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PUBLIC SERVICE
COMMISSION

Mr. Jeff DeRouen
Executive Director
Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

Re: Case No. 2011-00036

Dear Mr. DeRouen:

Enclosed you will find the original and 10 copies of Kenergy Corp.'s brief in the above matter.

Your assistance in this matter is appreciated.

Respectfully,

DORSEY, KING, GRAY, NORMENT & HOPGOOD

By

J. Christopher Hopgood
Counsel for Kenergy Corp.

JCH/cds
Encls.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:	)
	) **CASE NO. 2011-00036**
NOTICE AND APPLICATION OF BIG RIVERS ELECTRIC FOR AN ADJUSTMENT IN IN EXISTING RATES	)))

KENERGY CORP.'S BRIEF

Intervenor, **KENERGY CORP.** ("Kenergy") submits the following brief pursuant to the order of the Commission:

Introduction

Kenergy submits its brief on the issue of the proper apportionment among the rate classes of the rate increase awarded by the Commission. The key component of this issue is the treatment of the smelter (**ALCAN** and **CENTURY ALUMINUM)** contract payments for the purposes of cost of service analysis.

FACTS

It is undisputed that the smelter power contracts with Kenergy and **BIG RIVERS ELECTRIC CORPORATION** ("Big Rivers") were the result of arms length negotiations over multiple years involving countless man hours and the terms contained therein reflect how and where the parties gave concessions to achieve elements that were important to each party. In consideration of agreeing to long term power commitments, Big Rivers and Kenergy extracted from the smelters certain rate and payment obligations for the benefit of the non-smelter customers that make up the Big Rivers rural and large industrial classes.

As noted by the summary of Jack Gaines' testimony below, Big Rivers and Kenergy were clear in negotiations that it would justify entering into long-term power contracts with the smelters if the rate terms produced revenues from the smelters above traditional cost of service. As such, the smelter contracts (entered into in 2009) begin with the large industrial rate but contain the following provisions for contractual payments:

§4.2 adder;
§4.7 Tier surcharge; and
§4.11 Surcharge

Despite entering into agreements whereby the two (2) smelters agreed to pay rates above the cost of service, the smelters now complain to the Commission about the rate of return disparity between the smelters as compared to the rural class.

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS ("KIUC") asserts that the two (2) smelters are paying above cost of service and therefore the Commission should rectify that by aggressively mitigating the alleged subsidy through this rate case. Based on its calculation of the alleged subsidy, KIUC is recommending to place the first $18 million in rate increase on the rural class. KIUC proposes to mitigate the effect of the increased rural rates by shifting the Rural Economic Reserve from its intended function to base rate mitigation.

Kenergy submits that the KIUC approach is wrong for two (2) reasons. First, the rate of return and corresponding subsidies as calculated by KIUC are wrong for rate making purposes in this case because they include the effects of the smelter contract payments which were agreed to by the smelters in order to obtain a power contract from Big Rivers. Once those contract payments are placed in their proper context, then, and only then, can the Commission address the apportionment of the base rate increase in a manner that will not effectively change the fundamental structure and intent of the smelter contracts. Second, regardless of the size of the base rate differential, the KIUC approach ignores the concept of gradualism which is a well-settled concept of the Commission.

In order to focus properly on these issues, a summary of the pertinent testimony is necessary. The cost of service testimony comes from William Steve Seelye who testified for Big Rivers, Stephen J. Barron who testified for KIUC, and Jack Gaines who testified for Kenergy.

Mr. Seelye used a standard cost of service approach where costs are allocated and then the margins resulting from revenues less costs are calculated. (Seelye direct testimony at p. 11) Mr. Seelye's table on page 18 of his rebuttal testimony shows the following rates of return:

Rurals	- 1.48%
Large Industrials	+ 1.65%
Smelters	+ 3.14%

Mr. Seelye explained that he included in smelter revenues the contractual payments represented by the §4.2 adder, the §4.7 Tier adjustment[1] and the §4.11

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[1] In so preparing his rate analysis, Mr. Seelye utilized a twelve (12) coincident peak approach and consistent with Big Rivers' position, set the Tier adjustment at $7.1 million. While this is consistent with Big Rivers' test year and with the smelter contracts, Kenergy notes that the effect of this is to shift the other $7.1 million of the Tier adjustment to the other classes.

surcharge revenues paid by the smelters and he included in the rural and industrial revenues all of the revenue credits (namely the Unwind Surcedits) that are a byproduct of the §4.11 surcharges. (*Id.* At p. 17) He further explained that these revenues are the principle reason why the smelter rate of return in his cost of service is higher than those of the other two classes. (Seelye rebuttal testimony at p. 8) By including the contractual payments, Mr. Seelye concludes there is a difference, or subsidy, of $11 million between the revenue produced by the rural class and the cost of providing service to them. (Seelye direct testimony at p. 18)

However, he acknowledges that the $11 million subsidy includes the effects of the contractual payments made by the smelters. (Seelye rebuttal testimony at p. 19) According to Mr. Seelye's testimony, he agrees with Kenergy that the subsidies paid by the Smelters pursuant to the terms of the contracts should be preserved. (*Id.*) He further testified that he addressed this issue through his method of base rate apportionment by focusing solely on the parity relationship between the rural and large industrial classes. (Seelye direct testimony at p. 19) As will be explained below, the approach used by Mr. Seelye would not fully preserve the effect of the smelter contracts because it does not recognize the role of the § 4.11 surcharge and its interaction with the rural class and industrial class Unwind Surcredits.

He further utilized the concept of gradualism by proposing to apply $1.9 million more of the base rate revenue increase to the rural class relative to the large industrial class. (*Id.*) By his calculation, this will eliminate 22% of the subsidy between the rural and large industrial classes. (*Id.* At p. 20) According to Mr. Seelye, the rate to the smelters will increase as a function of the large industrial rate because the smelter base rate is the genesis of the smelter contract rate. (*Id.* At p. 18)

Mr. Jack Gaines submitted rebuttal testimony. A crucial element of Mr. Gaines' testimony is that he was actively involved in the Unwind and the resulting smelter contracts. (Gaines rebuttal testimony at p. 4) He points out two (2) key points from his knowledge of the Unwind:

- That the *sine qua non* of the smelter agreements was that Big Rivers would only agree to a power contract where the smelters agreed to pay above cost of service; and
- That the smelter contractual payments (§4.2 adder; §4.7 Tier adjustment and §4.11 surcharge) all were entered into with the knowledge that they pushed the smelters above a cost of service rate. (*Id.* At pp. 4-5)

Based on his knowledge of the Unwind and the smelter contracts, Mr. Gaines explained in his rebuttal testimony that the revenues associated with these contractual terms represent "negotiated amounts that were demonstrably intended to be compensatory to Big Rivers above so called cost of service"[2] and that they should not be included in the class cost of service for determining the allocation of the revenue requirement between classes because to do so would result in a reallocation of revenues among classes that would have the effect of altering the terms of the contracts. (Gaines rebuttal testimony at p. 5) Simply put, as explained by Mr. Seelye, these contractual amounts drive up the rate of return paid by the smelters and translate into rate subsidies to

[2] Under cross examination, Mr. Seelye agreed almost entirely with this testimony of Mr. Gaines. (Seelye testimony [7-27-11] at 14:55-58)

the rural and large industrial classes. (Seelye direct testimony at p. 17) But, as explained by Mr. Seelye and Mr. Gaines, they are subsidies that the Smelters agreed to pay as part of a negotiated contract. (Seelye rebuttal testimony at p. 21; Gaines rebuttal testimony at p. 3) If not specifically identified and carved out as recommended by Mr. Gaines, there is the potential that those contractual payments could be factored into the parity equation and that is precisely what KIUC is proposing. (Gaines rebuttal testimony at p. 6)

To avoid confusion and doubt regarding the effect and treatment of the contractual payments, Mr. Gaines proposed a very simple and direct approach to modify the Big Rivers and KIUC cost of service results such that the parity issue can be examined solely as it relates to the base rates. (Gaines hearing testimony [7-27-11] at 16:26) The simple modification made by Mr. Gaines was to remove the contractual payments from the overall cost of service calculation. (Gaines rebuttal testimony at pp. 4-5) Yet, he did not ignore these payments because he recognized that the §4.2 adder and §4.7 Tier adjustment produce net revenue to Big Rivers and, therefore he concluded that they serve to reduce the Big Rivers' base rate revenue requirement. (Gaines rebuttal testimony at p. 4) However, Mr. Gaines explained that these revenues "should be removed entirely for purposes of determining the relative class rates of return". (*Id.* At p. 6) Mr. Gaines further explained that the "effects of the additional revenues from Section 4.11 should also be removed from each class' revenues for determining relative class rates of return" and that "the overall effect is revenue neutral". (*Id.* At pp. 6-7) This is because the Smelter surcharge revenue and the corresponding revenue credits under the Unwind Surcredit tariffs applicable to the rural and large Industrial classes offset each other. (*Id.* At pp. 7-8) By removing these contractual payments and the corresponding credits Mr. Gaines arrived at the figure on Gaines' Exhibit JDG-1 (line 4) adjusted Pro Forma Operating Revenue for Cost of Service Study Purposes.

When this analysis is completed, the rates of return from base rates are isolated without the effects of the Smelter contractual subsidies. Those rates of return are:

Rural Class	- .43%
Large Industrials	+5.32%
Smelters	+ .87%
Total Systems	+ .80%

(Gaines rebuttal Exhibit JDG-1)

The revelation that the base rates, with the effects of the contractual subsidies carved out and placed in their proper context, produce a modest rate of return from the smelters is a perfect explanation for the vociferous objection made by KIUC to the admission of Mr. Gaines' testimony into the record.

The final step of Mr. Gaines' analysis is to apply the Big Rivers' revenue request to determine the rate of return from base rates that will result if the Commission accepts Big Rivers' revenue request using Big Rivers' apportionment method. The resulting rates of return are shown on Gaines' Exhibit JDG-1, line 32:

Rurals	+ 3.48%
Large industrials	+ 8.42%
Smelters	+ 4.00%
Overall	+ 4.22%

This approach is consistent with the concept of gradualism and shows that the only substantial difference in the rates of return from base rates is between the large industrial class and the other two (2) classes. Under the concept of gradualism, this differential can be eliminated in years, not decades.

Both Mr. Seelye and Mr. Gaines agree that the contractual subsidy payments paid by the Smelters should be preserved and therefore should not be considered as part of the cost of service for purposes of making parity adjustments to the base rates. Although Mr. Seelye did not carve out the contract subsidy payments, he partially addressed the issue by focusing on the parity imbalance between the rural and large industrial classes only. In contrast, Mr. Gaines did carve out the contractual subsidies and in so doing found that Mr. Seelye's approach did not fully recognize the purpose of the § 4.11 surcharges paid by the smelters and the Unwind Surcredits received by the rural class and large industrial class, a revenue neutral event to Big Rivers. As explained by Mr. Gaines, the Smelters pay surcharges that are "in addition to any other amounts payable under" the Agreements. (Alcan and Century Aluminum contracts at §4.11) Those payments are intended to offset some of the fuel costs that the rural and large Industrial customers would otherwise incur as a result of the transaction to unwind the then existing contracts. Since the §4.11 intended to pay for fuel costs otherwise attributable to the non-Smelter members, the Unwind Surcredit was developed as the mechanism to credit the rural and large Industrial classes for the costs that were covered by the Smelters through the surcharges. To remove the effects of §4.11 from the cost of service, Mr. Gaines eliminated the surcharge revenue and the credits under the Unwind Surcredit. As explained by Mr. Gaines, the same result could have been achieved by leaving the revenues in the cost of service and adjusting the cost allocations to directly assign the fuel expenses to the smelters that they contractually agreed to pay through the §4.11 surcharges and correspondingly decrease the rural and large Industrial class fuel costs by the amounts of the Unwind Surcredits which reflect amount of fuel costs the smelters agreed to pay through the surcharges. Either approach would recognize that the §4.11 surcharges provide revenues to offset costs that the smelters agreed to pay "in addition to any other amounts payable under" (Alcan and Century Aluminum Contract §4.11) the Agreements. Not making these cost of service adjustments in their entirety improperly boosts the smelter rate of return while reducing the rural and large Industrial rates of return and would ultimately lead to the elimination of the contractual benefit of §4.11 that was negotiated by the parties.

Unfortunately, unlike Mr. Gaines and Mr. Seelye, the KIUC cost of service witness failed to recognize any of the contractual payments in their true context. (Barron rebuttal testimony at p.5) As a result, not only does he include all of the contractual subsidy payments in the Smelter revenues for purposes of determining the rate of return paid by the smelters, he also concludes that the subsidies provided through those payments should be eliminated through the allocation of the base rate increase. (Barron direct testimony at p. 6) This is clearly a back door attempt to undermine the intent of the smelter contracts.

Mr. Barron analyzed cost of service in light of all the funds paid by the smelters (including contractual payments). (*Id.*) He utilized a six (6) co-incident peak method and set the Tier adjustment figure at $14.2 million (the top of the band width). (*Id.* at pp. 4-5) As a result of his approach, he found that the rural class is being subsidized by $18 million. (*Id.* at p. 27) He gave no consideration in his revenue allocation recommendation to how much of the amount is the result of the contractual payments made by the smelters.

Mr. Barron had no personal knowledge of the Unwind negotiations and the smelter power contract negotiations. (Barron hearing testimony [7-27-11] at 16:56) Although he contends, lock step with the KIUC mantra that "we are not trying to change the contract,"[3] the most telling point in his testimony is the following:

> It is appropriate to fully eliminate the present rate subsidies received by the Rural rate class (<u>for example, contractual obligations require the Smelters to pay for minimum demand and energy, regardless of actual usage, the Tier adjustment provisions of the Smelter contracts that provide financial support to Big Rivers in the form of additional revenues paid only by the Smelter customers; and the concentration risk to Big Rivers that is increased as a result of excess charges to the Smelters</u>). (emphasis added)

Barron direct testimony at p. 6. Big Rivers Hearing Exhibit 2.

Mr. Barron's approach is consistent with Alcan's stated goal, "Sebree will seek to have a true cost of service rate." Big Rivers Exhibit 7.

While Mr. Barron appeared to be more advocate than analyst in his testimony at the hearing, he had difficulty denying that any subsidy paid by the smelters is paid due to the power contract. As shown by the following argument, the proper apportionment of rate increase to the classes should be achieved by comparison of the base rates of the classes, with proper treatment of the smelter contractual payments as not subject to reallocation among the classes.

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[3] (*Id.* at 16:44)

ARGUMENT

I. Cost of Service Rate Differentials
Should Be Analyzed Without the Effects of the Smelter Contractual Payments

In resolving the apportionment of the rate increase, the Commission will find very little help in the Kentucky Revised Statutes or the Kentucky Administrative Regulations. However, it is interesting to note that the definitions in KRS 278.010 contain the following two (2) in succession:

> "Arms length" means the standard of conduct under which unrelated parties, each party acting in its own best interest, would negotiate and carry out a particular transaction.
>
> "Subsidize" means the recovery of costs or the transfer of value from one (1) class of customer's activity or business unit that is attributable to another.

Despite entering into an "arms length" transaction two (2) years ago, KIUC uses this forum to complain about having to "subsidize" the rural rate class. Its protests to the contrary, KIUC is seeking to undo in this matter what was agreed upon in the smelter power contracts. Of course, the smelter contracts were merely a component of the entire Unwind agreement.

The fundamental question for the Commission is whether it will allow the smelters to undo what was recently agreed upon. It is recognized that the subsidies to the rural class from the smelters arise because of the smelter power contracts. Thus, any elimination of those subsidies through adjustments to base rates directly negates the effect of the smelter contractual payments. The purpose of the contractual payments was to provide direct rate mitigation to the rural and large industrial classes through compensation to Big Rivers in exchange for the additional risks and costs of accepting the smelters back into the Big Rivers system. As a result, the rate terms of the smelter contracts were not based on cost of service. Once the Commission has decided that it will not eliminate subsidies created by the smelter power contracts, then it need only address the base rates.

Jack Gaines is the only cost of service witness who distilled the analysis to the base rates. His conclusion is that while there is still rate differential between the large industrial class and the other classes, the smelters are not subsidizing the rural class through the base rates. As such, the smelters should bear their fair share of the base rate increase.

To reject this approach is to reject the powers of the parties to contract. The sanctity of a contract is so ingrained in our jurisprudence that the Kentucky Constitution prohibits laws impairing the obligation of contracts. Ky. Const. § 19. Courts have long held that they will not interfere with the ability of parties to contract, absent extraordinary circumstances. *Zeitz v. Foley*, 264 S.W.2d 267 (Ky. 1954). The Public Service Commission has followed this established precedent between the same parties in *The Application of Kenergy Corp. For Review and Approval of Existing Rates*, PSC Case No. 2003-00165, page 20, in which the Commission rejected a plea by KIUC to eliminate a contractual distribution fee executed two years prior in a ten year contract. The Commission held:

> In this instance, KIUC's challenge is essentially to the imposition of the fee on the self-generated power and this challenge clearly violates the terms of the contract. Therefore, the Commission finds that KIUC's request should be denied.

As there, so here.

The smelters contend that the contract reserved to them the right to intervene and participate in regulatory proceedings regarding cost of service issues of the non-smelter rate payers. While no one objected to the right of the smelters to intervene and participate in these proceedings, nothing about that language supports a challenge to the cost of service formula created as a result of the agreement. No one denies the right of the smelters to contest the cost of service of the base rates which Kenergy contends is the proper focus of this issue.

Kenergy submits that this issue of the rate differential was settled years ago in *National-Southwire v. Big Rivers Elec.*, 785 S.W. 2d 503 (Ky. App. 1990). Although that case resolved the issue of the legality of tying the smelters to a variable rate depending upon the price of aluminum, the Court held that:

> Even if some discrimination actually exists, Kentucky law does not prohibit it *per se*. According to KRS 278.170(1), we only prohibit "unreasonable prejudice or disadvantage" or an unreasonable difference. KRS 278.030(3) allows reasonable classification for service, patrons, and rates by considering the "nature of the use, the quality used, the quantity used, the time when used . . . and any other reasonable consideration." Id. at p. 514

No one could quarrel with the proposition that any discrimination in rates of return between the smelters and other classes is reasonable if founded in an arms length agreement. As such, when cost of service is examined under base rates, no significant disparity exists between the smelters and the rural class.

II. Proper Apportionment of Rate Increase

As there is no dispute that there is a disparity between the rural class and the large industrial class, Kenergy submits the disparity should be eliminated gradually. Big Rivers proposes to eliminate twenty-two percent (22%) of the disparity in their rate increase. Kenergy agrees with that approach.

This approach is consistent with past Commission practice and holdings supporting gradualism both among the rate classes and within them. *In the matter of Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company*, PSC Case No. 10064, and *In the matter of Application of Meade County Rural Electric Cooperative Corporation to adjust electric rates*, PSC Case No. 2010-00222, KIUC contends that the concept of gradualism should be disregarded due to the position of the Kentucky smelters relative to the world aluminum market. No one disputes the importance of the smelters to the economy of Western Kentucky. However, the issues raised by the smelters are more for the Kentucky Economic Development Office, not the Kentucky Public Service Commission. Kenergy supports the smelters in their attempts to obtain long-term economic development solutions to maintain the smelters' viability. However, modifying the smelter contracts or disregarding the concept of gradualism is not the proper solution.

CONCLUSION

The Commission should place the smelter contractual payments in proper context and examine the cost of service from a base rate revenue perspective, and apportion the necessary rate increase equitably according to the principal of gradualism.

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By J. Christopher Hopgood
J. Christopher Hopgood

CERTIFICATE OF SERVICE

I hereby certify that the foregoing was served on this 10th day of August, 2011, by mailing true and correct copies of same, postage prepaid, to those listed on the attached Service List.

J. Christopher Hopgood
J. Christopher Hopgood

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