COMMONWEALTH OF KENTUCKY

BEFORE THE

PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS)
AND ELECTRIC COMPANY) CASE NO. 98-426
FOR APPROVAL OF AN ALTERNATIVE METHOD)
OF REGULATION OF ITS RATES AND SERVICE)

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY)
FOR APPROVAL OF AN ALTERNATIVE METHOD) CASE NO. 98-474
OF REGULATION OF ITS RATES AND SERVICE)

RESPONSE TESTIMONY

OF

LANE KOLLEN

TO AMENDED APPLICATION

ON BEHALF OF THE

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

J. KENNEDY AND ASSOCIATES, INC.
ATLANTA, GEORGIA

MAY 1999

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RESPONSE TESTIMONY OF LANE KOLLEN

I. SUMMARY

1

2 **Q. Please state your name and business address.**

3 A. My name is Lane Kollen. My business address is J. Kennedy and Associates, Inc.

4 ("Kennedy and Associates"), 35 Glenlake Parkway, Suite 475, Atlanta, Georgia 30328.

5

6 **Q. Have you previously filed testimony in this proceeding?**

7 A. Yes. I filed Direct Testimony on behalf of the Kentucky Industrial Utility Customers,

8 Inc. ("KIUC") addressing the Companies' proposal for an alternative form of

9 regulation, which they have termed the electric performance based rate ("EPBR"). In

10 that Direct Testimony, I urged the Commission to set rates at fair, just, and reasonable

1 levels prior to the implementation of any alternative form of regulation. I quantified a
2 significant base rate reduction based upon the Commission's historic use of rate of
3 return regulation. In addition, I urged the Commission to reject the Companies'
4 selective EPBR and to instead adopt a comprehensive alternative form of regulation,
5 the earnings sharing mechanism ("ESM"). The ESM would provide the Companies
6 strong incentives to grow revenues and reduce costs while sharing the benefits of their
7 success with their ratepayers.
8
9 **Q. What is the purpose of your Response Testimony to the Companies' Amended**
10 **Plan?**
11 A. The purpose of my Response Testimony is to address the reasonableness of the
12 Companies' Amended Plan and to respond to the claims made in its Petition to Amend
13 as well as the testimony of Mr. Willhite in support of the settlement between the
14 Companies and the Attorney General ("AG"). In addition, I will explain why a larger
15 rate reduction is necessary and why the KIUC ESM is a superior form of alternative
16 regulation compared to the EPBR.
17
18 **Q. Please summarize your testimony.**
19 A. The Commission has taken a necessary and timely first step in reducing the base
20 revenues of the Companies by $52 million over the next five years. However, this first
21 step reduction does not result in rates that are fair, just, and reasonable. To the

1 contrary, base revenues over the next five years will be excessive by more than $600
2 million for the two Companies. In addition, electric ratepayers of both LGE and KU
3 will subsidize the gas ratepayers of LGE as addressed by KIUC witness Mr. Baron. I
4 have quantified the appropriate and necessary base revenue reductions in my
5 Additional Direct Testimony for each Company.
6
7 Additional base rate reductions will not endanger the Companies' ability to provide safe
8 and reliable service. It is not necessary for the Commission to allow the Companies
9 excessive returns in exchange for its agreement to provide high quality service.
10
11 Additional base rate reductions will not hamper the Companies' ability to comply with
12 any additional NOx emission limitations. The environmental surcharge ("ECR") will
13 provide the Companies full recovery of these and all other environmental costs. This
14 full recovery of environmental costs will likely result in significant ECR **rate increases**
15 to the Companies' ratepayers regardless of and independently from the base rate
16 reductions established in this proceeding.
17
18 Additional base rate reductions will not discourage economic growth in the
19 Commonwealth. To the contrary, base rate reductions will encourage economic
20 growth, according to elementary economics theory.
21

1 Additional base rate reductions will not increase the costs of future rate proceedings.
2 The Companies have proposed no proforma adjustments in response to discovery to
3 reduce their O&M expense for lower regulatory costs in conjunction with the Amended
4 Plan. Therefore, the costs of future proceedings essentially will be unchanged from the
5 levels included in current base revenues.
6
7 The Companies' EPBR is not comprehensive. It is not an appropriate transition form
8 of regulation. It allows the Companies to retain overearnings, provides only limited
9 rewards and penalties to the Companies, and penalizes ratepayers.
10
11 The Companies' EPBR suffers from numerous infirmities, generally providing no new
12 incentives beyond those which exist already and generally ensuring that customers will
13 pay excessive amounts well in excess of the alleged benefits of the Companies' EPBR.
14
15 The Companies' EPBR does not create regulatory certainty. To the contrary, actual and
16 potential rate increases ensure that ratepayers and the Commission will not be the
17 beneficiaries of the alleged regulatory certainty. There will continue to be future rate
18 proceedings and rate changes. The level of the rate cap approved by the Commission
19 in the Merger Order in Case No. 97-300 remains unchanged. Consequently, base rates
20 still can be increased to the rate cap levels at any time during the rate cap period. In
21 fact, under the Companies' Amended Plan, base rates will increase after the first year

1 by $12 million between the two Companies. In addition, ECR rates will increase
2 significantly over the next five years if the Companies' claims of hundreds of millions
3 of dollars of environmental costs are correct. The EPBR itself is subject to ongoing
4 regulatory review. Finally, evidence filed by the Companies in response to discovery
5 demonstrates that the abolition of the fuel adjustment clause ("FAC") mechanism
6 coupled with the implementation of the EPBR would have raised 1998 fuel rates to
7 KU's ratepayers by $1.321 million and to LGE's ratepayers by $0.117 million.
8
9 In contrast to the Companies' EPBR, the KIUC ESM provides a comprehensive
10 alternative form of regulation. It ensures that the Companies are provided strong
11 financial incentives to focus on and improve every aspect of their operations, not just in
12 limited areas with limited rewards and penalties.
13
14 The KIUC ESM is straightforward, administratively and computationally simple, and
15 is widely accepted as an alternative form of regulation for electric utilities. The KIUC
16 ESM aligns the Companies' interests with their ratepayers' interests in order to achieve
17 even lower cost electric service with safety, reliability, and high quality customer
18 service.

1 **II. THE AMENDED PLAN IS NOT FAIR AND REASONABLE**

2

3 **Q. Is the Amended Plan fair and reasonable as alleged by the Companies?**

4 A. No. Fundamentally, the Amended Plan fails to address the full extent of the
5 Companies' overearnings situation and to provide appropriate base revenue reductions.
6 The Companies claim that the Amended Plan will provide $52 million in base revenue
7 reductions for the ratepayers of the two Companies over five years. However, base
8 revenues should be reduced by more than $600 million for the ratepayers of the two
9 Companies over those five years, based upon the quantifications that I provided in
10 Additional Direct Testimony. Thus, the Companies' Amended Plan provides less than
11 one tenth of the base revenue reductions necessary to establish fair, just, and reasonable
12 rates.

13

14 In addition, the EPBR does not provide a comprehensive alternative form of regulation.
15 It does not represent an appropriate transition form of regulation. It does not provide
16 incentives beyond those which exist already. It penalizes ratepayers.

17

18 In short, the Amended Plan is not fair and reasonable. It falls far short of the necessary
19 base revenue reductions. The EPBR is an expensive and unnecessary experiment
20 designed by the Companies to ensure continuing excessive returns.

1 **Q. Are the base revenue reductions proposed by the Companies sufficient?**

2 A. No. First, I have quantified the appropriate reductions for the next five years at more
3 than $600 million. Comparatively, the $52 million offered by the Company is less than
4 10% of the appropriate base revenue reduction. According to the Company's response
5 to discovery, the reduction in the first year is only 1.71% for LGE and 1.76% for KU,
6 and the increase in the second year is 1.02% for LGE and 1.06% for KU, for a net
7 reduction in years two through five of only .69% for LGE and .70% for KU.

8

9 Second, the Companies will have significant rate increases through the ECR if the
10 Companies' projections of NO_x costs are correct. Assuming $400 million in
11 incremental investment, an approximate 11% grossed-up rate of return, and a 5%
12 average depreciation rate, the annual revenue requirement on this level of investment
13 will be $64 million, or more than $300 million over a five year period. Operating
14 expenses would increase this ECR revenue requirement even further.

15

16 Thus, the Companies' Amended Plan would allow them to retain more than $550
17 million in excessive base revenues and then to recover another $300 million in ECR
18 rate increases. Such a result is not fair and equitable and should not be allowed.

19

20 **Q. Have the Companies offered any improvements to the EPBR between the original**
21 **filing and the Amended Plan?**

1 A. No. Despite extensive criticisms from numerous parties, including the experts retained
2 by the Attorney General at several informal conferences with Commission Staff, there
3 have been no improvements whatsoever. Thus, the same infirmities still exist that I
4 addressed in my Direct Testimony in this proceeding.
5
6 Q. **In response to discovery, have the Companies quantified the effect of the**
7 **hypothetical implementation of the EPBR in calendar year 1998?**
8 A. Yes. And the results are not surprising. First, the fuel cost recovery ("FCR")
9 component of the EPBR would have cost ratepayers more than the existing fuel
10 adjustment clause which provided recovery of actual fuel and purchased power costs
11 during the 1998 calendar year. The increase in fuel costs to ratepayers under the
12 proposed EPBR occurred because the Companies' actual fuel costs rose less than the
13 FCR index level. The use of the Companies' actual data for 1998 demonstrates that the
14 abolition of the fuel adjustment clause and the implementation of the EPBR would
15 have increased fuel costs to ratepayers by approximately $1.4 million. This "reward"
16 to the Companies would have resulted in the collection of more than actual fuel costs.
17 Regulation which results in the over recovery of actual costs is not fair, just and
18 reasonable.
19
20 Second, KU's computations of the generation performance ("GP") and service quality
21 ("SQ") components of the EPBR would have increased ratepayer costs, according to

1 KU. However, there appear to be errors in the computations provided by KU in
2 response to PSC4-KU-7, p. 19 of 60.
3
4 Q. **Have the Companies released publicly any information regarding its fuel costs for**
5 **1999?**
6 A. Yes. In the LGE Energy/LGE/KU 1998 SEC 10-K, LGE projects that its coal costs
7 will decrease in 1999, after increasing slightly in 1998. KU projects that its coal costs
8 will increase slightly in 1999, after decreasing slightly in 1998. In addition, the
9 Companies reported that approximately 79% of its LGE's and 66% of KU's coal was
10 purchased in 1998 pursuant to coal supply agreements (contracts) rather than through
11 spot purchases.
12
13 The significance of this information is that the FCR is a poor substitute for the FAC.
14 The FCR compares the increase in the Companies' fuel costs to the increase in an index
15 of spot fuel prices. Spot fuel prices are more volatile than most of the Companies' coal
16 costs, which are purchased under longer term contracts. By contrast, the FAC provides
17 recovery of actual fuel costs and ensures that the Companies recover the entirety of
18 their prudently incurred fuel costs on a timely basis.
19
20 Thus, the FCR component of the EPBR is not fair and reasonable. It represents an
21 unnecessary gaming process that likely will increase costs to ratepayers. The

1 Companies have not identified even a single action they would take differently under
2 the FCR than they are currently taking under the FAC. Because the Companies' off-
3 system sales are made at market prices, they already have more than adequate incentive
4 to purchase fuel efficiently as possible. It requires no further incentives. The FAC
5 should be retained and the FCR rejected.
6
7 **Q. Does the extension of the Merger Order rate cap by one year make the Amended**
8 **Plan fair and reasonable?**
9 A. No. It is highly unlikely that the Companies will file for a base rate increase upon the
10 expiration of the base rate cap, given their full recovery of environmental costs through
11 the ECR and their newly found focus on "price" due to "impending" retail competition.
12
13 **Q. Does the extension of the merger surcredit for a sixth year make the Amended**
14 **Plan fair and reasonable?**
15 A. No. The Merger Order requires a filing by the Companies in the fifth year following
16 merger consummation. After five years, the costs of the merger will be amortized fully
17 by the Companies. Presumably, ratepayers then will be entitled to the entirety of the
18 savings as represented in a test year revenue requirement determination at that time, not
19 only 50% of the savings. Although the extension of the merger surcredit for a sixth
20 year provides a certain rate benefit in the sense that it is quantified and guaranteed, it
21 also postpones the required filings and the potentially greater rate reductions available

1 in order to reflect the entirety of the merger savings in the revenue requirement. Thus,
2 the extension of the merger surcredit for a sixth year does not make the Amended Plan
3 fair and reasonable.
4
5 In addition, to the extent that the merger surcredit extension into year six reduces the
6 possibility that the surcredit will extend for a full ten years in order to fully reflect all
7 merger savings upon which the Commission's merger approval order was based, then
8 the extension to year six is a detriment to ratepayers.
9
10 **Q. Does the avoidance of a potential LGE gas base rate increase for the next five**
11 **years make the Amended Plan fair and reasonable?**
12 A. No. KIUC witness Mr. Baron addresses this issue more extensively in his testimony.
13
14 **Q. Does the Amended Plan create regulatory "certainty" and eliminate "costly and**
15 **distracting" regulatory proceedings?**
16 A. No. It creates regulatory certainty only in the sense that the Companies will not be
17 required to further reduce their base revenues or implement a comprehensive form of
18 PBR such as earnings sharing if there are no changes to the Amended Plan. Thus, the
19 Companies do have some level of regulatory certainty that they will be able to continue
20 to retain overearnings. However, the Amended Plan does not create regulatory
21 certainty for ratepayers or the Commission. Base rates will increase after the first year

1 by $12 million between the two Companies. ECR rates are projected to increase
2 significantly over the next several years as the Companies incur costs to comply with
3 the new NOx requirements. The EPBR will cause rates to change quarterly. Thus,
4 there will be no reduction in regulatory uncertainty for the ratepayers or the
5 Commission.
6
7 In addition, the Amended Plan will not eliminate "costly and distracting" regulatory
8 proceedings. The Companies will continue to be subject to regulatory proceedings,
9 regardless of whether it finds them "distracting." The Commission still retains a
10 statutory and necessary obligation to regulate the rates of a monopoly provider of
11 electric utility service. The issue of whether regulatory proceedings are "costly" is
12 debatable, given that the incremental costs largely are incurred at the Companies'
13 discretion. Nevertheless, the costs of necessary regulatory proceedings are recovered
14 through the current base revenue requirement. The Companies have not proposed to
15 reduce their current base revenue requirements in order to reflect the avoidance of the
16 costs associated with these "costly" regulatory proceedings.
17
18 **Q. Does the fact that the Companies retain the "risk" of load growth make the**
19 **Amended Plan fair and reasonable?**
20 A. No. First, the Companies agreed to that risk when they agreed to the base rate cap in
21 Case No. 97-300. Second, sales to ultimate (native load) customers historically have

1 carried higher margins compared to off-system sales. Third, if customer load growth
2 exceeds the Companies' supply capability, then they will have to build or purchase
3 additional resources. The cost of production per kWh for the Companies' new CT
4 capacity is considerably less than the Companies' projections of forward prices for
5 market purchases, providing evidence that increased load is not a risk but rather an
6 opportunity. In any event, the Companies always have had load growth risk. Load
7 growth risk, or opportunity, is not the function of the Amended Plan. Thus, the fact
8 that the Companies retain the "risk" of load growth does not support their claim that the
9 Amended Plan is fair and reasonable.

1 **III. THE PLAN PROPOSED BY KIUC IS FAIR AND REASONABLE**

2

3 Q. **Is the plan proposed by KIUC fair and reasonable?**

4 A. Yes. In terms of providing balanced rewards and penalties to ratepayers and
5 shareholders, the KIUC plan is superior to the Companies' Amended Plan in almost
6 every respect. The plan proposed by KIUC first establishes base rates at fair, just, and
7 reasonable levels. The setting of rates at fair, just and reasonable levels has been a
8 threshold issue for other states that have adopted PBR plans for electric utilities. On
9 the other hand, the Companies' Amended Plan is an experimental form of regulation
10 with increased risk to ratepayers. The Companies' Amended Plan jeopardizes
11 Kentucky's status as a low cost electric state. Accordingly, the Amended Plan
12 jeopardizes economic development and jobs.

13

14 The plan proposed by KIUC establishes a comprehensive alternative form of regulation
15 through earnings sharing that provides strong financial incentives for the Companies to
16 improve their performance in every aspect of its operations, not just in limited areas
17 with limited rewards and penalties. When combined with an appropriate up-front rate
18 reduction, the earnings sharing form of PBR will help maintain Kentucky's status as a
19 low cost electric state. While other states pursue vague promises of lower rates through
20 deregulation, Kentucky can assure timely and definitive rate reductions through an
21 appropriate up-front rate reduction and the operation of the ESM.

22 Q. **Why is an ESM superior to the Companies' EPBR?**

1 A. First, the ESM provides a comprehensive measure of performance with unlimited
2 financial incentives for the Companies to improve its performance.
3
4 Second, the ESM aligns the interests of the Companies and their ratepayers through the
5 reward and penalty process in order to achieve lower cost electric service with safety,
6 reliability, and high quality customer service.
7
8 Third, the ESM replaces the historic cost of service regulation with an appropriate
9 transitional form of regulation. Thus, the Companies no longer will be subject to the
10 uncertainties of potential base rate reductions due to overearnings because increased
11 earnings after rates are initially set to fair, just, and reasonable levels will represent an
12 authorized return for performance. Ratepayers will benefit through timely base
13 revenue reductions at the same time that the Companies timely recover their
14 environmental costs through ECR rate increases.
15
16 **Q. Does this complete your Response Testimony to the Amended Plan of the**
17 **Companies?**
18 A. Yes.