COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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| APPLICATION OF BIG RIVERS ELECTRIC CORPORATION FOR A GENERAL ADJUSTMENT IN RATES | ) ) | CASE NO. 2011-00036 |

<u>O R D E R</u>

On March 1, 2011, Big Rivers Electric Corporation ("Big Rivers") tendered an application requesting approval to increase its wholesale electric rates for service to its three member-owner distribution cooperatives, Jackson Purchase Energy Cooperative ("JPEC"), Kenergy Corp. ("Kenergy") and Meade County Rural Electric Cooperative Corporation. Big Rivers proposed to increase its wholesale electric base rates by $39.95 million,[1] a 9.2 percent increase over its normalized test year revenues, with its new rates to become effective for service rendered on or after April 1, 2011.[2] The Commission found that an investigation would be necessary to determine the reasonableness of Big Rivers' proposed rates and suspended them for five months, up to and including August 31, 2011 pursuant to KRS 278.190(2).[3]

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[1] Big Rivers later revised its requested increase to $39.34 million.

[2] The stated amount of the requested increase, $39.95 million, does not reflect three items which, according to Big Rivers' application, effectively reduced its proposed increase to $29.6 million. Throughout this order, unless stated otherwise, references to the proposed increase will be to the revised amount of $39.34 million set forth in Big Rivers' Hearing Exhibit 1, which does not reflect these three adjustments.

[3] See Commission's suspension and procedural Order entered March 17, 2011.

On September 1, 2011, pursuant to KRS 278.190(2), Big Rivers provided notice of its intent to place its proposed rates in effect, subject to refund, given that a final Order had not been issued by the end of the five-month suspension period. We issued an Order on September 6, 2011 acknowledging that Big Rivers had provided such notice and had acted according to the Commission's statutes. That order also required that Big Rivers maintain its records in such a manner that will allow it, the Commission, or any customer, to determine the amounts to be refunded and to whom due, in the event a refund is ordered upon final resolution of this case.

## BACKGROUND

Big Rivers is a member-owned rural electric generation and transmission cooperative organized pursuant to KRS Chapter 279. Its three member-owners sell electric energy to approximately 112,000 retail customers in 26 western Kentucky counties. In July 2009, Big Rivers consummated what is commonly referred to as the "Unwind Transaction" under which it terminated a long-term lease of its generation to Western Kentucky Energy Corp. ("WKE").[4] In conjunction with the Unwind Transaction, Big Rivers negotiated with the two aluminum smelters ("Smelters") served by Kenergy, ultimately entering into agreements ("Smelter Agreements") with them. Those agreements established the terms and conditions of service to the Smelters and also

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[4] The Commission approved the Unwind Transaction in Case No. 2007-00455, The Applications of Big Rivers Electric Corporation for: (1) Approval of Wholesale Tariff Additions for Big Rivers Electric Corporation, (2) Approval of Transactions, (3) Approval to Issue Evidences of Indebtedness, and (4) Approval of Amendments to Contracts; and of E.ON U.S. LLC, Western Kentucky Energy Corp., and LG&E Energy Marketing, Inc. for Approval of Transactions (Ky. PSC Mar. 6, 2009) (the "Unwind proceeding").

set forth the base rates and other non-base rate charges negotiated in conjunction with the Unwind Transaction.[5]

In support of the Unwind Transaction, Big Rivers filed, in Case No. 2007-00455, a financial model which projected a need for a general rate increase in 2016. Those projections were based on Big Rivers generating revenues from off-system sales well above what it has actually realized since closing the Unwind Transaction on July 16, 2009.[6] Big Rivers' application in this proceeding indicates that lower-than-projected off-system sales revenues are a primary reason for having filed for a rate increase prior to the 2016 date as projected at the time of the Unwind proceeding.

The Commission established procedural schedules that provided for discovery, intervenor testimony, and rebuttal and surrebuttal testimony. The parties intervening in this proceeding are the Attorney General of the Commonwealth of Kentucky by and through his Office of Rate Intervention ("AG"), KIUC, JPEC, and Kenergy. Both the AG and KIUC propounded data requests to Big Rivers, as did the Commission Staff. KIUC and Kenergy were the only intervenors filing testimony in this proceeding and KIUC's was the only intervenor testimony which addressed the issue of Big Rivers' revenue deficiency and the amount of Big Rivers' proposed increase.[7]

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[5] The Smelters, Rio Tinto-Alcan and Century Aluminum, are two of the industrial customers represented in this matter by the Kentucky Industrial Utility Customers, Inc. ("KIUC"). The Smelters account for more than 70 percent of Big Rivers' energy sales and approximately 65 percent of its system demand.

[6] According to Big Rivers, its off-system sales volumes have been in line with what had been projected. However, due to the weakness of the regional and national economies for the past two years, prices for off-system sales have been depressed.

[7] KIUC recommended that Big Rivers receive an increase of $18.7 million.

The Commission held a public hearing on the proposed rate adjustment on July 26, 27, and 28, 2011 at its offices in Frankfort, Kentucky. No members of the public offered comments at the hearing and the Commission has received no written comments on the proposed increase. Post-hearing briefs were filed by Big Rivers, the AG, KIUC and Kenergy. All information requested at the public hearing has been filed and the case now stands submitted for a decision. As discussed more thoroughly through the remainder of this Order, we are granting Big Rivers a base rate increase of $26,744,776, or roughly 67 percent of the amount it requested.

## TEST PERIOD

Big Rivers proposed to use the 12-month period ending October 31, 2010 as the historic test period to determine the reasonableness of its proposed rates. None of the intervening parties offered objections to the proposed test period or suggested an alternative test period. The Commission finds the use of this proposed test period to be reasonable. In using a historic test period, the Commission has given full consideration to appropriate known and measurable changes.

## VALUATION

### Rate Base

Big Rivers proposed a net investment rate base of $1,173,308,136[8] based on the test-year-end value of plant in service and construction work in progress; the 13-month average balances for fuel stock, materials and supplies, and prepayments; plus a cash working capital allowance, minus the adjusted accumulated depreciation balance. None of the intervenors addressed Big Rivers' proposed rate base.

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[8] Big Rivers' Response to Commission Staff's First Information Request, Item 12.

The Commission concurs with Big Rivers' proposed rate base with the exception that working capital has been adjusted to reflect the pro forma adjustments to operation and maintenance expenses found reasonable herein.[9] Based on this adjustment to working capital, Big Rivers' net investment rate base found reasonable for rate-making purposes is as follows:

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| Utility Plant in Service | $ 1,943,034,107 |
| Construction Work In Progress | 46,802,138 |
| Total Utility Plant | $ 1,989,836,245 |
| ADD: | |
| Fuel Stock | $ 35,586,271 |
| Materials and Supplies | 20,961,301 |
| Prepayments | 3,586,232 |
| Working Capital | 29,982,839 |
| Subtotal | $ 90,116,643 |
| DEDUCT: | |
| Accumulated Depreciation | $ 904,713,040 |
| NET INVESTMENT RATE BASE | $ 1,175,239,848 |

Capitalization and Capital Structure

Big Rivers' test-year-end capitalization was $1,201,027,934[10] and consisted of $385,705,395 in equity and margins and $815,322,539 in long-term debt. Using this capital structure, Big River's equity to total capitalization ratio is 32.1 percent. None of the intervenors addressed Big Rivers' proposed capitalization. The Commission finds Big Rivers' test-year-end capitalization to be reasonable for rate-making purposes.

[9] Big Rivers' working capital calculation was in error in that it was based on 13 rather than 12 months of expenses; also, based on 13 months, its use of 45 days in the calculation resulted in a ratio of 11.4% (45/396) instead of 12.5% (45/360).

[10] Big Rivers' Response to Commission Staff's First Information Request, Item 12.

## REVENUES AND EXPENSES

Big Rivers proposed 28 adjustments to revenues and expenses to reflect current and expected operating conditions.[11] KIUC accepted 21 of the adjustments Big Rivers proposed, disagreed with seven of Big Rivers' proposed adjustments and proposed four adjustments of its own. In its rebuttal testimony, Big Rivers agreed with two of KIUC's proposed adjustments. The Commission finds that 20 of the adjustments proposed by Big Rivers which were not contested by KIUC and the two adjustments proposed by KIUC to which Big Rivers agreed are reasonable and should be accepted.[12]

The Commission makes the following findings and/or revisions to the remaining adjustments proposed by Big Rivers and KIUC:

### Smelter TIER Adjustment Charge

Under the Smelter Agreements, a Smelter Times Interest Earned Ratio ("TIER") Adjustment Mechanism was established. The purpose of the Smelter TIER Adjustment Mechanism was to allow Big Rivers to charge the Smelters up to an additional $14.2 million annually as a means of ensuring that it is able to meet the TIER requirements set out in its loan covenants. The financial model Big Rivers relied upon in conjunction with the Unwind Transaction did not include any Smelter TIER Adjustment revenues. Big Rivers stated that, largely due to the depressed off-system sales prices mentioned earlier in this Order, it needed to call on the Smelters for the maximum amount of revenues allowed under the Smelter TIER Adjustment Mechanism, and defer a

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[11] Direct Testimony of John Wolfrom, Exhibit Wolfrom 2, page 1 of 2.

[12] The 20 adjustments the Commission has accepted are shown in Appendix B to this Order. For the adjustments containing both revenue and expense components, the appendix reflects the net amount.

significant amount of planned maintenance work, in order to meet the financial requirements in its loan covenants.[13]

As part of its rate request, Big Rivers proposed a ratemaking adjustment to reduce its revenues under the Smelter TIER Adjustment Mechanism from the amount it received in the test year, the $14.2 million maximum permitted, to one-half that amount, or $7.1 million. Big Rivers stated that this was done in order to "[r]estore $7.1 million to the TIER Adjustment bandwidth which would then be available, as contemplated in the Smelter Agreements, to meet any differences that could arise between pro forma operating results developed in this proceeding and actual operating results that occur once the rates go into effect."[14]

KIUC opposed Big Rivers' adjustment to reduce the revenues under the Smelter TIER Adjustment by $7.1 million, stating that the proposed adjustment assumes that the TIER Adjustment Charge will be reduced from $1.95 per MWh to only $0.975 per MWh.[15] It argued that the Smelters paid the full $1.95 throughout the test year and in each and every month since the end of the test year. It cited Big Rivers' 2011 budget, which shows no reduction in the TIER Adjustment Charge occurring after the conclusion of this case and shows that this charge is projected to increase, as permitted under the Smelter Agreements, effective January 1, 2012.[16] KIUC claimed the proposed

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[13] Direct Testimony of Robert W. Berry at 8.

[14] Direct Testimony of William Steven Seelye at 24.

[15] Direct Testimony of Lane Kollen at 5-7.

[16] Id.

adjustment did not meet the "known and measurable" standard the Commission has historically applied to proposed adjustments in cases based on a historical test period.

On rebuttal, Big Rivers reiterated why it proposed an adjustment to reduce Smelter TIER Adjustment Revenues, emphasizing that its adjustment had the effect of reestablishing the buffer intended and planned for under the provision of the Smelter Agreements which established the Smelter TIER Adjustment Mechanism.[17] Big Rivers indicated that it did not expect the TIER Adjustment revenues provided by the Smelters to decline to $7.1 million after receiving a final Order in this proceeding; and that the existing $1.95 per MWh charge would continue through the end of calendar year 2011.

We recognize that Big Rivers operates under unique circumstances by having an annual minimum Margins For Interest Ratio ("MFIR") of 1.10 established in its indenture and being limited to earning a maximum TIER of 1.24 as established in the Smelter Agreements. These circumstances were clearly the primary reason for its proposed adjustment. However, the Commission concludes that the adjustment to reduce the Smelter TIER Adjustment Revenue is not appropriate under the circumstances presented here. As is well established in the record of this proceeding, none of the parties, including Big Rivers, expect that these revenues will be reduced at any time in the near future, either because of this rate case or for any other reason.

Given that (1) test-year Smelter TIER Adjustment Revenues have continued at the same level since the end of the test year and (2) this level of revenue is projected to continue until, as per the Smelter Agreements, Big Rivers is permitted to increase it by 50 percent the first of calendar year 2012, the proposed adjustment does not meet our

[17] Seelye Rebuttal at 38.

"known and measurable" ratemaking standard. Accordingly, Big Rivers' proposed adjustment to reduce Smelter TIER Adjustment Revenues by $7.1 million is denied.

Avoided Interest and TIER on RUS Series A Note

KIUC recommended an adjustment to reduce Big Rivers' revenue requirement by $2,536,730 to reflect the avoided interest expense and associated TIER related to Big Rivers having prepaid its Rural Utilities Service ("RUS") 2009 Promissory Note Series A in April of 2011.[18] Big Rivers used money from its Transition Reserve fund to make the prepayment after being granted a waiver of Section 5.09(C) of its revolving credit agreement with CoBank ACB.

Due to having based the determination of its revenue deficiency on the 1.24 "Contract TIER" set forth in the Smelter Agreements, Big Rivers claimed on rebuttal that KIUC's proposed adjustment was not appropriate.[19] It cited Section 4.75(f) of the Smelter Agreements as prohibiting use of the Transition Reserve from having any impact on margins in the calculation of its Contract TIER.[20] Big Rivers stated that the prohibition contained in Section 4.75(f) of the Smelter Agreements was the reason it had excluded $271,105 in interest income on the Transition Reserve from its derivation of adjusted margins and, hence, its calculation of its Contract TIER.[21]

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[18] $35 million X 5.845 percent = $2,045,750 plus 1.24 TIER thereon of $490,980.

[19] Hite Rebuttal at 9.

[20] The text of Section 7.45(f) states that "[i]t shall be assumed that the Rural Economic Reserve, the Economic Reserve and the Transition Reserve shall not generate any revenue or tax liability and the application of funds from the Rural Economic Reserve, the Economic Reserve or the Transition Reserve shall not result in any change in the net margins of Big Rivers."

[21] Hite Rebuttal Testimony at 10.

The Commission will not adopt KIUC's proposed adjustment, in part due to the provision contained in Section 4.75(f) of the Smelter Agreements cited by Big Rivers. Even in the absence of said provision, adjustments to reflect a post-test-year change in a utility's total capitalization go beyond our typical ratemaking practices in cases based on a historic test year. The Commission has for many years, to the greatest reasonable extent, consistently rejected utility requests to recognize post-test-year increases in capitalization in the determination of utility revenue requirements because such increases do not comport with the concept of reflecting actual test-year "volumes" or levels in an adjusted historical test year used for ratemaking purposes.[22] Recognizing either post-test-year increases or decreases in total capitalization would be inconsistent with the rather broad view we have taken, and continue to take, of the matching principle, as it pertains to the ratemaking process. For these reasons, we will not adopt KIUC's proposal.

Labor and labor overhead expenses

In its application, Big Rivers proposed an adjustment to increase labor and labor overhead expenses by $624,894, from $68,084,003 to $68,708,897.[23] KIUC disagreed

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[22] Volumes or levels in this context pertains not only to sales volumes, but to number of employees, rate base dollars, total capitalization dollars, etc. With some exceptions, such as the addition or loss of a large industrial customer or delays in drawing down long-term loan funds to reimburse internal or short-term funding, the Commission generally does not include post-test-year changes in these volumes for ratemaking purposes. However, changes in rates or prices that occur after the test year are, to a somewhat limited extent, recognized for ratemaking purposes. Examples are changes in a utility's rates pursuant to another proceeding before the Commission, changes in employee wage rates, changes in the price of gasoline or postage, as well as changes in the utility's cost of debt due to changes in its variable interest rates or due to refinancing of existing fixed-rate debt.

[23] Exhibit Wolfrom-2, Reference Schedule 2.07.

with Big Rivers' proposed adjustment, claiming that Big Rivers did not reflect the fact that a portion of its labor and labor overhead costs were capitalized.[24] Based on the percentage of test-year labor and labor overhead costs that were capitalized by Big Rivers, KIUC recommended that Big Rivers' proposed level of labor and labor overhead expenses be reduced by $1,304,000 to reflect the portion that would be capitalized rather than charged to expense.[25]

In its rebuttal testimony, Big Rivers acknowledged that its original proposal did not properly recognize the capitalized portion of its labor and labor overhead costs. Its revision, however, reduced its original adjustment by $174,679, not the larger amount recommended by KIUC.[26] Big Rivers stated that this is due to KIUC having applied the capitalization ratio to the net amounts of both test year and proposed labor and labor overhead costs after the capitalized portions had been deducted. Applying the 1.505 percent capitalization ratio to the total amounts of the test year and proposed labor and labor overhead costs results in an increase of $450,215, which is $174,679 less than Big Rivers' originally proposed adjustment.

Having considered the arguments advanced by Big Rivers and KIUC, we find that Big Rivers' revised adjustment should be accepted. Big Rivers' rebuttal testimony correctly reflects the derivation of the test-year capitalization ratio and its application to the proposed level of labor and labor overhead costs, resulting in the proper adjustment to increase its test-year labor and labor overhead expenses.

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[24] Kollen Direct Testimony at 13.

[25] The test-year capitalization ratio was 1.505 percent.

[26] Hite Rebuttal at 13-14.

Non-outage production O & M expenses

During the test year, Big Rivers deferred a significant amount of maintenance work in order to realize the necessary margins[27] required to achieve the minimum MFIR of 1.10 established in its First Mortgage Indenture to U.S. Bank National Association, Trustee.[28] In its attempt to "catch up" on this required maintenance and reflect the related expense in its revenue requirement, Big Rivers proposed an adjustment of $5,660,678 based on its budgeted expense levels for the years of 2011 through 2014.[29] This adjustment, which would result in an increase of the test-year expense level from $33,216,868 to $38,877,546, also included an inflation component for each of the four years, which Big Rivers derived based on the Consumer Price Index for the years 2000 to 2010.

KIUC opposed Big Rivers' proposed adjustment, claiming that only the inflation component for 2011 should be included in the calculation of the adjustment. It argued that including inflation for a period of four years beyond the test year violated a "[r]easonable determination of the test year expense."[30] KIUC also stated that Big Rivers' estimate of inflation for the years 2012-2014 was not known and measurable. KIUC recommended that Big Rivers' proposed adjustment reflect inflation only for 2011,

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[27] Several Big Rivers' witnesses stated that the weak wholesale market, which caused its revenues from off-system sales to fall far short of the levels reflected in the financial model in use at the time of the Unwind Transaction, was the primary cause of its need to improve its 2010 margins through the deferral of required maintenance.

[28] The calculation for MFIR is the same as the calculation of a conventional TIER.

[29] Berry Direct Testimony, Exhibit Berry-5.

[30] Kollen Direct Testimony at 16.

which reduced the adjustment by $1,324,000 and resulted in a $37,553,546 adjusted level of expense.[31]

When a rate request is based on a historical test year, the Commission generally adheres to the concept that adjustments to the test year should be known and measurable. Consequently, adjustments based on events occurring beyond the end of the test year are rarely accepted due to their inability to meet the requisite evidentiary standard. Other than permitting an inflation factor to be included in adjustments based on historical averages for costs that tend to fluctuate greatly from year to year, such as storm damages, injuries, and damages, the Commission's application of the known and measurable standard does not avail itself to recognizing inflation factors in adjustments based on budgets of future costs, particularly budgets that extend four years beyond the end of the test year.

Having considered Big Rivers' deferral of required maintenance during the test year, its proposal to "catch up" on said maintenance, and the longstanding standard by which we review post test-year adjustments in historical test-year rate cases, we will not accept the adjustment proposed by Big Rivers. The proposed adjustment is based on budgets, or forecasts, that go four years beyond the test year. It also includes an inflation factor--something that is neither known nor measurable in a post-test-year adjustment. Likewise, we will not accept the alternative adjustment proposed by KIUC, which also included an inflation factor as well as budgeted amounts extending four years beyond the test year. Given Big Rivers' lack of historical data on which to base an adjustment and recognizing its need to catch up on its required maintenance, the

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[31] Id. at 15.

Commission will permit an adjustment to the test-year expense based upon the amount budgeted by Big Rivers for calendar year 2011, which is $37,480,160. The resulting increase of $4,263,292 above the test-year expense reflects a reduction of $1,397,386 to Big Rivers' proposed adjustment of $5,660,678.[32]

Midwest ISO case-related expenses

During the test year, Big Rivers incurred expenses of $1,305,377 related to the regulatory proceedings involving its becoming a member of the Midwest Independent System Operator ("Midwest ISO), both at this Commission and at the Federal Energy Regulatory Commission ("FERC"). Big Rivers' total costs for those proceedings were $1,602,777, which it charged to expense at the time the costs were incurred. Big Rivers proposed an adjustment to reduce expenses by $771,118 for ratemaking purposes, which would allow it to amortize the total cost over three years and include one-third of the cost, $534,259, in the determination of its revenue requirements.[33] Big Rivers largely based its proposed three-year amortization on the Commission's practice of allowing the costs of rate cases to be amortized over a like period of time, stating that amortization over three years would result in a reasonable matching of the benefits of joining the Midwest ISO with the costs of the cases related to its becoming a member of the Midwest ISO. It also stated that a three-year amortization would allow for the full recovery of the costs between this rate case and its next rate case.

KIUC opposed the adjustment arguing, first, that including the cost incurred prior to the test year in such an adjustment would constitute improper retroactive ratemaking.

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[32] The approved adjustment is $73,386 less than KIUC had recommended.

[33] Exhibit Wolfrom-2, Reference Schedule 2.21.

It argued that the expense incurred during the test year was nonrecurring and should simply be removed from the test year and that the proposal to amortize the expense was, at best, discretionary, and would create an unnecessary and avoidable expense for the three years following the conclusion of this case.[34]

On rebuttal, Big Rivers compared its proposal to the Commission's decision in a 1990 rate case involving Louisville Gas and Electric Company ("LG&E").[35] In that case, the Commission found that LG&E's costs incurred as a result of downsizing its work force, which had been charged to expense at the time they were incurred, could be amortized and recovered for ratemaking purposes. The Commission's findings in that case were based on (1) the material nature of the costs, (2) the future benefits of the downsizing, and (3) the appropriate matching of the costs with the benefits over a future period of time. Big Rivers claims that, in this instance, the costs it incurred in conjunction with its Midwest ISO regulatory proceedings meet the same three criteria applied by the Commission in concluding that amortization and recovery of the LG&E downsizing costs were reasonable.

The Commission will not allow Big Rivers' proposed adjustment. The effect of the costs it incurred in conjunction with its Midwest ISO regulatory proceedings has already been reflected in its expenses and margins for calendar years 2009 and 2010. To now defer and amortize these costs for ratemaking purposes would result in both retroactive accounting as well as ratemaking. The appropriate action for Big Rivers to

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[34] Kollen Direct Testimony at 12.

[35] Case No. 1990-00158, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, (Ky. PSC. Sept. 30, 1991).

have taken, had it wanted to preserve its right to seek rate recovery of these costs, would have been to request Commission approval to establish a regulatory asset to defer the costs when incurred, rather than charge them to expense at that time. This decision is consistent with a recent Delta Natural Gas Company ("Delta") rate case in which Delta sought to amortize and recover a cost that had previously been charged to expense. In denying that rate recovery, we stated, "[i]f the Commission were now to allow Delta to increase its revenues to recover this cost on an amortized basis . . . there would be no expense on its books of account to match against, or offset, the additional revenue."[36] While there are similarities between Big Rivers' situation as a result of its Midwest ISO regulatory proceedings and the circumstances in the 1990 LG&E rate case, we are not persuaded that the same outcome is warranted. In the LG&E case, the future benefits of its downsizing included a demonstrable showing of annual cost savings that equaled 95 percent of the one-time costs of the downsizing. While there is every expectation that membership in the Midwest ISO will produce benefits for Big Rivers and, in turn, the customers of its member cooperatives, there is no evidence in this case of actual savings. Thus, the instant case is not comparable to the 1990 LG&E case. Consistent with last year's decision in the Delta rate case, we find that non-recurring costs which are expensed should not be considered for ratemaking purposes. Accordingly, the amortization and recovery proposed by Big Rivers is denied.

[36] Case No. 2010-00116, Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates (Ky. PSC Oct. 21, 2010).

Depreciation expense adjustment

During the test year, Big Rivers recorded total annual depreciation expense of $36,279,438. Based on the depreciation study[37] performed on behalf of, and adopted by, Big Rivers in response to the requirement in our Order approving the Unwind Transaction that it perform a new study, Big Rivers proposed an increase in its annual depreciation expense of $6,252,651, to $42,532,089.[38] The depreciation study relied on the Whole Life method, which was used for most general plant accounts, and the Life Span method which, combined with the Remaining Life technique, was used for transmission and production accounts and Account 390 – Structures.

KIUC disagreed with the results of the Big Rivers study. KIUC's primary contention is that many of the remaining service lives used to calculate the proposed depreciation rates for production plant were shorter than they should be and, in fact, shorter than the lives supported by the underlying analyses contained in Big Rivers' study. For some accounts, KIUC claimed that the results were "arbitrary and skewed toward the lower end of the remaining life spectrum."[39] Because Big Rivers' proposal included depreciation expense on its test-year-end CWIP balance, KIUC argued that a reduction in depreciation expense based on estimated plant retirements in the first year

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[37] Performed in 2010 by Burns & McDonnell, an engineering, architectural and construction consulting firm, the depreciation study reflected utility plant balances as of April 30, 2010. Burns & McDonnell had performed Big Rivers' prior depreciation study in 1998.

[38] Exhibit Wolfrom-2, Reference Schedule 2.06. Big Rivers' proposed adjustment was based on its test year-end utility plant account balances, including Construction Work In Progress ("CWIP").

[39] Direct Testimony of Charles W. King at 9.

new electric rates are in effect should be recognized in the pro forma depreciation expense amount.[40] On that basis, and using the shorter remaining service lives it recommended for production plant accounts, KIUC proposed depreciation rates that produce a $784,312 decrease in Big Rivers' actual test-year depreciation expense, from $36,279,438 to $35,595,126,[41] or $6,936,963 less than the pro forma depreciation expense proposed by Big Rivers.

On rebuttal, Big Rivers acknowledged that various qualitative factors, as well as professional judgement, went into the selection of the remaining service lives used in its depreciation study.[42] Big Rivers provided several scenarios using combinations of assumptions as to (1) annual operating hours of its generating units, (2) the retirement dates of units at multi-unit generating stations using the age of the oldest, or newest, unit, and (3) the remaining service lives of all generating units, all of which were factors considered in developing its proposed depreciation rates.[43] In addition, Big Rivers' rebuttal indicated that, by updating KIUC's analysis to reflect years 2010 and 2011 and the installation dates as of a conventional mid-year date rather than as of January 1 of the year each unit began operation, each remaining life would be reduced by 2.5 years. These changes, according to Big Rivers, would increase KIUC's recommended depreciation expense by $2 million.

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[40] Kollen Direct Testimony at 18-19.

[41] Exhibit_(LK-12) Revised.

[42] Rebuttal Testimony of Ted J. Kelly at 3-4.

[43] Exhibits Kelly Rebuttal-1 through 6.

Big Rivers also testified to the losses experienced from early plant retirements since taking over operation of its generating units following the Unwind Transaction. It claims this is the result of (1) liberalized capitalization practices employed by WKE during its 1998 to 2009 operation of the generating units, (2) the requirements under the Smelter Coordination Agreement that it use the WKE capitalization practices, and (3) the number of short-lived retirement units in the Coordination Agreement that were required to be included in longer-life retirement groups under its 1998 depreciation schedule. According to Big Rivers, this unique set of circumstances has resulted in early retirements that have accumulated $68.8 million in losses. It claims that its proposed depreciation rates would improve this situation, while KIUC's proposed rates would make it worse.

As Big Rivers and KIUC testified, determining the proper level of depreciation is not an exact science and it cannot be done with absolute precision. In this instance, the differences between the positions of Big Rivers and KIUC are caused by differences in remaining service lives and the fact that Big Rivers' proposal includes depreciation on its test-year-end CWIP balance. The Commission must exercise its best judgement in determining the depreciation rates that Big Rivers should use on a going-forward basis. Accordingly, our judgement is based on the totality of the evidence presented in this case.

As we analyze the evidence, we concur with the depreciation experts that the remaining service lives of Big Rivers' assets are essentially estimates based on past patterns of retirements, in addition to assumptions of the remaining number of plant operating hours and the probability of plant life extensions. In this instance, our review of the record indicates that both Big Rivers and KIUC have presented credible evidence in support of their respective positions on the remaining service lives and proposed depreciation rates. However, due to the problem of early retirements experienced by Big Rivers since the closing of the Unwind Transaction, there is a clear need to utilize shorter service lives. For that reason, we will approve and authorize Big Rivers' use, on a going-forward basis, of the depreciation rates proposed in its application. However, we will not authorize a level of depreciation expense that reflects the accrual of depreciation on Big Rivers' test-year-end CWIP balance. Going beyond the end of test year plant-in-service balances is inconsistent with the concept of a historical test year and a violation of the broad "matching principle" described previously in this Order. For this reason, we will limit the adjustment to the amount derived by applying Big Rivers' proposed depreciation rates to its test-year-end plant in service balances. This results in an adjustment that increases Big Rivers' depreciation expense by $3,489,340 and an adjusted depreciation expense level of $40,218,778.[44]

Cost of energy efficiency programs

Big Rivers proposed to increase its test-year expenses by $1 million to reflect the cost of energy efficiency programs presented in its 2010 Integrated Resource Plan ("IRP"), which it filed with the Commission in November 2010.[45] The programs included in Big Rivers' IRP consisted of nine pilot programs, which were to be conducted at

[44] Big Rivers' proposed depreciation expense of $42,532,089 less depreciation on test-year-end CWIP balance of $2,313,311 = $40,218,778.

[45] Big Rivers budgeted $544,000 for its energy efficiency programs in 2011 when its programs would be launched in the form of small scale pilot programs. It planned to increase its expenditures to $1.1 million in 2012 when the programs' ramp-up was complete.

various intervals, with some beginning in late 2010 and others beginning in early to mid-2011.[46] Big Rivers indicated that, prior to the Unwind Transaction, when it was able to purchase low-cost power at fixed prices from WKE's affiliate, LG&E Energy Marketing, Inc., there was little incentive for it to pursue energy efficiency. After the closing of the Unwind Transaction, Big Rivers began looking into energy efficiency and demand-side management ("DSM") possibilities, which were incorporated into its 2010 IRP.[47]

KIUC opposed Big Rivers' proposal to increase expenditures by $1 million in order to implement energy efficiency programs, arguing that Big Rivers did not have a well-defined DSM plan which could be tied to its planned expenditure level of $1 million. KIUC stated that, since the programs were primarily designed for the Rural customer class[48] and not for the Smelters, it would be appropriate to recover the expenditures from the specific customer classes that would benefit from the programs via a DSM surcharge mechanism as permitted under KRS 278.285.

On rebuttal, Big Rivers claimed that all customers, including the Smelters, will benefit from it deferring new generating capacity due to its energy efficiency and DSM programs and that recovering the programs' costs from all customers is appropriate. It

[46] According to Big Rivers' post-hearing data responses, all of the pilot programs were to be completed by the end of September 2011.

[47] Big Rivers stated that during the test year ended October 31, 2010 it did not have sufficient funds to support a significant level of energy efficiency programs and still meet the TIER requirements in its debt covenants.

[48] Big Rivers recognizes three classes for the customers of its member-owners. Those are: (1) the Smelters; (2) the direct-serve large industrial customers; and (3) the rural class, which is made up of all the remaining customers.

reiterated its commitment, contingent upon being allowed to recover its costs, to creating and promoting incentives for a number of energy-efficiency measures.

Having heard the arguments advanced by the parties, and mindful of the near-term needs of Big Rivers to address the issues created by recently adopted and proposed environmental rules, the Commission will accept Big Rivers' proposed adjustment which increases its test-year expenses $1 million. Not only can energy efficiency and DSM programs provide a service to customers, well-designed and cost-effective programs can help reduce emissions and assist in deferring the need for new generation. However, while we agree in theory with Big Rivers' argument that all customers can benefit from deferring new generation, we are mindful that the cost of DSM programs should be allocated to the classes of customers that are eligible to participate in those programs. For that reason, in allocating the revenue increase granted herein, we will incorporate an adjustment to ensure that none of the $1 million will be recovered from the Smelters.

In light of Big Rivers' relative lack of experience with energy-efficiency and DSM programs, and given the timing of this case, the Commission believes it should monitor the development of Big Rivers' programs. We also believe we should not wait to review Big Rivers' next IRP in 2013 to begin our monitoring. Therefore, we will require that Big Rivers file a report with the Commission detailing the results of its evaluations of the nine pilot programs identified in its 2010 IRP, along with its plans for each of the nine programs. Big Rivers' initial report shall include a proposed budget for the $1 million in expenditures we are approving herein. Given that Big Rivers' 2010 IRP indicated that all of the pilot programs were to be completed by the end of September of 2011, we will require that it file the report described herein with the Commission no later than January 31, 2012. Every six months thereafter, beginning on July 31, 2012, until a new IRP is filed, Big Rivers shall file a report updating its DSM and energy-efficiency programs. These six-month reports shall include an analysis of the expenditures on those programs showing them in the same categories and/or accounts that were used in the budget provided in Big Rivers' initial report described herein.

Pro Forma Adjustments Summary

The effect of the accepted adjustments on Big Rivers' net income is as follows:

| | Actual Test Period | Pro Forma Adjustments | Adjusted Test Period |
|---|---|---|---|
| Operating Revenues | $522,923,675 | $(124,469,261) | $ 398,454,414 |
| Operating Expenses | 480,578,990 | (113,809,768) | 366,769,222 |
| Net Operating Income | 42,344,685 | (10,659,493) | 31,685,192 |
| Interest on Long-Term Debt | 47,622,709 | 70,408 | 47,693,117 |
| Interest Charged to Constr. | (515,767) | 0 | (515,767) |
| Interest Expense-Other | 149,903 | 0 | 149,903 |
| Other Income and (Deductions)–Net | (4,775,853) | 5,119,486 | 343,633 |
| Net Income | $ (9,688,013) | $ (5,610,415) | $ (15,298,428) |

## REVENUE REQUIREMENTS

Big Rivers' actual test-year rate of return on its net investment rate base found reasonable herein was 3.60 percent. Its test-year TIER was 0.80X. Big Rivers based its revenue requirement determination on the maximum Contract TIER of 1.24X as permitted under the Smelter Agreements and the non-Smelter member tariffs.[49] None of the intervenors opposed using the 1.24X Contract TIER as the means of determining Big Rivers' revenue deficiency or its revenue requirement

[49] Based on Big Rivers' adjusted test-year level of Interest on Long-Term Debt of $47,693,118, a 1.24X TIER results in margins of $11,446,348.

The Commission finds that a 1.24X TIER is a reasonable basis for determining Big Rivers' revenue requirement. Based upon the adjustments found reasonable herein, the Commission has determined that, in order to produce a TIER of 1.24X, Big Rivers will require an increase in revenues of $26,744,776. This additional revenue should produce net operating income of $58,429,968, resulting in a rate of return of 4.97 percent on the $1,175,239,848 net investment rate base found reasonable herein. Based on a 1.24X TIER and the interest on long-term debt found reasonable herein of $47,693,118, the resulting net margins are $11,446,348.

## PRICING AND TARIFF ISSUES

### Cost-of-Service Study

Big Rivers filed a cost-of-service study ("COSS") which used a 12 coincident peak ("CP") methodology to allocate production and transmission demand-related costs for ratemaking purposes.[50] The COSS showed the Rural class rate of return to be lower than the rates of return for the Large Industrial and Smelter classes,[51] and that the Rural class was receiving a subsidy of $11.1 million. Stated another way, the revenues provided by the Rural class were $11.1 million less than the cost to serve that class.[52] In an attempt to reduce the subsidy, Big Rivers proposed increases of $14.2 million to the Rural class, $3.3 million to the Large Industrial class, and $22.5[53] million to the

[50] Seelye Direct Testimony at 14.

[51] Id. at 16.

[52] Id. at 18-19.

[53] This amount reflects the proposed Smelter increase prior to Big Rivers' Smelter TIER Adjustment of $7.1 million.

Smelters.[54] Big Rivers' allocation of the increase would reduce the subsidy received by the Rural class by $1.9 million, from $11.1 to $9.2 million, and reduce the rate of return gap between the Rural and Large Industrial classes by approximately 22 percent.[55]

KIUC filed a COSS which used a 6 CP methodology to allocate production demand-related costs. KIUC stated that customer demands during the three peak summer months and three peak winter months are capacity drivers on Big Rivers' system and that, although off-peak months have high system peaks, demand in those months does not drive cost responsibility.[56] Consistent with its recommended revenue requirement, KIUC's COSS also eliminated the $7.1 million Smelter TIER Adjustment made by Big Rivers. Using its COSS, KIUC concluded that the Rural class is receiving an $18.3 million subsidy[57] under present rates.[58]

KIUC proposed to allocate its recommended increase of approximately $18.7 million to the rate classes as follows: $18.4 million to the Rural class; $34,000 to the Large Industrial class; and $227,000 to the Smelter class.[59] KIUC's proposal would eliminate 100 percent of what it calculated to be the current Rural subsidy. However,

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[54] Exhibit Seelye-6 at 1.

[55] Seelye Direct Testimony at 19-20.

[56] Baron Direct Testimony at 12-13.

[57] Id. at 22.

[58] KIUC also provided the results of an alternative COSS that eliminated Big Rivers' proposed Smelter Adjustment but used a 12 CP methodology to allocate production demand-related costs. The results of this COSS showed the subsidy for the Rural class to be $13.24 million.

[59] Baron Direct Testimony at 31.

KIUC states that the Rural class will still receive a subsidy of over $6 million under proposed rates because the Smelter's base rates are contractually linked to the Large Industrial base rates.[60]

In order to lessen the impact of its recommended increase on the Rural class, KIUC proposed two mitigation measures. The first measure would require Big Rivers to use $4.2 million of the Rural Economic Reserve ("RER") fund[61] annually to offset the increase.[62] The second measure would have the Commission direct Big Rivers to adopt a plan to retire patronage capital. KIUC states that, "the Company should distribute 25% of the prior year's margins each year to the extent the margins are available for distribution, subject to retaining its investment grade debt rating and meeting all Indenture and Loan Contract limitations."[63]

On rebuttal, Big Rivers stated that its reason for using a 12 CP methodology for production demand-related costs was that, largely because of the Smelters, its load consists of a large percentage of industrial load and is relatively flat from month to month.[64] Big Rivers also opposed KIUC's recommendation to eliminate 100 percent of the Rural class subsidy at one time. Big Rivers argued that, when equalizing class

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[60] Id. at 9.

[61] The RER fund was established in Case No. 2007-00455 to be used for the benefit of the Rural class upon exhaustion of the Economic Reserve fund. The Commission ordered the establishment of this fund to partially offset the adverse effect on the Rural class of higher fuel costs and the exhaustion of the Economic Reserve. The RER fund was initially established with approximately $60.9 million.

[62] Baron Direct Testimony at 28.

[63] Kollen Direct Testimony at 30-31.

[64] Rebuttal Testimony of William Steven Seelye at 30.

rates of return, it is inappropriate to eliminate all differentials in one step, citing the Commission's long-standing use of the principle of gradualism in setting rates.[65]

Big Rivers also opposed KIUC's mitigation proposals. It argued that using the RER fund to mitigate the increase would be harmful to the Rural class in that it would exhaust the RER funds sooner than they would otherwise be exhausted. Big Rivers stated that "the KIUC proposal merely shifts the effect of increasing the Rurals' rates from the present to the future."[66] Big Rivers also opposed KIUC's patronage capital distribution proposal, claiming that such distributions should only be made if there is no adverse impact on the financial condition of the utility. Big Rivers argued that KIUC's proposal would reduce its cash flow, increase the need for borrowings, and place its investment grade credit ratings at risk.[67]

Kenergy filed rebuttal testimony in which it recommended that approximately $27.5 million[68] of non-base rate smelter-provided revenues be removed from the COSS. Kenergy argued that these revenues should be considered as offsets to the total revenue requirement, but that they should not be treated as subsidies in the COSS.[69] Kenergy's recommended adjustments to Big Rivers' COSS resulted in a Rural subsidy

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[65] Id. at 23.

[66] Rebuttal Testimony of Mark A. Bailey at 14.

[67] Rebuttal Testimony of Mark A. Hite at 23.

[68] Gaines Rebuttal Testimony at 3.

[69] Id. at 5.

of $156,936 and a Smelter subsidy of $3.7 million, all contributed by the Large Industrial class.[70]

In response to Kenergy's testimony, KIUC filed surrebuttal testimony stating that the rates paid by the smelters are fair, just, and reasonable, and that eliminating them from the COSS would be unprecedented.[71] KIUC also objected to Kenergy's acceptance of the Smelter TIER Adjustment made in Big Rivers' COSS, stating that "[t]here is no credible evidence that a $7.1 million TIER Adjustment rate decrease will actually occur on September 1, 2010 (sic) and it is inappropriate to make such an assumption."[72]

After considering the competing arguments, the Commission finds that Big Rivers' load shape, influenced as it is by the Smelters' very large loads coupled with extremely high load factors, makes the 12 CP methodology presented by Big Rivers more appropriate for use in this case. In addition, as the Commission has rejected Big Rivers' adjustment to the Smelter TIER Adjustment revenues for revenue requirement purposes, we will likewise reject it for COSS purposes.

The Commission is not persuaded by the record in this case to accept Kenergy's adjustment to remove all non-base rate smelter revenues from the COSS. Even though the Smelters agreed to pay these additional revenues, excluding them from the calculation of the Smelters' rate of return has not been shown to be reasonable. The Commission agrees with Big Rivers that "the higher rate of return for the Smelters is to

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[70] Id. at 9.

[71] Baron Surrebuttal Testimony at 7.

[72] Id. at 9.

be fully expected due to the special contract rate provisions prescribed in the Smelter Agreements."[73]

We will make one other adjustment to Big Rivers' COSS which relates to the $1 million cost of the energy efficiency programs authorized by this Order. As discussed previously in this Order, the Commission agrees in theory with Big Rivers' argument that all customers benefit from programs that defer the need for additional capacity. However, for purposes of revenue allocation, it has been our practice to allow the costs of programs to be assigned only to the customer classes that are eligible to participate in the programs. Here, Big Rivers has not shown a sufficient basis to allocate the costs of these DSM programs to customer classes not eligible to participate in the programs. Therefore, the Commission will make an adjustment to reflect the assignment of the full $1 million cost for Big Rivers' energy efficiency programs to the Rural rate class.

Revenue Allocation

As previously stated, Big Rivers' revenue allocation proposal would reduce the Rural subsidy shown in its COSS results by $1.9 million, from $11.1 million to $9.2 million, and reduce the rate-of-return gap between the Rural and Large Industrial classes by 22 percent. KIUC's proposal eliminates 100 percent of the Rural subsidy of $18.7 million shown in its COSS results at present rates.

Based on the Commission's decision to accept a 12 CP methodology for calculating Big Rivers' COSS, coupled with the exclusion of Big Rivers' proposed Smelter TIER adjustment and the inclusion of the DSM adjustment, the Rural subsidy at present rates is $13.5 million. The Commission will not accept KIUC's proposal to

[73] Rebuttal Testimony of William Steven Seelye at 19.

eliminate 100 percent of the Rural subsidy in a single step as part of this proceeding. Such an action would be inconsistent with our long-standing practice of employing the principle of gradualism in moving toward cost-of-service-based rates. Considering the amount of the Rural subsidy, moving to cost-of- service-based rates for all classes is a goal to be achieved gradually, in incremental steps. However, based on the COSS results, and considering the unique characteristics of the loads on Big Rivers' system, we find that the Rural subsidy should be reduced by an amount greater than proposed by Big Rivers, $2.4 million, with the rate-of-return gap between the Rural and Large Industrial classes being reduced accordingly.[74] Taking into consideration the evidence regarding cost-of-service and using the principles of gradualism and rate continuity, the Commission finds that the $26,744,776 million increase granted herein should be allocated to the rate classes as follows: $10.6 million to the Rural class; $1.97 million to the Large Industrial class; and $14.18 million to the Smelter class.

The Commission also finds no need to adopt KIUC's proposal to use the RER fund to mitigate the increase to the Rural class. As we are not adopting KIUC's proposal to eliminate 100 percent of the rural subsidy and are employing a gradual approach in moving rates toward cost-of-service, it is not necessary to use the RER fund to mitigate the Rural class rate increase.

The Commission further finds no basis to adopt KIUC's proposal that Big Rivers be directed to adopt a plan to retire patronage capital. The decision by a cooperative to distribute patronage capital, much like the decision by an investor-owned utility to pay

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[74] The reduction in the rate of return gap is approximately 1.25 times the 22 percent reduction Big Rivers proposed, or roughly 28 percent.

out dividends, is a decision the Commission has historically left to utility management. The evidence in this case does not persuade us that it is necessary or appropriate to interfere with management's discretionary policies relating to the distribution of patronage capital.

Billing Demand

Big Rivers proposed to bill the Rural class on the basis of coincident peak demand rather than non-coincident peak demand as is done currently. Big Rivers stated that this will send a more accurate price signal to the Rural class. The Large Industrial class will continue to be billed on the basis of non-coincident peak.[75] None of the intervenors objected to this change. The Commission finds that Big Rivers' proposal is reasonable and should be approved.

Midwest ISO Attachment O Transmission Formula Rate

In an order dated November 1, 2010, the Commission approved Big Rivers' membership in the Midwest ISO.[76] The Midwest ISO Attachment O rate schedule is approved by the FERC to be used to determine transmission service rates under the Midwest ISO tariff.[77] Because Big Rivers had not yet received approval from this Commission to use the Midwest ISO Attachment O formula rate, it requested and received approval from FERC for an interim Attachment O that is effective through

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[75] Seelye Direct Testimony at 6.

[76] Case No. 2010-00043, Application of Big Rivers Electric Corporation for Approval to Transfer Functional Control of its Transmission System to Midwest Independent Transmission System Operator, Inc. (Ky. PSC Nov. 1, 2010).

[77] Seelye Direct Testimony at 40-41.

December 31, 2011.[78] On a going-forward basis, Big Rivers is requesting approval to adjust its transmission rates to utilize the Midwest ISO Attachment O formula rate and to update the inputs used in the transmission formula rate annually.[79] Big Rivers states that adoption of the Midwest ISO Attachment O formula rate will not affect base rates charged to Big Rivers' members.[80] No intervenor objected to this change. The Commission finds that Big Rivers' proposal is reasonable and should be approved.

Non-Fuel Adjustment Clause Purchase Power Adjustment

Big Rivers is proposing to reduce the amount of the Non-Fuel Adjustment Clause Purchase Power Adjustment ("Non-FAC PPA") included in the base rates of the Smelters and non-smelter customers from $.00175 per kWh to $.000874 per kWh, or $.000876 per kWh.[81] The proposed base amount of $.000874 per kWh reflects the average purchased power costs for June 2010. This amount was chosen as it is close to the test-year average cost of $.00082 per kWh. Big Rivers stated that "[d]etermining the Base on the basis of the cost for a single month is consistent with the Commission's normal practice of determining the FAC Base on the basis of fuel costs for a particular month."[82] None of the intervenors objected to this change. The Commission finds that Big Rivers' proposal is reasonable and should be approved. This results in a reduction in base-rate revenues of $2,959,159.

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[78] Id. at 42.

[79] Id. at 43.

[80] Seelye Direct Testimony at 44.

[81] Id.

[82] Seelye Direct Testimony at 27.

Non-FAC PPA for Non-smelter Customers

Big Rivers has two Non-FAC PPA mechanisms, one for the Smelters, which provides for a monthly calculation of a Non-FAC PPA factor charged or credited to bills; and a second for non-smelter customers in which Non-FAC PPA charges or credits are recorded in a regulatory account to be amortized at a later date.[83] As set forth in its proposed Non-FAC PPA tariff for non-smelter customers, Big Rivers is requesting to amortize, over 24 months,[84] the balance of the non-smelter regulatory account as of June 30, 2011, which is a liability balance of $7,041,523. Amortization of this account will result in credits on non-smelter bills which, as proposed by Big Rivers, would begin with bills for September 2011.[85] In addition, Big Rivers is proposing to continue to accumulate the difference between the amount of the Non-FAC PPA for non-smelters included in base rates and the amount it actually incurs in a regulatory account and to amortize the account balance as of June 30 each year over a 12-month period beginning in September.[86] None of the intervenors objected to this change. The Commission finds that Big Rivers' proposal and associated tariff are reasonable and should be approved. Based on a June 30, 2011 balance of $7,041,523, the credit to be

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[83] Id. at 37.

[84] Big Rivers stated in response to Item 33 of Commission Staff's Second Information Request that it is proposing an initial amortization period of 24 months because the regulatory account "will have been in place for almost 24 months as of June 30, 2011."

[85] Id. See also, Big Rivers' response to Item 4 of the information requested at the hearing.

[86] Seelye Direct Testimony at 37.

applied over 24 months is $.001041 per kWh.[87] This credit results in an immediate reduction in energy rates. However, as pointed out by Big Rivers, "the off-setting effect that lowering the Purchased Power Base [to $.000874 per kWh, as discussed in the preceding section of this Order] will have on the amounts charged or credited to the Regulatory Account will not be reflected in the bills to the Non-Smelters until one year later, when the Regulatory Account will be amortized under Big Rivers' proposed Non-FAC PPA."[88]

Member Rate Stability Mechanism

Big Rivers' Member Rate Stability Mechanism ("MRSM"), established as a result of the Unwind Transaction,[89] was originally expected to operate for no longer than 48 months. It is now expected to continue beyond 48 months and Big Rivers is proposing a change to specify how the MRSM will operate beginning in month 49.[90] Big Rivers proposes to modify the mechanism in order to establish an amount for the Expense Mitigation Factor ("EMF"), which is part of the MRSM, after 48 months. Four EMFs were initially established, each to be in place for 12 months. Big Rivers proposes to add a fifth EMF of $.007 per kWh for months 49-60 and an EMF of $.009 per kWh for all

[87] Big Rivers' response to Item 4 of the information requested at the hearing.

[88] Seelye Direct Testimony at 28.

[89] The source of funds for this mechanism is the Economic Reserve account that was initially established at approximately $157 million. It is used to offset cost increases to non-smelter customers following the closing of the Unwind Transaction.

[90] Seelye Direct Testimony at 33.

months thereafter.[91] There were no objections to this proposal from the intervenors. The Commission finds that Big Rivers' proposal is reasonable and should be approved.

RER Mechanism

The RER fund was established in the Unwind Transaction to be used for the benefit of the Rural class upon exhaustion of the Economic Reserve fund. The RER mechanism is currently designed to be applied to the Rural class over a 24-month period as set out in Big Rivers' tariff. Big Rivers has proposed to change the RER mechanism so that it operates in the same manner as the MRSM, except that it will apply only to the Rural class, as intended at the time it was established.[92] In essence, once the Economic Reserve fund is depleted through the operation of the MRSM, the EMFs identified in the MRSM would be adopted by the RER so that there will be continuity in the amounts credited to the Rural class between the two mechanisms.[93] There were no objections to this proposal from the intervenors. The Commission finds that Big Rivers proposal is reasonable and should be approved.

Expanded Load for Large Industrial Customers

Under Big Rivers' current tariff, new loads or expanding loads of existing large industrial customers of 5 MW or more are required to take service under its Large Industrial Customer Expansion Rate ("LICX").[94] The LICX tariff prices expansion power at what Big Rivers pays for purchases from third-party suppliers. KIUC argued that this

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[91] Id. at 35.

[92] Id. at 36.

[93] Id.

[94] Baron Direct Testimony at 38.

is essentially a market-based rate and that the LICX tariff deters economic development.[95] KIUC recommended that existing customers be allowed to take expansion service under the existing Large Industrial tariff. Big Rivers opposed KIUC's recommendation in its rebuttal testimony, stating that, if the expansion load is unlimited, it could incur costs to serve the increased load that exceed the revenues provided from the load under the Large Industrial rate.[96] When questioned at the hearing, Big Rivers stated that the expansion load limit of 5 MW "could be a little bit higher" and that "5 to 10 would seem reasonable."[97]

The Commission is not persuaded to eliminate the upper limit on incremental loads of existing customers as proposed by KIUC. Although there is no evidence that any customer has not located or not expanded due to this tariff, we believe that increasing the upper limit of the loads to which the Large Industrial tariff would apply is appropriate at this time. Hence, the Commission finds it reasonable to increase the load expansion limit in Big Rivers' Large Industrial tariff to 10 MW for both new and existing loads with a corresponding increase to the minimum load to which the LICX tariff would apply.

Tariff Reorganization

Big Rivers is proposing a reorganization of its existing tariff to include the addition of a general index and a division of the tariff into four major sections.[98] The four major

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[95] Id.

[96] Rebuttal Testimony of William Steven Seelye at 48.

[97] Hearing Video at 14:51:15.

[98] Yockey Direct Testimony at 6.

sections are identified as Standard Rate Schedules; Adjustment Clauses and Service Riders; Special Rules, Terms, and Conditions; and Definitions.[99] Big Rivers states the reorganization will assist readers in finding information contained in the tariff. In addition, Big Rivers is proposing that the existing Standard Rate for electric service to rural members be renamed as Standard Rate-RDS-Rural Delivery Service.[100] The Commission finds that Big Rivers' tariff reorganization proposals are reasonable and should be approved.

## OTHER ISSUES

### Energy Efficiency and DSM

The Commission believes that conservation, energy efficiency and DSM have become more important and cost-effective in recent years; and that they will grow in importance, particularly, as there will be more constraints placed upon utilities whose main source of supply is coal-based generation. The Governor's proposed energy plan, *Intelligent Energy Choices for Kentucky's Future, November 2008,* calls for an increase in DSM by 2025. In addition, the Commission stated its support for cost-effective demand-side programs in response to several recommendations included in *Electric Utility Regulation and Energy Policy in Kentucky,* the report the Commission submitted in July 2008 to the Kentucky General Assembly pursuant to Section 50 of the 2007 Energy Act.

As stated in its application, historically, Big Rivers has not offered significant energy-efficiency and DSM programs to its members and their retail customers. With

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[99] Id. at 7-8.

[100] Id. at 8.

assistance from an outside consulting firm, Big Rivers has now developed several pilot programs for its member cooperatives. While this is a reasonable first step, the Commission believes that Big Rivers should continue its efforts by further developing and expanding programs that will be available to its member cooperatives and their customers. The Commission strongly encourages Big Rivers, and all other electric energy providers, to make a greater effort to offer cost-effective DSM and other energy efficiency programs.

Smelter Economic Issues

Four of KIUC's witnesses offered testimony which addressed either: (1) the economic viability of the Smelters; (2) the economic impact the Smelters have on the local, regional, and statewide economies; (3) the impact on Big Rivers if one or both Smelters were to close; (4) the scarcity of jobs in western Kentucky with salaries and wages comparable to those of the Smelters' employees; or (5) the need for a long-term solution to maintain the economic viability and competitiveness of the Smelters in a volatile global industry. The KIUC testimony shows that aluminum is a global commodity that is sold at a price based on world-wide supply and demand. Consequently, the Smelters have no ability to influence the price at which they sell the aluminum they produce. With the cost of electricity amounting to approximately one-third of their cost to produce aluminum, the Smelters are highly sensitive to increases in the price of electricity. Since 1978, 24 of 34 aluminum smelters in the United States have closed, primarily due to high electricity prices.

The Smelters expressed deep concern that their economic viability will be seriously jeopardized as the price they pay for electricity continues to rise as forecasted by Big Rivers. They asserted that the prices they will be paying will be among the highest paid by the remaining smelters in the United States, and that such prices will not allow them to survive an economic downturn when the world price of aluminum drops. In addition to the specific rate adjustments the Smelters have proposed in this case, they also discussed the need for a long-term statewide solution to insure their continued economic viability. Examples of the types of solutions they suggest include development of a statewide development fund, provisions for tax credits, and a redistribution of the Smelters' load among multiple utilities.[101]

In its rebuttal testimony, Big Rivers generally agreed with KIUC as to the economic importance of the Smelters to both the economy of western Kentucky and the financial condition of Big Rivers. However, it claimed that the financial viability of the Smelters was not relevant to the evaluation of its revenue requirements in this rate case.[102] Big Rivers further stated that it and its member-owners lack the resources to ensure that the Smelters can operate successfully in the international aluminum market, and it agreed with KIUC on the point that any real solution must be developed on a statewide basis.

The Commission recognizes the importance of the Smelters to the local economies in which they operate, as well as their importance to the economies of western Kentucky and the Commonwealth. The Commission also recognizes the importance of the Smelters to Big Rivers' financial condition. As noted by KIUC, we

[101] Direct Testimony and Exhibits of Henry W. Fain at 23-24.

[102] Seelye Rebuttal at 4.

have acknowledged that importance in the past, going back at least 24 years.[103] In fact, our decision in 2009 to approve Big Rivers' unwind of its generation lease agreement in Case No. 2007-00455 was to ensure that the Smelters would have a long-term power contract at rates that were not subject to market price variability.

Despite the Commission's broad scope of regulatory authority under KRS Chapter 278, we are unable to control or even influence prices in the international aluminum market. We are highly sympathetic to the Smelters' concerns about their continued viability and competitiveness in an industry which is subject to wide swings in the world market price of aluminum. However, we agree with both KIUC and Big Rivers that the type of long-term solution sought by the Smelters will necessitate legislative action at the statewide level. It is simply beyond the Commission's authority to develop the type of long-term statewide solution described by KIUC.

Refund Requirements

As stated previously, after Big Rivers placed its proposed rates in effect on September 1, 2011, we required it to maintain its records in order that the amount of any refund could be determined if the rates ultimately granted were less than Big Rivers' proposed rates. Given that the rates authorized herein are less than the proposed rates placed in effect by Big Rivers, the Commission finds that refunds should be made. Accordingly, Big Rivers will be required to refund the excess revenues collected from September 1, 2011 through the date of this Order to its three member-cooperatives in compliance with the refund provisions contained in KRS 278.190(4).

[103] Direct Testimony and Exhibits of Henry W. Fain at 16.

Consistent with the Commission's requirement in other rate cases in which refunds were required, Big Rivers will be required to pay interest on the refunded amounts at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release on the date of this Order.[104] Pursuant to KRS 278.190(4), all refunds must be made within 60 days of the date of this Order.

## SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A to this Order are the fair, just, and reasonable rates for Big Rivers to charge for service rendered on and after the date of this Order.

2. The rate of return and TIER granted herein are fair, just, and reasonable and will provide sufficient revenue for Big Rivers to meet its financial obligations.

3. The rates proposed by Big Rivers would produce revenue in excess of that found reasonable herein and should be denied.

IT IS THEREFORE ORDERED that:

1. The rates and charges proposed by Big Rivers are denied.

2. The rates in Appendix A to this Order are approved for service rendered by Big Rivers on and after the date of this Order.

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[104] See Case No. 1992-00346, The Application of The Union Light, Heat and Power Company for an Adjustment of Rates (Ky. PSC July 23, 1993); and Case No. 2010-00036, Application of Kentucky-American Water Company for an Adjustment of Rates Supported by a Fully Forecasted Test Year (Ky. PSC Dec. 14, 2010).

3. Within 20 days of the date of this Order, Big Rivers shall file new tariff sheets setting forth the rates and charges approved herein and reflecting their effective date and that they were authorized by this Order.

4. Within 60 days of the date of this Order, Big Rivers shall refund with interest all amounts collected for service rendered from September 1, 2011 through the date of this Order that are in excess of the rates set out in Appendix A to this Order. The amount refunded to each customer shall equal the amount paid by each customer during the refund period in excess of the rates approved herein.

5. Big Rivers shall pay interest on the refunded amounts at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release on the date of this Order.

6. Within 75 days of the date of this Order, Big Rivers shall submit a written report to the Commission in which it describes its efforts to refund all monies collected in excess of the rates that are set forth in Appendix A to this Order.

7. Big Rivers shall begin using the depreciation rates approved herein effective with the first day of the first calendar month beginning after the date of this Order.

8. Big Rivers shall perform a new depreciation study within five years of the date of this order, or the filing of its next rate case, whichever is earlier.

9. Big Rivers shall file reports on its DSM and energy-efficiency programs with the Commission as described in this Order at six-month intervals, with the first report to be filed no later than January 31, 2012.

By the Commission

ENTERED PA

NOV 17 2011

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2011-00036 DATED NOV 17 2011

The following rates and charges are prescribed for the customers in the area served by Big Rivers Electric Corporation. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

RURAL DELIVERY SERVICE
FORMERLY SCHEDULE C.4.d(2)

| | |
|---|---|
| Demand Charge | $ 9.50 |
| Energy Charge per kWh | $ .029736 |

LARGE INDUSTRIAL CUSTOMER
FORMERLY SCHEDULE C.7.c(2)(b)

| | |
|---|---|
| Demand Charge | $ 10.50 |
| Energy Charge per kWh | $ .024505 |

COGENERATION/SMALL POWER PRODUCTION SALES – OVER 100 kW
FORMERLY SCHEDULE 9f(3)(1)

| | |
|---|---|
| Demand Charge - Weekly | $ 2.192 |
| Energy Charge per kWh | $ .029736 |

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2011-00036 DATED NOV 1 7 2011

| Table 1: Big Rivers' and KIUC's Accepted Adjustments* | | |
|---|---|---|
| Description | | Adjustments |
| Revenue Adjustments | | |
| Annualize revenues & expenses for new customer | $ | 92,165 |
| Adjust mismatch in fuel cost recovery | $ | 2,225,346 |
| Eliminate environmental surcharge | $ | 633,559 |
| Temperature normalization of sales volumes | $ | (126,318) |
| Adjust for Non-FAC PPA | $ | (427,156) |
| Eliminate RRI Domtar backup revenues & expenses | $ | 971,257 |
| Eliminate WKE lease | $ | (149,673) |
| Eliminate WKE Unwind-related expenses | $ | 5,119,486 |
| Total of Revenue Adjustments | $ | 8,338,666 |
| Expense Adjustments | | |
| Reflect levelized planned outage expenses | $ | (2,726,965) |
| Reflect going forward IT support services | $ | (292,194) |
| Reflect Midwest ISO-related expenses | $ | (5,353,444) |
| Eliminate expense for leased property | $ | 128,368 |
| Eliminate costs related to LEM dispatching | $ | 936,815 |
| Adjust costs related to ACES Power Marketing | $ | (205,090) |
| Eliminate Southeastern Federal Power membership | $ | 180,775 |
| Eliminate advertising, lobbying, donations, etc. | $ | 531,388 |
| Reflect going-forward level of income taxes | $ | (183,084) |
| Reflect going-forward level of outside services | $ | 1,000,000 |
| Annual interest expense on long-term debt | $ | (70,408) |
| Interest on Construction Work in Progress | $ | - 0 - |
| Total of Expense Adjustments | $ | (6,053,839) |

* Adjustments, as shown, reflect their impact on Big Rivers' pro forma net income

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