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JUL 22 2011

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COMMISSION

**Via Overnight Mail**

July 21, 2011

Mr. Jeff Derouen, Executive Director  
Kentucky Public Service Commission  
211 Sower Boulevard  
Frankfort, Kentucky 40602

**Re: Case No. 2011-00036**

Dear Mr. Derouen:

Please find enclosed the original and ten (10) copies of SURREBUTTAL TESTIMONY OF STEPHEN J. BARON on behalf of KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC to be filed in the above-referenced matter.

By copy of this letter, all parties listed on the Certificate of Service have been served. Please place these documents of file.

Very Truly Yours,



Michael L. Kurtz, Esq.

Kurt J. Boehm, Esq.

**BOEHM, KURTZ & LOWRY**

MLKkew  
Attachment

cc: Certificate of Service  
David C. Brown, Esq.

## CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by electronic mail (when available) or by mailing a true and correct copy by overnight mail, unless other noted, this 21<sup>st</sup> day of July, 2011 to the following



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**COMMONWEALTH OF KENTUCKY**  
**BEFORE THE PUBLIC SERVICE COMMISSION**

**IN THE MATTER OF:**

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

**SURREBUTTAL TESTIMONY**  
**OF**  
**STEPHEN J. BARON**

**ON BEHALF OF**  
**KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.**

**J. KENNEDY AND ASSOCIATES, INC.**  
**ROSWELL, GEORGIA**

**July 2011**

**COMMONWEALTH OF KENTUCKY**  
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**ELECTRIC CORPORATION FOR A        )**       **CASE NO. 2011-00036**  
**GENERAL ADJUSTMENT IN RATES    )**

**SURREBUTTAL TESTIMONY OF STEPHEN J. BARON**

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

A. My name is Stephen J. Baron. My business address is J. Kennedy and Associates, Inc. ("Kennedy and Associates"), 570 Colonial Park Drive, Suite 305, Roswell, Georgia 30075.

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

A. Yes. I filed Direct Testimony.

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

A. I am responding to the Rebuttal Testimony of Kenergy Corp. ("Kenergy") witness Jack Gaines regarding cost of service and the apportionment of the Big Rivers revenue increase to Rural, Large Industrial and Smelter rate classes. Mr. Gaines has presented an alternative class cost of service study in his Rebuttal Testimony,

1           arguing for the first time by any party in this proceeding that \$27.5 million of  
2           revenues actually paid by the Smelters during the test year under lawful, Kentucky  
3           Public Service Commission approved rates should be ignored in the cost of service  
4           study.

5  
6           As I discussed in my Direct Testimony, I only made two changes to the Big Rivers'  
7           cost of service study presented by Mr. Seelye. The first change is to use a 6 CP  
8           demand allocation methodology instead the 12 CP method used by Mr. Seelye.<sup>1</sup>  
9           The second adjustment that I made to Mr. Seelye's analysis is to use the actual  
10          TIER Adjustment revenues paid by the Smelters during the test year (and almost  
11          certainly to be paid in the rate effective year as well), instead of removing 50% of  
12          this Smelter surcharge, which Mr. Seelye did in his analysis based on his  
13          assumption that the Smelters would get a \$7.1 million TIER Adjustment rate  
14          reduction at the conclusion of this rate case. In all other respects, I used the  
15          identical methodology and revenues (Rural, Large Industrial and Smelter) used by  
16          Mr. Seelye.

17  
18          In contrast to the cost of service study methodology used by Big Rivers and KIUC  
19          in this case, Mr. Gaines simply subtracts \$27.5 million from the Smelter's test year  
20          revenues because he asserts that these revenues were never intended to be included

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<sup>1</sup> Mr. Gaines does not appear to object to the use of a 6 CP method.

1 in determining just and reasonable rates (via a class cost of service study). He goes  
2 even further by “adding” \$8 million to the Rural class test year revenues and \$3  
3 million to the Large Industrial Class revenues that these customers did not pay  
4 during the test year. After adding phantom revenue to the Rural and Large Industrial  
5 classes and ignoring the revenues actually paid by the Smelters, Mr. Gaines then  
6 develops a test year class cost of service study and concludes that the Rural class is  
7 receiving only \$0.156 million in annual subsidies. This compares to KIUC’s  
8 calculation that I presented in my Direct Testimony showing that the Rural rate class  
9 was receiving \$18 million in subsidies at present rates and compares to Big Rivers’  
10 own class cost of service study which showed that the Rural rate class was receiving  
11 \$11 million in annual subsidies.<sup>2</sup>

12  
13 **Q. Would you describe the cost of service analysis that Mr. Gaines developed?**

14 **A.** Yes. As shown in his Exhibit JDG-1, he started with the 12 CP class cost of service  
15 study developed by Mr. Seelye. He then subtracted 100% of the Smelter revenues  
16 actually paid during the test year for three specific components in the Smelter rate.  
17 These three components of the Smelter rate are: 1) \$.025/mWh of the base energy  
18 charge defined in Section 1.1.20 of the Agreement, 2) the TIER Adjustment charge  
19 of \$1.95/mWh defined in Section 4.7.1 of the Agreement and 3) surcharges  
20 amounting to \$11,466,492 defined in Section 4.11 of the Agreement. The revenue

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<sup>2</sup> Direct Testimony of Big Rivers’ witness Steven Seelye at page 18, line 24.

1           paid by the Smelters in the test year associated with these three rate components is  
2           \$27,520,068. Mr. Gaines simply subtracts these amounts from the Smelter rate class  
3           and effectively pretends that the Smelters did not actually pay these Commission  
4           approved charges to Big Rivers on their monthly electric bills. There is no basis for  
5           pretending that these three Commission approved rate components do not exist.

6  
7           **Q.    In addition to his removal of \$27.5 million in revenues from the Smelter class,**  
8           **Mr. Gaines also added \$8 million in revenues to the Rural class and \$3 million**  
9           **in revenues to the Large Industrial class that these customers did not actually**  
10           **pay. Would you discuss this adjustment that he made?**

11           A.    During the test year, the Rural rate class had surcredit revenues of \$8 million  
12           pursuant to Big Rivers' rate schedule US (Unwind Surcredit). Similarly, the Large  
13           Industrial class had test year surcredit revenues of \$3 million. These amounts, which  
14           reduce the overall charges to these rate classes, are part of the lawful, Commission  
15           approved "rate" that Rural and Large Industrial customers pay to Big Rivers. Mr.  
16           Gaines argues that these \$11 million in revenue surcredits, which were actually  
17           received by Rural and Large Industrial customers during the test year and used to  
18           reduce their payments to Big Rivers, should be ignored for class cost of service  
19           purposes. He then simply adds these revenues back to the test year Rural and Large  
20           Industrial revenues in his cost of service study, thus pretending that the surcredits  
21           were never provided to these two rate classes. This is shown on line 3 of his Exhibit  
22           JDG-1.

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**Q. What is Mr. Gaines' argument to support his elimination of \$27.5 million in Smelter revenues in his cost of service analysis associated with selected parts of the lawful, Commission approved, Smelter rate?**

A. He asserts that these charges, which are part of the lawful Smelter rate that has been approved by the Commission, are subsidies that the Smelters agreed to pay. He therefore concludes that these \$27.5 million of revenues should not be counted in the cost of service analysis to determine the extent to which each rate class is paying its reasonable share of Big Rivers' costs.

His assertion that these revenues are subsidies that have been previously agreed upon by the Smelters is based on his participation in the Big Rivers Unwind proceeding. He states that these were negotiated by the Smelters.

He uses the same argument to support his adding \$11 million to test year Rural and Large Industrial rate class revenues in his cost of service study.

**Q. Is there any dispute that these three charges are part of the lawful, Commission approved Smelter rate?**

A. No. These charges, along with all other charges paid by the Smelters, are part of the overall "rate" approved by the Commission. There is nothing in the Smelter Agreement (which is the Smelter "rate") which states that these charges should be



1 treated differently from any other component comprising the approved Smelter rate.  
2 Mr. Gaines assertion that he is competent to determine which Commission approved  
3 rate components should be counted and which should be ignored is without  
4 foundation and unprecedented. Irrespective of positions taken by parties during a  
5 negotiation, or the foundation or basis for a particular rate element (or the entire  
6 rate), once the Commission approves the rate it becomes the fair, just and reasonable  
7 lawful rate. Segregating \$27.5 million of the rate revenues paid by the Smelters into  
8 a separate category and then simply eliminating them from the cost of service study  
9 as though they had never been paid, based on positions that parties took during a  
10 settlement negotiation, is unprecedented in my experience and should be rejected by  
11 the Commission.

12  
13 I have been in numerous cases in Kentucky during the past 30 years. Many of these  
14 cases have resulted in negotiated rates that were subsequently approved by the  
15 Commission. Once the rate is approved, it becomes the lawful rate and revenues  
16 paid by the customer pursuant to this rate are included in test year revenues in  
17 subsequent cases. The original position of the parties in the negotiation cannot be  
18 used to ignore or disqualify a portion of the charges paid by the customer. In rate  
19 proceedings, it is commonplace for cost of service experts to argue over how the  
20 various costs of the utility should be assigned to customer classes. But Mr. Gaines  
21 adjustment that removes revenues actually paid (and will continue to be paid by the

1 Smelters) and adds revenues that have not been paid (and will not be paid in the  
2 future by Rural and Large Industrial customers) is unprecedented.

3  
4 **Q. Can you provide any examples of negotiated rates that have subsequently**  
5 **become “lawful rates” in Kentucky?**

6 A. Yes. In the most recent Kentucky Power rate case all parties accepted AEP’s cost of  
7 service study which showed that at current rates the residential class was providing  
8 the Company with a negative return. As part of a settlement, the Commission  
9 approved a revenue allocation which resulted in the residential class paying a return  
10 that was now positive, but was only one fifth of the system average return. Also as  
11 part of the settlement, the industrial customers through KIUC agreed to pay a return  
12 substantially in excess of the system average and thereby agreed to provide the  
13 residential class with a “subsidy” payment. Under the logic of Mr. Gaines, in the  
14 next Kentucky Power rate case KIUC will be prohibited from utilizing the actual  
15 revenues paid by the industrial class for cost of service because they “agreed” to a  
16 subsidy. This result would be absurd for numerous reasons and would among other  
17 things effectively forever preclude settlements in Kentucky. Yet, in this case,  
18 Kenergy witness Gaines is proposing a cost of service study that eliminates more  
19 than 10% of the actual test year revenues paid by the Smelters on the grounds that  
20 the Smelters agreed to pay these subsidies during a previous negotiation. Regardless  
21 of the circumstances or prior positions of the parties in a negotiation, once the  
22 Commission approves the rate, it is the lawful rate and any revenues paid pursuant to

1 the rate must be included in assessing its reasonableness via a class cost of service  
2 study.

3

4 **Q. Is KIUC proposing to change the approved Smelter Agreement in this case?**

5 A. No. The KIUC rate analysis is directly premised on the provisions of the existing  
6 Smelter Agreement. The Smelters have paid and will continue to pay, all of the  
7 charges approved by the Commission pursuant to the Agreement. Nothing in the  
8 KIUC class cost of service study assumes otherwise.

9

10 **Q. Are there any additional problems with Mr. Gaines's analysis?**

11 A. Yes. On line 43 of his Exhibit JDG-1, he shows that there will be a \$7,114,653  
12 TIER Adjustment "decrease" in the charges paid by the Smelters as a result of this  
13 rate case. There is no credible evidence that a \$7.1 million TIER Adjustment rate  
14 decrease will actually occur on September 1, 2010 and it is therefore inappropriate to  
15 make such an assumption.

16

17 During the test year 12 months ending October 2010, the Smelters paid a TIER  
18 Adjustment surcharge of \$1.95/mWh, producing revenues to Big Rivers of  
19 \$14,229,306.<sup>3</sup> For each of the nine months ending July 2011 following the test year,  
20 the Smelters have continued to pay the \$1.95/mWh surcharge and there is no

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<sup>3</sup> As I discussed above, Mr. Gaines' cost of service study assumes that the Smelters did not pay any TIER Adjustment surcharge during the test year, contrary to the known facts.

1 evidence that there will be a \$7.1 million decrease in this charge when the  
2 Commission approved rates in this case are implemented in September 2011.

3  
4 **Q. Is the reduction in the current \$1.95/mWh Smelter TIER Adjustment charge**  
5 **assumed by Mr. Gaines (and assumed in the Company's filing) actually an**  
6 **"illusion" that improperly increases the Company's revenue requirement to all**  
7 **ratepayers?**

8 A. Yes. Mr. Gaines incorrectly assumes that there will be a \$7.1 million reduction in  
9 the Smelter TIER Adjustment Charge and the related revenues upon which base  
10 rates will be reset in this proceeding on September 1, 2011. This illusory  
11 assumption, which was included in the Company's filing, results in an improper  
12 increase in the Company's overall revenue requirement to all consumers (Smelter,  
13 Large Industrial and Rural). This assumption is an "illusion" that does not comport  
14 with reality because the Smelters will continue to pay the maximum TIER  
15 Adjustment Charge once new rates are implemented in this case and Big Rivers will  
16 continue to receive those revenues.

17  
18 Under this illusion, the Company asserts that there will be a net rate increase to the  
19 Smelters of \$15,438,743, consisting of a base rate increase of \$22,553,396 and a  
20 "TIER Adjustment Decrease" of \$7,114,653. However, the Company has no  
21 intention of reducing the Smelter TIER Adjustment Charge from \$1.95/mWh to

1           \$0.975/mWh when base rates are reset in this proceeding. Consequently, the  
2           proposed increase to the Smelters is \$22,553,396 (8%).

3  
4           The evidence in this proceeding is that there will be no reduction in the Smelter  
5           TIER Adjustment Charge or the related revenues. The Company's budget and  
6           multi-year financial forecast (which assume that every dollar of the requested \$39.9  
7           million base rate increase is approved) reflect no TIER Adjustment reduction from  
8           \$1.95/mWh to \$0.975/mWh, as both Mr. Kollen and I explained in our Direct  
9           Testimonies. To the contrary, the Company's budget and multi-year forecast reflect  
10          the maximum TIER Adjustment Charge of \$1.95/mWh in each month during 2011  
11          and then an increase to the maximum of \$2.95/mWh in January 2012. There  
12          actually will be no \$7.1 million TIER Adjustment rate reduction to the Smelters on  
13          September 1, 2011. The illusory assumption that the Smelters will get a \$7.1 million  
14          TIER Adjustment rate reduction on September 1, 2011 did three things: 1)  
15          understated the Smelter revenue contribution for cost of service purposes; 2) masked  
16          the true rate impact of this case on the Smelters and 3) improperly inflated the base  
17          rate revenue requirement to be recovered from all ratepayers (Smelter, Large  
18          Industrial and Rural).

19

1       **Q. Both Mr. Gaines and Big Rivers presented their respective analyses to the**  
2       **Commission showing a \$7.1 million reduction in the Smelter TIER Adjustment**  
3       **charges beginning September 1, 2011. Is the Commission being asked to**  
4       **approve a \$7.1 million TIER Adjustment rate reduction in this case?**

5       A. No. Despite the fact that both Big Rivers and Mr. Gaines (on behalf of Kenergy)  
6       showed such a reduction in their respective schedules filed with the Commission,  
7       any reduction in the TIER Adjustment charges actually paid by the Smelters is  
8       dependent on Big Rivers actually earning a calendar year TIER of at least 1.24. If  
9       Big Rivers earns less than a 1.24 TIER, then the Smelters will always pay the full  
10      TIER Adjustment amount. The Commission is not being asked to decide the  
11      issue of where the Smelters should be in the TIER Adjustment bandwidth (i.e.,  
12      top, middle or bottom) on the September 1, 2011 effective date of new base rates.  
13      Rather, the Commission is only being asked to approve Big Rivers' base rate  
14      revenue increase. The Commission's rate case order in no way will obligate Big  
15      Rivers to actually reduce the TIER Adjustment charges to the Smelters or place  
16      the Smelters in the middle of the TIER band width -- that result is governed by the  
17      terms of the Smelter Agreement based on actual calendar year financial results. It  
18      would be incorrect to assume that this case presents the Commission with the  
19      policy question of where the Smelters should be in the TIER Adjustment band  
20      width (top, middle or bottom).

21

1       **Q.    On page 11 and 12 of his testimony, Mr. Gaines discusses the principle of**  
2       **gradualism in ratemaking. Do you have any response to his testimony on this**  
3       **issue?**

4       A.    Yes. It is important to remember that KIUC is not proposing to eliminate the  
5       subsidies paid by the Smelters in this case, or to change the Smelter Agreement in  
6       any manner. Rather, the KIUC proposal starts with eliminating current subsidies  
7       received by the Rural class. However, as I showed on my Table 4, at KIUC's  
8       proposed rates, the Rural class would still be receiving \$6.1 million in subsidies  
9       and the Smelters would continue paying \$7.7 million in subsidies. While the  
10      KIUC proposal does reduce the subsidies received by the Rural class, it  
11      recognizes gradualism and continues to incorporate millions of dollars of  
12      subsidies into the Rural rates.

13  
14      **Q.    Would you summarize your response to Mr. Gaines' testimony?**

15      A.    Mr. Gaines pretends that the Rural rate class paid \$8 million in revenues that they  
16      did not actually pay, the Large Industrial class paid \$3 million in revenues that they  
17      did not pay and that the Smelters did not pay \$27.5 million in test year revenues that  
18      they did actually pay. He arrives at these adjustments by selectively picking and  
19      choosing which elements of the Commission approved Smelter, Rural and Large  
20      Industrial rates that he will include in his adjusted class cost of service study. Based  
21      on this analysis, he then concludes that there is only a \$156,936 Rural subsidy (line  
22      16 of Exhibit JDG-1) instead of the \$11,051,909 Rural subsidy calculated by Mr.

1           Seelye and the \$18,319,114 Rural subsidy that I calculated in the cost of service  
2           study that I am recommending. His conclusions are flawed and should be rejected  
3           by the Commission.

4

5       **Q.    Does that complete your Surrebuttal Testimony?**

6       A.    Yes.