COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

Big Rivers Electric Corporation's	)	
Application for Approval of	)	
Restructuring Agreement and for	)	CASE NO. 10217
Authority to Issue Notes or Other	)	
Evidences of Indebtedness	)	
Pursuant Thereto	)	

TESTIMONY AND EXHIBIT

OF

LANE KOLLEN

ON BEHALF OF

ALCAN ALUMINUM CORPORATION

AND

NATIONAL SOUTHWIRE ALUMINUM COMPANY

KENNEDY AND ASSOCIATES
ATLANTA, GEORGIA

MAY 1988

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

CASE NO. 10217

DIRECT TESTIMONY OF LANE KOLLEN

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

2

3 A. My name is Lane Kollen. My business address is Kennedy and Associates,
4 Suite 475, 35 Glenlake Parkway, Atlanta, Georgia 30328.

5

6 Q. **What is your occupation and by whom are you employed?**

7

8 A. I am a utility rate and planning consultant holding the position of Manager,
9 Financial Consulting with the firm of Kennedy and Associates.

10

11 Q. **Would you please describe your education and professional experience?**

12

13 A. Yes. I received my Bachelor of Business Administration with honors in
14 Accounting from the University of Toledo. I also received a Master of
15 Business Administration from the University of Toledo. I am a Certified
16 Management Accountant (CMA) and a Certified Public Accountant (CPA).

17

18 I began my professional career with The Toledo Edison Company in 1976 in the
19 Budget and Accounting Reports Section of the Accounting Division. I assisted
20 in preparing the company's operating budgets, management financial and
21 operating reports, and financial reports to the SEC (10-K, 10-Q), the FERC
22 (Form 1 and others), state regulatory agencies, shareholders (quarterly and

1 annual reports) and others.
2
3 In 1978, I was promoted to the Tax Department where I conducted tax
4 research, prepared schedules supporting federal, state and local tax returns,
5 developed tax, plant and depreciation related support for the company's rate
6 cases, responded to tax related audit requests, and prepared tax, plant and
7 depreciation related schedules for management reports, budgets, and forecasts.
8 I also performed extensive depreciation analysis with the consulting firm of
9 Gilbert and Associates.
10
11 In late 1979, I was promoted to the Auditing Department where I assisted in
12 and conducted numerous audits, primarily operational in nature. I was involved
13 in audits of nuclear and coal plant construction and operating records.
14
15 In 1980, I transferred to the Corporate Planning Department and was later
16 promoted to Financial Planning Supervisor. In this capacity, I was responsible
17 for computer modeling and the financial evaluation of the company's strategic
18 plans. I was responsible for the preparation of the capital budget, various
19 forecast filings with regulatory agencies, and assistance in rate and other
20 strategy formulation. I utilized the strategic planning model PROSCREEN II
21 and other software products to evaluate capacity swaps, sales, sale/leasebacks,
22 cancellations, write-offs, unit power sales, and long term system sales, among
23 other strategic options.
24
25 In 1983, I joined the consulting group at Energy Management Associates. I

1 specialized in utility finance, computer financial modeling and utility
2 accounting issues. I also directed consulting and software projects utilizing
3 PROSCREEN II and ACUMEN proprietary software products to support utility
4 rate case filings, budgets, internal management and external reporting, and
5 strategic and financial analyses.
6
7 In early 1986, I joined Kennedy and Associates where I specialize in revenue
8 requirements analyses, taxes, evaluation of rate and financial impacts of
9 traditional and non-traditional ratemaking and other utility strategic and
10 financial issues. I have developed and presented papers on utility rate and
11 tax issues at Energy Management Associates and Electricity Consumers
12 Resource Council (ELCON) industry conferences.
13
14 I have appeared as an expert witness on accounting and planning issues before
15 regulatory commissions in Kentucky, Louisiana, Minnesota, West Virginia and
16 Connecticut. My qualifications and regulatory appearances are further detailed
17 in my Exhibit___(LK-1).
18
19 Q. **On whose behalf are you testifying in this proceeding?**
20
21 A. Kennedy and Associates has been retained by National-Southwire Aluminum
22 Company ("NSA"), and ALCAN to review and comment on the modified
23 restructuring agreement which Big Rivers has entered into with the REA and
24 the New York banks, Irving Trust and Manufacturers Hanover.
25

1 **Q. What is the purpose of your testimony?**

2

3 A. The purpose of my testimony is to evaluate whether the Big Rivers
4 Restructuring Agreement, presented for Commission approval in this case,
5 conforms with the terms of the Modified Agreement presented to the
6 Commission in Case 9885, the testimony of Company witnesses supporting that
7 Agreement, and the Commission's Order in that case. I also address the
8 implications to NSA, ALCAN and other ratepayers of the non-conforming and
9 extended provisions of the Restructuring Agreement.

10

11 **Q. Please summarize your testimony.**

12

13 A. There are fundamental differences between the Modified Agreement in Case
14 No. 9885 and the Restructuring Agreement in this case. The most fundamental
15 difference is the changed financial projection which formed the basis for the
16 decision in Case No. 9885. In addition, underlying financial and other
17 assumptions have changed substantially including lower interest requirements
18 due to Burdick refinancing, the short term outlook for aluminum prices, and
19 the new concept of Total Government Debt. As a consequence, the underlying
20 financial projections relied upon by the Commission in reaching their decision
21 in Order 9885, are no longer correct and no longer relevant. It would be
22 appropriate to revisit the variable smelter rate now.

23

24 I also conclude that certain substantive provisions of the Restructuring
25 Agreement are significantly different from those originally contained in the

Modified Agreement in Principle, the supporting testimony offered by BREC, and the Commission's Order in Case No. 9885. These changes have resulted in increased risk of default, a total and complete assignment of the risk of that default to all ratepayers and a significant reduction in risk to the creditors.

The Company and its creditors continue to flout the direction given by the Commission in their Orders in Case 9885 as well as Case 9613. Consequently, the Restructuring Agreement is subject to exactly the same criticisms as I testified to in those two cases and more. Unfortunately, this latest agreement is the most onerous and directly violative of Commission direction and intent yet. I will not repeat the criticisms to which I testified in the previous cases but will focus in this testimony on the additional criticisms directly related to the changes from the Modified Agreement to the Restructuring Agreement.

The Restructuring Agreement violates directly and indirectly the clear intent of the Commission as enunciated in the 9885 Order as well as the Commission's specific direction in that Order. Specific violations include:

- The REA and other lenders acknowledge no responsibility for off-system sales.

- There is no longer any guarantee that the "repayment plan will not require additional rate increases for debt service".

- The arrearage Government Debt and non-arrearage Government Debt has been subsumed into a single outstanding debt amount and assigned a single debt interest rate.

- The Wilson and non-Wilson debt has been subsumed into a single outstanding debt amount and assigned a single debt interest rate.

- No recognition is afforded the smelter contribution to payments made in excess of the minimum government debt service requirement.

- There is a substantially higher possibility of default than existed previously.

- There is now a prohibition against modification of the smelter variable rate formula.

The Restructuring Agreement also incorporates substantive extensions and new provisions which include:

- Definitions of default situations as well as specific consequences which 1) require that Case 9885 rates not be adversely modified and 2) a restrictive definition and application of the rolling five year cumulative overage or shortage concept.

- Incorporation of REA ratio requirements

- Application of payment amounts exceeding minimum levels are used to reduce tail end principal payments for 1) the second Burdick refinancing and 2) excess payments.

- Application of payment amounts to specific debt issues is at the discretion of the REA.

Q. Were the BREC financial projections reviewed and relied upon by the Commission in Case 9885, utilized by BREC and its creditors to determine the minimum debt service schedule incorporated in the Modified Agreement?

A. Yes. These minimum debt service amounts were derived from BREC's financial projections in that case, based upon the premises and assumptions in effect at that time, reflecting no Burdick refinancing savings and lower early year smelter revenues than currently projected, and with the intent that government arrearage debt not exceed $350 million at its peak. The BREC financial projections provided the backbone of the Workout Plan in the 9613 Case and the Modified Agreement in the 9885 Case.

1 Q. **How do the BREC financial projections relied upon in Case 9885 compare to**
2 **the current projections filed by BREC in this case?**
3
4 A. They are substantially different. In response to Item 9A of the April 22, 1988
5 KPSC Staff request, the Company provided an updated version of Exhibit 5
6 (the variable smelter rate financial projection) from Case No. 9885 reflecting
7 the actual variable smelter rate ordered by the Commission in that case. This
8 projection did not reflect the Burdick refinancing or any other changes
9 between the Modified Agreement and the Restructuring Agreement. The
10 Company also provided a copy of their current financial projection as Item 9B
11 of the same request which further updates Item 9A to reflect the Burdick
12 refinancing savings and other changes incorporated in the Restructuring
13 Agreement (most notably the Total Government Debt concept).
14
15 The most noticeable difference between the two sets of projections is the date
16 at which total long term debt is fully repaid. In the 9A projection, principal
17 is still being repaid in 2012, the last year of the projection, with the
18 expectation that it be fully repaid by year end 2018. In the current 9B
19 projection, the total long term debt is repaid completely by the end of 2005,
20 only 17 years from now!
21
22 Q. **This is certainly a major difference. What has caused this change?**
23
24 A. There are two primary reasons. The first reason is the reduction in interest
25 expense and principal as the result of the two Burdick refinancings completed

1 by BREC. The other reason is that all government related debt including
2 arrearage and non-arrearage debt has been consolidated into a single debt
3 instrument described as Total Government Debt. All interest rates, principal
4 repayment schedules, and amortization of arrearage debt related to REA/FFB
5 indebtedness has been subsumed into this single indebtedness. Other changes,
6 of less significance, have been made to the interest and principal payment
7 requirements of non-government related debt. Consequently, the timing and
8 amounts of interest and principal payments have been modified, resulting in an
9 acceleration of total debt repayment.
10
11 Q. **Have revenue or other non-debt related expenses or cash flow items been**
12 **modified between Case 9885 and this one?**
13
14 A. No. The rapid repayment of the total long term debt is due solely to the
15 reduced interest requirements resulting from the Burdick refinancings, the
16 consolidation of total government debt and other less significant changes in
17 other debt service requirements. The timing of payments and the interest rate
18 on the indebtedness are the two key factors in determining the length of a
19 repayment period. In this case, the changes in these items reduced the
20 payment period to 17 years from approximately 30 years.
21
22 As an analogy, a $100,000 loan at 12% could be fully paid off in 30 years at
23 the rate of $12,270 per year. If the interest rate was reduced to 10% and the
24 payment maintained at $12,270 per year, the loan would be fully repaid in 14.2
25 years.

1
2 Q. **Since the Commission relied heavily upon the financial projections supporting**
3 **the Modified Agreement in Case No. 9885, do the significant changes in the**
4 **financial projections suggest that a reconsideration may be in order in the**
5 **current proceeding?**
6
7 A. Absolutely yes. The financial projections were an essential component of the
8 Commission's investigation and ultimate decision in that case. That case
9 represented a radical departure for the Commission from traditional adherence
10 to cost of service based rates. Cost of service based rates gave way to ability
11 to pay rates for the smelters in order to meet the debt service cash
12 requirements of Big Rivers. To the extent that the underlying financial
13 projection relied upon by the Commission for this purpose has substantially
14 changed, it is clearly appropriate to revisit the entire decision. More
15 precisely, it is appropriate to revisit the components of the variable smelter
16 rate.
17
18 Q. **Did the July 17, 1987 Modified Agreement in Principle reference the financial**
19 **projections prepared by BREC?**
20
21 A. Yes. The second modification cited by the lenders in that letter references
22 "...the cash flows presently being projected by Big Rivers and debt service as
23 scheduled under this proposal... " This reference is clearly to the financial
24 model runs performed by BREC, specifically those represented as Exhibits 4
25 and 5 (revised) in Case 9885.

1

2 Q. **Did those financial projections contain projections of off-system sales, critical**
3 **to the success of the so-called Workout Plan?**
4
5 A. Yes. This was the center of considerable testimony and cross examination in
6 both the 9613 and 9885 cases.
7
8 Q. **Did the creditors recognize the need for off-system sales in the Modified**
9 **Agreement in Principle?**
10
11 A. Yes. They specifically cite, in the July 17, 1987 letter, that "The increased
12 revenues were to be achieved through the combined effects of three rate
13 increases (spread out over 5 years) and off-system power sales in the 1990's
14 and beyond... " (emphasis added).
15
16 Q. **Did the creditors assume the risk of off-system sales in the Modified**
17 **Agreement in Principle?**
18
19 A. Yes. They specifically limited the exposure of the ratepayers for debt service
20 to the three phase rate increase to $7.50 in 1987, $8.80 in 1989 and $10.15 in
21 1991.
22
23 Q. **Does the Restructuring Agreement address the issue of off-system sales?**
24
25 A. Barely. They acknowledge in Section 8.01 that:

1

2 "The parties hereto acknowledge that covenants set forth in
3 Section VI and the restructurings of debt provided for in this
4 Agreement have been agreed upon based upon the premise that
5 Big Rivers will be able to make off-system power sales which,
6 together with on-system power sales, will result in sufficient
7 revenues to enable Big Rivers to make all payments to the
8 Banks and with respect to the Bonds, the Notes and REA
9 expenses contemplated by this Agreement and to avoid the
10 occurrence of an Event of Default... "

11

12 Although they acknowledge the need for off-system sales, it is clear that the
13 creditors accept no explicit responsibility for the potential failure of Big
14 Rivers to achieve its projections of those sales.

15

16 Q. **Did the Commission address the issue of responsibility for off-system sales in**
17 **their 9885 Order?**

18

19 A. Not specifically, although they repeatedly cite the need for a "balancing of
20 interests" in the 9885 Order as they had in the 9613 Order. Clearly, however,
21 they did rely upon the representations of the creditors in the Modified
22 Agreement. In addition, the Commission's 9613 Order specifically addresses the
23 issue of responsibility for off-system sales revenue:

24

25 "We emphatically reject the claim of REA, the banks, and Big
26 Rivers that the members of the cooperative ultimately bear the
27 total risk and responsibility for the utility's debts. The
28 distribution cooperatives and their members do not stand in the
29 same position as shareholders of an investor-owned company.
30 The REA, with its oversight and monitoring responsibility,
31 bears a substantial amount of the risk associated with Big
32 River's actions." (page 19) (emphasis added)
33
34 "The immediate and primary source for debt service is off-

1 system sales. Therefore, an agreement on off-system sales
2 should be used in calculating any schedule of debt repayment.
3 Big Rivers' ratepayers should not have unlimited responsibility
4 for the payment of Big Rivers' debt. Furthermore, they should
5 not be required to provide all the revenues required to offset
6 shortfalls arising from insufficient off-system sales." (page 44)
7 (emphasis added)
8
9
10 Q. **Did the creditors specifically agree to limit the debt service exposure of the**
11 **ratepayers to the three phase increase noted earlier in the Modified**
12 **Agreement?**
13
14 A. Yes, in the July 17, 1987 letter, the creditors specifically state that :
15
16 "Instead of asking for separate rate increases, if Big Rivers
17 obtains one rate increase phased in as follows, the repayment
18 plan will not require additional rate increases for debt
19 service... " (emphasis added)
20
21
22 Q. **Did the Commission rely upon this specific representation by the creditors in**
23 **Case 9885?**
24
25 A. Yes. It is clear that the Commission relied upon this representation in that
26 case since they specifically note that.
27
28
29 "...the revised plan ...states that the 'repayment plan will not
30 require additional rate increases for debt service'." (page 9 of
31 Order).
32
33 Q. **Does the Restructuring Agreement provide that no additional rate increase for**
34 **debt service will be required?**
35

1 A. No. The Restructuring Agreement is deafeningly silent on this point.

2

3 Q. **Is this omission significant?**

4

5 A. Yes, it is critical. Since the Commission relied upon the representation that
6 no additional debt service rate increases would be required, it is essential that
7 the Restructuring Agreement specifically state that representation. It is
8 critical from the perspective of all ratepayers, including NSA and ALCAN, that
9 the exposure for additional debt service rate increases be limited. Otherwise,
10 in a period of potential cash shortfall, regardless of the reason for that
11 shortfall, all system customers once again face a default situation or further
12 increases in the demand rate.

13

14 Failure to include this stipulation in the Restructuring Agreement could at best
15 be described as an "oversight" and at worst, an intentional attempt to quietly
16 discard a key premise upon which this Commission based its decision.

17

18 Q. **What is the impact of the twofold failure of the creditors to explicitly**
19 **acknowledge and accept off-system sales risk and to explicitly limit the**
20 **exposure of the ratepayers for debt service rate increases in the Restructuring**
21 **Agreement?**

22

23 A. The creditors of Big Rivers have assumed absolutely no risk for failure in the
24 off-system sales arena. That risk falls squarely onto the ratepayers on the Big
25 Rivers system, since there is no limit to their risk for debt service

1 repayment. The failure to meet the five year cumulative zero shortfall
2 requirement of the Restructuring in Agreement due to unrealized off-system
3 revenues in whole or in part results in an Event of Default. As discussed
4 later in my testimony, this places the ratepayers, not the creditors, at risk due
5 to the likely requirement of additional increases in the demand charge. These
6 two Restructuring Agreement omissions are simply unconscionable.
7
8 Q. **Have the debt service assumptions and projections underlying the Modified**
9 **Agreement changed significantly?**
10
11 A. Yes. Debt interest (first Burdick refinancing) and debt principal (second
12 Burdick refinancing) have been substantially reduced due to the two Burdick
13 refinancings. The weighted average interest rate of all debt outstanding at
14 August 31, 1987, prior to the first Burdick refinancing was 9.35% (BREC
15 response to NSA request dated May 10, 1988, Item 9). In addition, the
16 multiplicity of government debt descriptions has been reduced to a single
17 indebtedness amount described as "Total Government Debt". A single interest
18 rate has been developed and utilized to compute interest on the Total
19 Government Debt. The REA now has total discretion in its application of
20 BREC payments to debt issues. Repayment of all Total Government Debt is
21 assumed to occur in the year 2005 under BREC's current financial projection.
22 Previous repayment schedules, utilized in support of the Modified Agreement,
23 segregated arrearage debt and non-arrearage debt. Interest and principal
24 repayments were previously a function of the underlying debt issues. The
25 underlying debt issues were scheduled to be repaid over the next thirty years,

1 with the final repayment scheduled for the year 2018.

2

3 Q. **Have BREC and the creditors reflected the Burdick refinancing savings in the**
4 **minimum government debt service requirements?**

5

6 A. No. The Restructuring Agreement reflects the same level of minimum debt
7 service requirements as the Modified Agreement.

8

9 Q. **What was the basis for determination of the minimum government debt service**
10 **schedule incorporated in the Modified Agreement?**

11

12 A. The minimum government debt service schedule was developed by BREC and its
13 creditors based upon the financial projections (Exhibits 4 and 5) utilized in
14 Case 9885 predicated upon a maximum limit of $350 million in total arrearage
15 debt.

16

17 The Commission accepted this representation and states in the Case 9885
18 Order:

19

20 **"The revised plan does not rely on cash flow targets but rather**
21 **is based on a minimum debt service schedule. The REA has**
22 **agreed to a cumulative debt service shortfall cap of $350**
23 **million."** (page 9)

24

25 Q. **What impact does this failure to recognize the Burdick refinancing savings on**
26 **the minimum government debt service schedule have on BREC's ratepayers?**

27

1 A. The obvious answer is that at best BREC ratepayers receive absolutely no
2 benefit from two Burdick refinancings until after the turn of the century. The
3 minimum debt service obligation has not been changed; however, the maximum
4 government debt arrearage limit has effectively been reduced. The only
5 benefit is that the Total Government Debt is paid off more rapidly. This, of
6 course, is beneficial to the creditors because their exposure is reduced. This
7 is not beneficial in the least to the smelters or other ratepayers for the next
8 seventeen years since their obligation to pay is not appropriately reduced
9 during that time. Consequently, the risk of default is not reduced even though
10 the creditors' position has been greatly enhanced.
11
12 If the Commission should approve the Restructuring Agreement (which I
13 believe is totally inappropriate), the Commission should absolutely insist that
14 the minimum government debt service schedule be revised and reduced to
15 reflect the substantial annual savings resulting from the Burdick refinancings
16 and reduced creditor risk.
17
18 Q. **Is there any benefit of the banks loaning $24 million to BREC in 1989 upon**
19 **the occurrence of the "Final Decision Date"?**
20
21 A. Evidently the banks perceive a benefit. However, the benefit to the
22 ratepayer, if there is any, exists only to the extent that such a loan would
23 avoid the occurrence of an Event of Default under the five year rolling
24 interval requirement.
25

1 The Restructuring Agreement provides that the $24 million loan will be made
2 within ten days of the Final Decision Date. The Restructuring Agreement
3 further provides that the entire $24 million loan must be repaid by August 31,
4 1995, assuming that the Final Decision Date occurred two years or more prior
5 to that (Section 3.06).
6
7 The Final Decision Date is currently assumed by BREC to occur in 1989.
8 Consequently, the banks will be required to loan the $24 million in 1989, BREC
9 will be required to borrow the money and REA will receive the funds to be
10 applied to total government debt in 1989.
11
12 It is clear from the current BREC financial projection that an Event of
13 Default under the five year rolling interval test is not expected in 1989.
14 However, borrowing the $24 million (which is required under the Agreement) in
15 1989 triggers the cash repayment requirements in subsequent years through
16 1995. As a result, cash available to apply against the total government debt is
17 reduced on an annual basis which in turn increases the likelihood of an Event
18 of Default in the years between 1989 and 1995.
19
20 Instead of the $24 million loan benefiting the ratepayers, once again, it is
21 detrimental. The risk of default in the years 1994 through 2000 is actually
22 increased because of the reduced cash flow on a rolling five year basis.
23 However, the REA, in this case, obtains an immediate reduction in risk
24 exposure of $24 million (discounted) against its total government debt.
25

1 Consequently, the requirement of the $24 million loan at the Final Decision
2 Date is onerous, detrimental to ratepayers and unnecessary. Indeed, the loan
3 could only be beneficial if it could be accessed, if necessary, to avoid an
4 Event of Default. If the Commission should approve the Restructuring
5 Agreement, it should insist that the requirement for the $24 million loan be
6 changed to an option, accessible only to avoid an Event of Default.
7
8 Q. **The Total Government Debt concept has been portrayed by BREC witness**
9 **Schmitz (prefiled testimony page 2 of 13 lines 33-41) as a simplification of**
10 **the multiplicity of debt descriptions previously utilized. Are there other**
11 **considerations?**
12
13 A. Yes. The Total Government Debt concept is significantly more than a
14 "simplification". It is a vehicle for combining both arrearage and non-
15 arrearage debt, for obscuring Wilson and non-Wilson related debt, for
16 transferring all control over debt repayment schedules to the REA, and for
17 providing a windfall to the REA while accelerating the payment of 30 year
18 BREC obligations to 17 years (if there is no default, as assumed by Big
19 Rivers). This is obviously considerably more than a "simplification".
20
21 The Modified Agreement reflected a conversion of arrearage debt to 30 year
22 debt at an 8% interest rate contingent upon available cash flow. Non-
23 arrearage debt was separately identified by issue with specific maturity dates,
24 sinking fund requirements and interest rates for each issue. Unfortunately,
25 the "simplification" no longer provides for conversion of arrearage debt into 30

1 year debt since it has been subsumed into total government debt. Nor does
2 the simplification allow BREC to repay its highest cost debt as excess cash is
3 available since the total government debt note replaces all other evidence of
4 indebtedness between BREC and the REA. The 8.36% rate utilized in the
5 Restructuring Agreement purportedly reflects a levelized interest rate which
6 assumes that high cost debt is repaid first (Schmitz prefiled testimony page 2
7 of 13 lines 23-41).
8
9 However, the derivation of the 8.36% rate is necessarily contingent upon a
10 projection of excess payments which in turn reflects a projection of on-system
11 and off-system revenues which will be either too high or too low. For the
12 near term, the BREC projection of on-system revenues is too low due to actual
13 higher than expected aluminum demand and the effects of the variable smelter
14 rate. This means that the interest rate of 8.36% is too high, not only for 1988
15 but for all future years. Consequently, the payments made by BREC on its
16 total government debt are discounted more heavily than is appropriate. This
17 results in an overpayment to the REA. The 8.36% levelized rate is clearly in
18 excess of that required and penalizes ratepayers.
19
20 Q. **Did the Commission address the application of excess payments by BREC to the**
21 **REA in Case 9885?**
22
23 A. No. Consequently, the Company and its creditors have determined the most
24 advantageous application of excess payments from their perspective, totally
25 disregarding the very ratepayers who are generating the revenues for those

1 excess payments. As a result, the Restructuring Agreement provides for a
2 levelized 8.36% interest rate, principal reduction at the tail end, and no
3 reduction in the minimum debt service schedule, all of which are detrimental
4 to the ratepayer over the next 17 years and highly beneficial to the creditors.
5
6 Q. **Do the ratepayers receive any reductions in minimum government debt service**
7 **obligations as a result of excess payments prior to the total government debt**
8 **repayment?**
9
10 A. No. The minimum government debt service obligations remain unchanged until
11 the total government debt is entirely paid off regardless of the level of
12 payments in excess of the minimum. That is because excess payments are used
13 to reduce the principal balance, which is a tail end (latter year) benefit,
14 rather than a current benefit.
15
16 Q. **Who does this benefit?**
17
18 A. Once again, the tail end benefit of more rapid principal reduction benefits only
19 the creditors for the next 17 years (under BREC's projection). Their risk
20 exposure is continually reduced, while the ratepayers' minimum debt service
21 obligation and risk of default remains absolutely unchanged.
22
23 Q. **Is there any attempt in the Restructuring Agreement to address the**
24 **Commission's interest in "equity between the parties", in particular, that**
25 **"Subject always to the viability of the aluminum companies, the amounts**

1 **foregone by Big Rivers in bad times should in principle be matched by the**
2 **premium prices paid by the aluminum companies in good times, but no more."?**
3 (page 24) (emphasis added)
4
5 A. No. The Restructuring Agreement does not reflect this major concern of the
6 Commission.
7
8 Q. **Does the Commission, in its 9885 Order, indicate that it will specifically review**
9 **this issue in upcoming rate hearings?**
10
11 A. Yes. The Commission further stated:
12

13 **"Accordingly, the Commission will in future hearings review the**
14 **extent to which the payments made by the aluminum companies**
15 **are enabling Big Rivers to maintain its debt-service schedule as**
16 **set out in Exhibit 4 or not. If it appears to the Commission**
17 **that payments made by the aluminum companies are**
18 **significantly higher than Big Rivers' needs, the Commission will**
19 **review the variable-rate curve with a view to making an**
20 **appropriate adjustment."** (page 25) (emphasis added)
21
22

23 Q. **What are the components of the variable rate curve?**
24
25 A. The variable rate curve includes the aluminum price per pound pivot point,
26 the upper slope, the lower slope, the floor and the ceiling.
27
28 Q. **Would you describe the "variable rate curve" as a "formula by which rates or**
29 **charges are determined" for the smelters?**
30

1 A. Yes. It is obvious that the variable rate curve is the formula by which
2 smelter rates are determined.
3
4 Q. **Does the Restructuring Agreement restrict the Commission's discretion to**
5 **modify the variable rate curve utilized in calculating the charges rendered to**
6 **the smelters?**
7
8 A. Yes. Any lender (according to Section 7.01(e)), in its sole discretion, may
9 precipitate an Event of Default if it determines that the Commission, courts
10 or any other government authority, " ...materially reduces rates or charges or
11 materially modifies, adversely to Big Rivers, any formula by which rates or
12 charges are determined... " This is clearly an outright attempt by the
13 creditors and Big Rivers to restrict the Commission's authority and ability to
14 revisit the variable smelter in future rate proceedings, as the Commission has
15 clearly indicated it intends to do. I believe that this is offensive and an
16 affront to the Commission. Further, this provision is discriminatory to the
17 smelters.
18
19 Q. **Were the conditions of default addressed in the Modified Agreement?**
20
21 A. Only to the extent that cumulative early payments would offset cumulative
22 cash flow shortfalls on a rolling five year basis. Mr. Schmitz, upon cross
23 examination, was asked to explain any consequences of a failure to maintain a
24 rolling five year positive cash flow. His response was essentially "I don't
25 know". (Transcript August 4, 1987 pages 292-293, 309, 312-313)

1

2 Q. **Did the Commission address the issue of default in their 9885 Order?**

3

4 A. They did not address the issue of default directly. However, they recognized
5 that their decision in that Order " ...may not entirely satisfy the constraints
6 of the revised workout plan. For instance, depending upon aluminum price
7 projections, it is possible that the provision to maintain cumulative debt
8 service payments over five year rolling intervals may be violated". (page 27)

9

10 They added "This negative effect may be more than offset, however, by the
11 possibility that the variable rate formula will generate enough revenue in
12 excess of the minimum debt service in the early years, when aluminum prices
13 are projected to be high, to allow for early payment of additional interest and
14 principal". (page 27)

15

16 The clear expectation by the Commission was that early payments could reduce
17 upcoming interest payments and thereby increase excess cash payments
18 available for minimum debt service obligations. Of course, the Commission's
19 clear intent in their Order was completely circumvented by BREC and its
20 creditors through the total government debt mechanism coupled with a newly
21 well defined five year cumulative cash shortage default provision in the
22 Restructuring Agreement.

23

24 The positive five year cumulative cash flow concept in the Modified Agreement
25 is now a specific requirement which can trigger default even though the

1 context of its application is now totally changed.

2

3 Q. **Are there other conditions of default, previously unidentified, but now included**
4 **in the Restructuring Agreement?**

5

6 A. Yes. The most onerous default provision after the five year rolling interval
7 requirements is one which provides each lender with the right to declare an
8 Event of Default if the rates under the 9885 Order and all subsequent orders
9 are not placed fully into effect as deemed necessary by the creditors.
10 Furthermore, each lender has the sole right to declare an Event of Default if
11 these rates are insufficient (i.e. off-system sales projections are not realized)
12 to allow payment of the minimum government debt service obligations and any
13 other obligations under the Restructuring Agreement. In other words, if they
14 don't find everything to their satisfaction, they have the right to declare an
15 Event of Default. In essence, the lenders have collectively and individually
16 asserted practical jurisdiction over the actions of this Commission and the
17 state court system. The Commission should not acquiesce to this blatant
18 attempt to usurp its authority.

19

20 Q. **What are the implications of this onerous default provision for the ratepayers**
21 **on the BREC system?**

22

23 A. In the event of any cumulative cash shortfall or other default situation,
24 regardless of the source, on-system or off-system sales revenue deficiencies
25 would likely be remedied by application to the Commission for further

1 increases in the demand rate. Remember, the creditors omitted the previous
2 prohibition against additional increases in the demand rate for debt service in
3 this version of the Agreement. This, of course, puts the ratepayers,
4 particularly the smelters, in the completely unenviable position of not only
5 paying excessively while aluminum prices are high but now facing the
6 "opportunity" to pay even more if the prices drop below projected levels or
7 off-system sales projections are not realized.
8
9 The very real concern is that the Restructuring Agreement provides the
10 Company and its creditors an out on the variable smelter rate. Mr. Schmitz
11 testified previously in Case 9885 that Big Rivers would have the option to
12 discontinue the variable rate under the Modified Agreement. (Transcript August
13 4, 1987, page 277) The Company and its creditors are bound (and gladly so)
14 to the variable rate only so long as an Event of Default does not occur. If
15 and when it does occur, then the smelters will be asked to pay more again.
16
17 Q. **Did the Modified Agreement establish any ratio requirements?**
18
19 A. No.
20
21 Q. **Does the Restructuring Agreement establish any ratio requirements?**
22
23 A. Yes. Section 6.07 establishes three new specific financial ratio requirements
24 for BREC. Specifically, the ratio requirements a) limit the level of coal
25 inventory which may to be maintained, b) prohibit the retirement of any

1 Patronage Capital if Patronage Capital is less than 40% of Total Assets, and c)
2 requires the maintenance of historic ratios comparing Total Current and
3 Accrued Assets to Current and Accrued Liabilities (current ratio).
4
5 Q. **Although these three ratio requirements were not addressed in the Modified**
6 **Agreement, does their inclusion in the Restructuring Agreement represent a**
7 **substantive change?**
8
9 A. The coal inventory and current ratio requirements are fairly innocuous. The
10 second requirement will severely limit the ability of the Company to request
11 or the Commission to order appropriately reduced rates at some point in the
12 future unless patronage capital, through excessive operating margins
13 (overcollections compared to traditional cost of service TIER or DSC revenue
14 recovery), is accumulated and maintained in excess of 40% of total assets.
15 Furthermore, this compares to a comparable ratio of <u>less than 4%</u> at the end
16 of 1985. Perhaps the 40% patronage capital requirement is a typographical
17 error. However, I doubt that to be the case given the overall nature of the
18 Restructuring Agreement.
19
20 At the end of 1997, for example, ten years after the Company and its
21 creditors implemented the terms of the Restructuring Agreement, the following
22 conditions are projected by BREC to exist:
23
24 - Total Government Debt of $380,930,300, a reduction of $887,288,400 from
25 $1,263,218,700 at 12/31/87.
26
27 - Total Assets of $1,239,733,700, a reduction of only $188,825,800 from

$1,428,559,500 at 12/31/87 for the same ten year period.

- Patronage Capital of $180,112,900, an increase of $265,508,100 from $(85,395,200) at 12/31/87.

At year end 1997, the total government debt is projected to be more than two thirds repaid. If this rapid debt repayment occurs as projected or even exceeds the current projection, the Commission may desire to reduce rates in recognition of this fact. However, patronage capital is "only" 14.5% of total assets at the end of 1997. The 40% ratio requirement of the Restructuring Agreement is not met. Consequently, the Commission would be limited to reducing rates only to the point where projected (not test year), operating margins would be positive. In other words, the Commission could not order rebates, if they would cause a net negative change in patronage capital (assuming that patronage capital is less than 40% of total assets).

It is not until 2001, under BREC's current projections that patronage capital would exceed 40% of total assets, only 4 years shy of the total repayment of all long term debt. This ratio requirement is unduly restrictive, excessive compared to historical levels, and severely limits the discretion of future Commissions to respond to conditions as they actually occur. Once again, the creditors are afforded reduced risk exposure with absolutely no reduction in risk to the ratepayers.

Q. **Please describe the discrepancy between the projected levels of net utility plant and the underlying debt supporting that net utility plant.**

A. The following table, based upon BREC's projection in this case, shows that the ratepayers are prepaying the cost of Big Rivers plant investment including all of Wilson. This is clearly violative of all historical efforts by this Commission and most others to match the cost of providing service with the use of that service.

	Net Utility Plant $(000)	Total Long Term Debt $(000)	Cumulative Ratepayer Prepayment
1988	1,288,114	1,236,408	51,706
1989	1,275,488	1,117,069	158,419
1990	1,261,828	1,021,762	240,066
1991	1,247,067	947,118	299,949
1992	1,231,134	895,527	335,607
1993	1,213,948	837,657	376,291
1994	1,195,422	753,169	442,253
1995	1,175,458	657,048	518,410
1996	1,153,948	589,610	564,338
1997	1,130,771	523,163	607,608
1998	1,105,797	459,165	646,632
1999	1,078,877	398,131	680,746
2000	1,049,852	339,752	710,100
2001	1,019,100	284,936	734,164
2002	985,865	225,191	760,674
2003	953,128	166,800	786,328
2004	917,445	103,921	813,524
2005	878,550	0	878,550

Under BREC's current projection, all long term debt will be repaid by the year 2005. However, total assets are projected to be at $878,550,000! At that point, Big Rivers will be free from the terms of the Restructuring Agreement and could apply to the future Commission for rate reductions or rebates, although this is not reflected in their current financial projections.

The issue here is clearly one of intergenerational and intercustomer equity.

1 The smelters will have been largely responsible for providing the revenues to
2 prepay the long term debt. Yet, their existing contracts are fully expired by
3 the year 2010.
4
5 Q. **Does the current BREC financial projection continue to reflect sinking fund**
6 **depreciation on the Wilson Plant and associated 345 KV transmission line?**
7
8 A. Yes.
9
10 Q. **Is BREC currently utilizing sinking fund depreciation on their actual books of**
11 **account?**
12
13 A. No. The Company switched from utilizing a sinking fund depreciation
14 methodology for Wilson and the 345 KV line to a straightline methodology at
15 the end of 1987. The following quote is taken from their 1987 Annual Report
16 (page 10):
17
18 **"....Big Rivers has returned to providing for depreciation using**
19 **the straightline method for all utility plant and unclassified**
20 **plant in service."**
21
22
23 Q. **What is BREC's intent with respect to utilizing sinking fund or straightline**
24 **depreciation for ratemaking purposes?**
25
26 A. They state in their 1987 Annual Report (page 10) that:
27

1 **"However, for <u>ratemaking purposes</u> Big Rivers may elect to continue using the**
2 **sinking fund depreciation method for Wilson Plant and the 345 KV transmission**
3 **lines and substations."** (emphasis added)
4
5
6 They evidently have made that election for this proceeding since this is what
7 they have reflected in their current financial projection.
8
9 Q. **Does it matter which depreciation method is utilized for ratemaking purposes?**
10
11 A. Yes. It is critical. Sinking fund depreciation, as reflected in the current
12 financial projection, is the same as that reflected in the financial projection
13 supporting the Modified Agreement in Case 9885. As described earlier in this
14 testimony, their current financial projection reflects an anomaly between the
15 total assets and long term debt outstanding. The total assets reflect
16 depreciation on a sinking fund basis, which has lower depreciation in the early
17 years and higher depreciation in the latter years compared to straightline
18 depreciation. Accordingly, the balance of total assets is higher after ten
19 years, for example, than it would be compared to the balance if it reflected
20 straightline depreciation.
21
22 The use of sinking fund depreciation for BREC ratemaking purposes is no
23 longer acceptable for the following reasons:
24
25 - The Commission's Order in Case 9885 was based upon ability to pay rates

1 for the smelters and was not predicated upon the determination of an
2 operating margin drawn by traditional cost of service ratemaking.
3
4 - It creates an inappropriate inconsistency between the Company's books
5 and its filings before the Commission.
6
7 - It exacerbates the divergence between total assets and total long term
8 debt previously discussed.
9
10 - The higher sinking fund depreciation in later years would create a higher
11 revenue requirement than would straightline if a future Commission
12 determines at some point that the current ability to pay smelter rates
13 would be more appropriately replaced with rates based upon traditional
14 cost of service. As discussed previously, this would be particularly unfair
15 and inequitable to the smelters.
16
17 Q. **Do you recommend that the Commission order BREC to utilize straightline**
18 **depreciation for the Wilson Plant and the 345 KV transmission lines and**
19 **substations as an outcome of this proceeding?**
20
21 A. Yes. Although the Company has not raised this issue in this proceeding, it
22 clearly is an issue which must be addressed. The Commission should act
23 decisively in this proceeding to direct BREC to utilize the straightline
24 methodology to avoid the problems that will clearly arise under the current
25 BREC financial projection if a sinking fund depreciation methodology is utilized

1 for ratemaking purposes.
2
3 Q. **In conjunction with the Company's actual implementation of the terms of the**
4 **Restructuring Agreement, have you noticed anything unusual?**
5
6 A. Yes. The Restructuring Agreement provides for the repayment of total
7 government debt through application of monthly discount factors to the actual
8 payments. The discount factor is an end of month factor. Consequently, it
9 makes no difference when during the month the payment is made, it receives
10 credit as though it were at the <u>end of the month</u>.
11
12 Therefore, any payments for one month which are delayed until the following
13 month, even by only one day, lose one month of interest credit. Any
14 payments which are made early during a particular month lose interest credit
15 because they are paid before the last day of that month.
16
17 Once again, the detriment is to the ratepayers because they ultimately receive
18 less credit against the total government debt than the level to which they are
19 entitled.
20
21 Q. **Do you have any recommendations to overcome this implementation problem?**
22
23 A. Yes. The best solution is to utilize a daily discount factor rather than a
24 monthly factor and to incorporate that into the Restructuring Agreement, <u>if</u> it
25 is approved by this Commission. In the absence of a daily discount factor, any

1 excess cash available prior to the required monthly payment date should be
2 invested in some type of interest bearing investment.
3
4 **Q. Do you have any concluding remarks?**
5
6 A. Yes. The Restructuring Agreement is inequitable, protecting the creditors at
7 every turn, while increasing the risk to the ratepayers. There has been no
8 respect for the Commission's concern of balancing all interests expressed
9 repeatedly in these multiple proceedings. The Commission must assert itself
10 not only in the areas in which it has already established its positions but also
11 in those other areas where the Company and its creditors have extended or
12 added to the Modified Agreement to create the Restructuring Agreement. The
13 Restructuring Agreement should be rejected.
14
15 **Q. Does this conclude your testimony?**
16
17 A. Yes.
18

Lane Kollen

State of Georgia
County of Fulton

Subscribed and sworn to before me, a notary public in and for the State and County aforesaid.

My commission expires

MY COMMISSION EXPIRES SEPT. 12, 1988

This 19th day of May 1988

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

Big Rivers Electric Corporation's	)	
Application for Approval of	)	
Restructuring Agreement and for	)	CASE NO. 10217
Authority to Issue Notes or Other	)	
Evidences of Indebtedness	)	
Pursuant Thereto	)	

EXHIBIT

OF

LANE KOLLEN

ON BEHALF OF

ALCAN ALUMINUM CORPORATION

AND

NATIONAL SOUTHWIRE ALUMINUM COMPANY

KENNEDY AND ASSOCIATES
ATLANTA, GEORGIA

MAY 1988

Kennedy and Associates
Expert Testimony Appearances
of
Lane Kollen
As of February 1988

ate	Case No.	Jurisdict.	Party	Utility	Subject Matter	Cross Exam
0/86	U-17282 Interim	Louisiana Commission	LPSC Staff	Gulf States Utilities	Cash Revenue Requirements Financial Solvency	Yes
1/86	U-17282 Interim Rebuttal	Louisiana Commission	LPSC Staff	Gulf States Utilities	Cash Revenue Requirements Financial Solvency	Yes
2/86	9613	Kentucky Commission	Attorney General Div. of Consumer Protection	Big Rivers Electric Corp	Revenue Requirements Accounting Adjustments Financial Workout Plan	Yes
1/87	U-17282 Interim	Louisiana 19th Judicial District Court	LPSC Staff	Gulf States Utilities	Cash Revenue Requirements Financial Solvency	Yes
3/87	General Order 236	West Virginia Commission	W. Va. Energy Users Group	Monongahela Power	Tax Reform Act of 1986	Yes
4/87	U-17282 Prudence	Louisiana Commission	LPSC Staff	Gulf States Utilities	Prudence of River Bend 1	Yes
4/87	M-100 Sub 113	N Carolina Commission	N Carolina Industrial Energy Consumers	Duke Power	Tax Reform Act of 1986	No
5/87	86-524-E-	West Virginia Commission	West Virginia Energy Users' Group	Monongahela Power	Revenue Requirements Tax Reform Act of 1986	Yes

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Expert Testimony Appearances
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Lane Kollen
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ate	Case No.	Jurisdict.	Party	Utility	Subject Matter	Cross Exam
5/87	U-17282 Case In Chief	Louisiana Commission	LPSC Staff	Gulf States Utilities	Revenue Requirements River Bend 1 Phase-in Plan Financial Solvency	Yes
7/87	U-17282 Case In Chief Surrebutt	Louisiana Commission	LPSC Staff	Gulf States Utilities	Revenue Requirements River Bend 1 Phase-in Plan Financial Solvency	Yes
7/87	U-17282 Prudence Surrebutt	Louisiana Commission	LPSC Staff	Gulf States Utilities	Prudence of River Bend 1	Yes
7/87	86-524-E-Rebuttal	West Virginia Commission	West Virginia Energy Users' Group	Monongahela Power	Revenue Requirements Tax Reform Act of 1986	Yes
8/87	9885	Kentucky Commission	Attorney General Div of Consumer Protection	Big Rivers Electric Corporation	Financial Workout Plan	Yes
8/87	E-015/GR-87-223	Minnesota Commission	Taconite Intervenors	Minnesota Power & Light	Revenue Requirements O&M Expense Tax Reform Act of 1986	Yes
.0/87	870220-EI	Florida Commission	Occidental Chemical Corp.	Florida Power Corp.	Revenue Requirements O&M Expense Tax Reform Act of 1986	Settled
.1/87	87-07-01	Conn. Dept. of Public Utility Control	Conn. Industrial Energy Consumers	Conn. Light and Power	Tax Reform Act of 1986	Yes

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Expert Testimony Appearances
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Lane Kollen
As of February 1988

ate	Case No.	Jurisdict.	Party	Utility	Subject Matter	Cross Exam
/88	U-17282	Louisiana 19th Judicial District Court	LPSC Staff	Gulf States Utilities	Revenue Requirements River Bend 1 Phase-in Plan	Yes
/88	9934	Kentucky Commission	Kentucky Industrial Utility Customers	Louisville Gas & Elec.	Economics of Trimble County Completion	Yes
/88	10064	Kentucky Commission	Kentucky Industrial Utility Customers	Louisville Gas & Elec.	Revenue Requirements O&M Expense, Capital Structure, Excess Deferred Income Taxes	Yes