, and the Commission and EKPC conducted one round of discovery regarding that testimony. On or about December 3, 2010 EKPC filed into the record a motion to approve a partial recommended settlement. All parties entered into the partial recommended settlement, but the Attorney General reserved the right to contest the issue of revenue requirements. A public evidentiary hearing was conducted on this matter on December 9, 2010.

II. REVENUE REQUIREMENTS

Gallatin Witness Mr. Lane Kollen submitted pre-filed written direct testimony regarding EKPC's revenue requirements. Mr. Kollen testified that the company's filing in the instant rate case showed significant increases in expenses when compared with prior cases.¹ This case marks the first time EKPC has used a fully-forecasted test year.² As such, those expenses are only projections and have not been incurred.³ The fact that these figures were prepared solely for purposes of the rate case, and not during the company's normal budgeting or for any other non-rate case managerial purpose should shed more suspicion on their reliability.⁴ As Mr. Kollen pointed out:

"Thus, these projected test year expenses were not developed in the normal course of business for use by EKPC to manage its costs in the same manner that its operating budgets are developed and utilized. . . . [therefore] . . . the Commission should carefully scrutinize the expense increases for reasonableness and remove excessive and unreasonable expenses."⁵

Witness Kollen then proposed a range of adjustments to EKPC's revenue request, which will be separately addressed herein by order of the magnitude of each adjustment.

¹ Kollen pre-filed written direct testimony ["Kollen"], p. 3, lines 15-16; p. 4, lines 2-4.

² Id. at p. 3 line 23.

³ Id. at p. 4, lines 6-9.

⁴ Id. at p. 4, lines 10-12.

⁵ Id. at p. 4, lines 16-18; 21-22. During the hearing of this matter, EKPC's CEO Campbell confirmed that the projected expense increases were not developed for management or budget purposes, but instead were developed specifically for purposes of the instant rate case. Video Transcript of Evidence ["VTE"], beginning at 10:57:28.

Adjustment No. 1:
Reduce Assumed Interest Expense on Debt Used to Fund Excess Cash

The most sizeable adjustment which witness Kollen proposed was to reduce the assumed interest expense on debt used to fund excess cash, which he valued at \$28.093 million. EKPC proposes to increase the interest it pays on debt by a whopping 30% from 2009-2011, more than one-half of which is based on the assumption that it will borrow hundreds of millions of dollars more than it needs to fund its projected increase in rate base.⁶ Indeed, witness Kollen states that this level of borrowing is:

“excessive and unnecessary . . . [and will] result in huge cash balances, which are not necessary to provide utility service and are not included in rate base. . . . [It] cannot be explained by an increase in net investment rate base . . . it stems from the unreasonable assumption that the utility will borrow hundreds of millions of dollars it does not need to fund actual construction projects . . . it simply results in huge cash balances. . . .”⁷

Perhaps the most significant aspect of the company’s forecasted huge interest expense is that none of it would go to finance the company’s net investment rate base.⁸ As witness Kollen stated, the company is assuming it will incur this debt “. . . to fund temporary, unnecessary and arbitrary increases in its cash and cash equivalent balances.”⁹ This excessive debt would, in essence, be issued “. . . to finance the buildup

⁶ Id. at p. 6, lines 12-15. The company filed a response to post-hearing data request 3, which verifies that the as-filed increase in interest expense amounts to a 30% increase from its 2009 actual interest expense of \$113.320 mil.

⁷ Id. at p. 7, lines 2-3; p. 9, lines 9-15.

⁸ Id. at p. 26, lines 11-13.

⁹ Id. at p. 26, lines 15-16.

of huge huge cash and cash equivalent balances, which are not included in rate base.”¹⁰ The effect of the company’s plan to acquire such huge amounts of capital will in essence have a boomerang effect, in that the company’s financial and credit metrics will actually be harmed rather than helped. The company will be forced to reduce its margins, which in turn would reduce its earned TIER and DSC.¹¹

The single-most striking particular segment of the company’s forecasted interest expense is the \$175 mil. of private placement debt, which the company at the time of its filing believed it would have to borrow at 7.5% interest.¹² This private placement financing was intended solely to finance the costs of constructing the Smith 1 generation plant.¹³ Of course, the Company has now informed the Commission, through Case No. 2010-00238 that it will abandon the construction of this plant. This decision on the part of the company *should* obviate the need for any and all of the exorbitantly expensive private placement debt and reduce the interest expense accordingly. Although the company will incur some debt to finance its costs expended to date (which will be collected in a regulatory asset, if the Commission approves same), there should be no reason why the company could not finance these costs through its existing credit facility at a much lower interest rate than through the private placement financing method.¹⁴

¹⁰ Id. at p.22, lines 21-22.

¹¹ Id. at p. 23, lines 18-21.

¹² Id. at p. 19, lines 19-20.

¹³ Hearing testimony of Mr. Frank Oliva, VTE beginning at 13:41:30.

¹⁴ The Commission in Case No. 2010-00166 approved new unsecured credit facilities for EKPC in a total sum of \$500 mil. The petition filed in that case indicated the facility was for “general corporate purposes.”

Nonetheless, Mr. Frank Oliva, testifying on behalf of EKPC stated that the company fully intends to pursue the more expensive private placement financing to cover its costs for the abandoned project rather than using its less expensive credit facility for this purpose.¹⁵

For these reasons, Mr. Kollen recommended that the Commission exclude the entire amount of interest on debt because none of the debt will be used to finance the company's net investment rate base and to provide services to the distribution co-ops.¹⁶ The effect of witness Kollen's adjustment for interest expense would reduce the company's overall revenue requirement by \$27.329 mil.¹⁷

Adjustment No. 2:
Reduce Assumed Interest Rate on Credit Facility Debt to 4%

Witness Kollen also determined that the company's assumption that it will have to pay an average of 5.5% in interest during the forecasted test year on its credit facility is mistaken, and that instead, it will actually owe only 4.0% (or less) on the facility.¹⁸ This would translate into a reduction of \$6.188 mil. of the company's test year interest expense and related TIER.

No portion of the total sum approved was predicated in any way upon the company's proceeding with the Smith-1 plant.

¹⁵ Hearing testimony of Mr. Frank Oliva, VTE beginning at 13:41:30.

¹⁶ Kollen pre-filed testimony at p. 26, lines 11-13.

¹⁷ Id. at p. 26, lines 20-21.

¹⁸ Id. at p. 28, lines 17-21.

Adjustment No. 3:
Reduce Assumed Salaries and Wages and Related Payroll Tax Expense

The company's responses to PSC 2-2 and Gallatin 2-19 indicate that the company forecasts an increase in payroll expenses of 10.9% from the base period through the end of 2011. Witness Kollen testified that this increase in payroll expenses in the test year is not reasonable because the average actual annual increase in payroll costs (expense plus amounts capitalized) from 2005 - 2009 was only 3.9%, and that, moreover, that low rate of growth was achieved despite the addition of Spurlock 3 in April 2005, Spurlock 4 in April 2009 and several CTs.¹⁹ Of course, no new generation plants are scheduled to come into operation during the test period.²⁰

Kollen recommended that the Commission reduce the rate of growth in payroll expense to 4% from the base period to the test year, which reduces the company's payroll expense by \$3.2 mil., and that the Commission accordingly reduce the projected payroll tax expense by \$244,000,²¹ for a total adjustment of \$3.444 mil. Mr. Kollen's proposal is further supported by Attorney General Hearing Exhibit-1, which depicted a 3% average forecasted annual base pay increment for workers in the utility industry for the calendar year 2011.²²

¹⁹ Id. at p. 11, lines 12-19.

²⁰ Id.

²¹ Id. at p. 12, lines 1-9.

²² See AG Hearing Exhibit-1, p. 2.

Adjustment No. 4:
Reduce Assumed Benefits Expense

The company asserts it will face an increase in benefits expenses from 2009 through the end of the test year of \$14.585 mil. to \$27.593 mil., or 89%. Witness Kollen identified eight (8) reasons why this level of increase was unreasonable.²³ The Attorney General agrees with Mr. Kollen's recommendation that the Commission reduce the company's projected benefits expense by \$2.661 mil., which he based on a reduction in the proposed benefits cost of \$3.059 mil.²⁴

Adjustment No. 5
Reduce Assumed Purchased Power Expense Due to Forced Outages

The company's revenue requirement filing includes \$10 mil. for projected forced outages, despite the fact the company's average cost incurred for this expense over the last five years has been only \$8.252 mil.²⁵ However, the company's average forced outage expense is reduced to \$7.240 mil. when the extraordinary 2008 forced outage is excluded, as it rightly should be,²⁶ notwithstanding the testimony of company witness Wood to the contrary.²⁷ Furthermore, the company now has an insurance policy

²³ Kollen pre-fled testimony at pp. 14-16.

²⁴ Id. at p. 16, lines 13-15.

²⁵ Id. at p. 17, lines 1-3.

²⁶ In Case No. 2008-00436, EKPC sought permission for and was granted a regulatory asset for the 2008 forced outages. The final Order in that case, dated Dec. 23, 2008 specifically stated that the 2008 forced outages were of an extraordinary and non-recurring nature (pp. 4, 7, and 9-10).

²⁷ VTE beginning at 11:50:20.

covering the cost of forced outages, with a deductible of \$1 mil. and annual premium of \$1.8 mil. (*see* EKPC's response to AG's Post-Hearing DR No. 2).

Witness Kollen computed the five-year average of actual forced outage costs from 2005-2009, and subtracted the amount of premium for the insurance policy, which the company has now verified via post-hearing data request to be \$1.8 mil. This yields a total figure of \$5.340 mil. which the Commission should allow for the company's projected forced outage expense,²⁸ which in turn reduces the company's total revenue request by \$3.860 mil.²⁹

Other Adjustments

Mr. Kollen made several other adjustments to EKPC's revenue requirements of a more minor nature, which the Attorney General urges the Commission to adopt in full. Additionally, the company acknowledged that its rate case expenses as of late November totaled only \$181,000, a significant departure from the forecasted amount of \$625,000, and much more in line with its costs in its last rate case, which totaled \$296,000.³⁰ The company should be held to its actual expenses incurred, not the figure it forecasted.

III. EKPC'S REVISED LOAD FORECAST

Following the completion of discovery in this case, the company filed into the record a revised load forecast in which it forecasts that energy sales during 2011 will be

²⁸ Kollen pre-filed testimony at p. 18, lines 6-12.

²⁹ Id. at p. 18, lines 16-18.

³⁰ Hearing testimony of company witness Wood, VTE beginning at 11:40:30.

reduced 9% from the last load forecast filed with the Commission, and that energy demand will be reduced by 5% over the same time frame.³¹ The company testified that with regard to its revenue requirements, it has shifted from relying solely on the record as it existed prior to and during discovery conducted in this matter, to relying primarily upon the revised load forecast.³² The company acknowledged that the other parties to this case have not had opportunity to engage in any discovery regarding the revised load forecast.³³ The company has further acknowledged that the data in the revised load forecast are not known, measureable and certain.³⁴ In fact, company witness McNally acknowledged that, “we see 2011 as being a very difficult year to anticipate economically.”³⁵

While the company did file the revised load forecast into the record depicting projected needs for additional revenue, it acknowledged that it has not filed any studies or other documents into the record depicting the reduced variable costs it is certain to incur as a result of less demand for its product.³⁶ This is despite the fact that the company acknowledged that ratemaking requires an examination of expenses, among

³¹ Hearing testimony of company witness Wood, VTE beginning at 11:03:10; 11:03:25.

³² Hearing testimony of company witness Wood, VTE at 11:02:46; 11:03:44; hearing testimony of company witness Oliva, VTE beginning at 13:35:00.

³³ Hearing testimony of company witness Oliva, VTE beginning at 13:36:00.

³⁴ Hearing testimony of company witness Wood, VTE beginning at 11:03:56; hearing testimony of company witness Oliva, VTE beginning at 13:36:05; hearing testimony of witness McNally, VTE beginning at 10:49:28.

³⁵ Hearing testimony of company witness McNally, VTE at 10:34:44.

³⁶ Hearing testimony of company witness Wood, VTE at 11:05:31; hearing testimony of company witness Oliva, VTE at 13:36:27.

other factors.³⁷ The company acknowledged that variable costs include certain types of O & M, certain environmental costs (limestone, and ash handling), and fuel costs. In fact, the company acknowledged that O & M is the single greatest cost driver in the company's filing.³⁸

IV. CONCLUSION

The record on file as it existed prior to the last-minute introduction of the company's revised load forecast indicates that the company is entitled to additional revenue in a sum no greater than \$3.030 million, which comports with the testimony of Gallatin witness Lane Kollen. The Attorney General acknowledges the introduction into evidence of the company's revised load forecast, which if it bears out will have a significant impact on the company. Nonetheless, the company has acknowledged that this study is only a forecast, and is not based on known and measurable data, which is the standard that governs ratemaking in this Commonwealth. Indeed, it is the Company which enjoys the opportunity to decide *when* to file its rate increase application as well as the *test year* it uses. However, there are rules which apply in the Commission's review of the application, including the information it uses in rendering its decision.³⁹ Even assuming the Commission relies upon the Company's revised load

³⁷ Hearing testimony of company witness McNally, VTE at 10:47:52.

³⁸ Hearing testimony of company witness Wood, VTE beginning at 11:33:15; 11:58:48.

³⁹ See KRS 278.192.

forecast,⁴⁰ the Company has failed to meet its burden in proving the need for the increase given the lack of evidence in the record of the myriad of offsetting costs associated with the lower sales, which only compounds the incredibly overstated initial application as clearly articulated by Mr. Kollen.⁴¹

Respectfully submitted,
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⁴⁰ Under 807 KAR 5:001 § 10(8)(d), "After an application based on a forecasted test period is filed, there shall be no revisions to the forecast, unless such revisions reflect statutory or regulatory enactments that could not, with reasonable diligence, have been included in the forecast on the date it was filed. There shall be no revisions filed within thirty (30) days of a scheduled hearing on the rate application." Notwithstanding this regulation, the Attorney General did not object to the update given the magnitude of the projected change in sales as well as the effect that same could have on EKPC's financial situation. However, the fact remains that no party, or the Commission itself can reasonably predict the change to revenue, associated with the drop in sales, without knowing the offsetting costs.

⁴¹ The Attorney General is not indifferent to the financial health of EKPC and the viability of its on-going operations. Nonetheless, there are regulatory rules that apply to a monopoly such as EKPC and the Company cannot simply disregard them. If the Company faces any extraordinary need for an increase, it has the right to file for emergency relief under KRS 278.190.

Certificate of Service and Filing

Counsel certifies that an original and ten photocopies of the foregoing were served and filed by hand delivery to Jeff Derouen, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; counsel further states that true and accurate copies of the foregoing were mailed via First Class U.S. Mail, postage pre-paid, to:

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this 17nd day of December, 2010



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