BEFORE THE

COMMONWEALTH OF KENTUCKY

PUBLIC SERVICE COMMISSION

In the Matter of:

An Investigation of Big Rivers	)	
Electric Corporation's Rates	)	Case 9885
for Wholesale Electric Service	)	
and a Financial Workout Plan	)	

TESTIMONY

OF

LANE KOLLEN

ON BEHALF OF

THE ATTORNEY GENERAL OF KENTUCKY

KENNEDY AND ASSOCIATES
ATLANTA, GEORGIA

JULY 1987

KENTUCKY PUBLIC SERVICE COMMISSION

CASE NO. 9885

TESTIMONY OF LANE KOLLEN

Q. Please state your name and address.

A. Lane Kollen, Suite 475, 35 Glenlake Parkway, Atlanta, Georgia 30328.

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

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

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

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

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

In 1978, I was promoted to the Tax Department where I conducted tax research, prepared schedules supporting federal, state and local tax returns, developed tax, plant and depreciation related support for the company's rate cases, responded to tax related audit requests, and prepared tax, plant and depreciation related schedules for management reports, budgets, and forecasts. I also performed extensive depreciation analysis with the consulting firm of Gilbert and Associates.

In late 1979, I was promoted to the Auditing Department where I assisted in and conducted numerous audits, primarily operational in nature. I was involved in audits of nuclear and coal plant construction and operating records.

In 1980, I transferred to the Corporate Planning Department and was later promoted to Financial Planning Supervisor. In this capacity, I was responsible for computer modeling and the financial evaluation of the company's strategic plans. I was responsible for the preparation of the capital budget, various forecast filings with regulatory agencies, and assistance in rate and other strategy formulation. I utilized the strategic planning model PROSCREEN II and other software products to evaluate capacity swaps, sales, sale/leasebacks, cancellations, write-offs, unit power sales, and long term system sales, among other strategic options.

In 1983, I joined the consulting group at Energy Management Associates. I specialized in utility finance, computer financial modeling and utility accounting issues. I also directed consulting and software projects utilizing PROSCREEN II and

ACUMEN proprietary software products to support utility rate case filings, budgets, internal management and external reporting, and strategic and financial analyses.

In early 1986, I joined Kennedy and Associates where I specialize in revenue requirements analyses, taxes, evaluation of rate and financial impacts of traditional and non-traditional ratemaking and other utility strategic and financial issues. I have developed and presented papers on utility rate and tax issues at Energy Management Associates and ELCON industry conferences.

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

A. The purpose of my testimony is to address the following components of the BREC Case 9885 filing of July 17, 1987 and its effects on rural customers:

1. The format, content and timing of the filing
2. The provisions of the Modified Workout Plan
3. The Arthur Andersen and Co. fixed/variable costs study

Q. **Please summarize your testimony.**

A. The format and content of the filing submitted by Big Rivers are insufficient to properly analyze the revenue requirements requested by the Company. There is no test year defined; hence, it is not possible to define or properly analyze the revenues required now or in the future. Wilson operating expenses, investment and supporting capitalization are not determinable. The timing of the filing and the expedited hearing schedule have precluded formal discovery. Consequently, the parties have been denied an opportunity to closely examine, review and analyze the Company's filing.

The Modified Workout Plan is predicated upon the assumption that Wilson costs will be recovered regardless of whether the investment is "used and useful". The structural essence of the Modified Workout Plan is unchanged from that originally filed in Case 9613. It is still flawed, even though it addresses, to a limited extent, the issues raised by the Commission in its March 17, 1987 Order. Several of these issues were also addressed in my earlier testimony in Case 9613.

The most significant concern from the rural members' perspective, is the fact that their first step rate increase exceeds 35% under the Modified Workout Plan. Another important concern is the apparent lack of any downside protection from the risk of not achieving projected off-system sales levels and revenues, despite claims to the contrary by Big Rivers. If the off-system sales levels, revenues and profitability are below the levels projected by BREC, the ratepayers bear the risk of higher rate increases to cover shortfalls. In addition, the need for additional rate increases due to increased operating expenses and capital investment is virtually ignored. The rural customers are precluded from sharing in any benefits from increased off-system sales or any lower costs resulting from debt refinancings in exchange for accepting a 35% first step rate increase with no apparent downside risk protection. It is clearly inequitable for the ratepayers to bear the downside risk without a commensurate opportunity to benefit.

The Arthur Andersen & Co. study, which attempts to classify power production O&M costs into fixed and variable components, is incomplete. Wilson costs are not separately identified. AA & Co. has focused on longer term system average variable cost to the exclusion of shorter term system average variable cost and Wilson unit variable costs.

Q. Why is the format and content of the filing submitted by BREC insufficient to properly analyze the revenue requirements of the Company?

A. Regulated utility ratemaking has traditionally been premised upon the definition of a test year where revenues, expenses, investment and capitalization could all be measured and analyzed for purposes of cost recovery and the establishment of future cost based rates. Indeed, the Commission stated in its Order in Case 9613 dated March 17, 1987 on page 38:

> **"In establishing rates that are fair, just, and reasonable, the Commission must (1) determine the appropriate level of operating expenses; (2) fix a value on the utility's property; and (3) ... establish a times interest earned ratio to allow the payment of interest and principal by a cooperative utility...."**

In this filing, BREC has ignored these fundamental ratemaking concepts. This is an obvious and critical deficiency which precludes appropriate Commission scrutiny. In addition, future increases in operating costs can not be appropriately addressed by the Commission in the absence of a conceptually defined recovery basis.

Further, the current filing is incomplete. There is insufficient information in this filing to separate Wilson expenses, investment and capitalization from the Existing System. It is clear from my testimony filed in Case 9613, that the revenues currently being recovered by BREC are in excess of Existing System requirements and therefore, result in a subsidization of Wilson expenses and debt service requirements. However, this issue cannot be directly and properly analyzed in this case without additional data filings by the Company.

Q. Is the Modified Workout Plan presented by the Company in this filing structurally different than the Workout Plan presented in Case 9613?

A. No. There have been two apparent structural adjustments to the original Workout Plan. The first is to specifically identify dates and amounts for two rate increases subsequent to implementation of the initial request. However, the dates and amounts of these subsequent rate increases were previously reflected in financial projections provided during discovery in Case 9613. They just weren't explicitly stated or identified by the Company. The second is to modify the assumptions utilized to forecast off-system sales. Neither of these or any other changes have significantly altered the structure of the Workout Plan.

Q. Mr. Thorpe has testified that the Modified Workout Plan is improved because there are no longer any "unspecified financial targets", a criticism contained in the Commission's March 17, 1987 Order. Please comment on the significance of this modification.

A. This modification has simply changed the issue of "unspecified financial targets" to a non-issue of no financial targets. In other words, as long as there are no undeclared, hidden or otherwise unknown financial targets, then this is no longer an issue or criticism. However, the Plan does not inherently improve one iota nor is it in any sense changed by acknowledging this fact. However, there are implied financial targets in the sense that the financial projections offered by the Company as Exhibits 4 and 5 must be met to satisfy the creditors. Failure to achieve these implied financial targets, particularly in the area of off-system sales, would inevitably lead to creditor demand for higher rate increases to assure continuation of the debt principal and interest repayment schedule.

Q. **What effect does the Company's Modified Workout Plan have on the revenues required from the various classes of customers?**

A. First step (September 1, 1987) and second step (January 1, 1989) proposed cumulative revenue increases for each customer class are identified as follows:

	Step 1	Step 2 (Cumulative)
Rural Members	36%	51%
Non-Smelter Industrial	12%	23%
Smelters	17%	23%
Average	21%	30%

It is clear that the rural member customers are hit the hardest under the Company's Modified Workout Plan. Within a year and four months, rural members' rates would increase by 51%, more than double the rates of increase for other customer classes. It is also clear that these projected rate increases reflect minimum rate levels, not expected levels since none of the future costs reflect inflation or other escalation.

There will be additional rate increases. The Plan does not offer the equitable balance among all interests considered necessary by the Commission in its March 17, 1987 Order (page 43 and 44).

Q. Do you have any other criticisms of this proposed Modified Workout Plan to offer the Commission?

A. Yes. They are as follows:

- The Plan represents a unilateral "all or nothing" offering by Big Rivers' creditors to the Commission.

- There appears to be no assumption of risk by the creditors of non-recovery of Wilson and other debt service requirements. The only risk apparently assumed by the creditors is that of the timing of recovery; however, any recovery delays will continue to accrue interest. Consequently, the Plan specifically violates the second guideline for a Revised Workout Plan established by the Commission in its March 17, 1987 Order (page 44);

  "Big Rivers' ratepayers should not have unlimited responsibility for the payment of Big Rivers' debt. Furthermore, they should not be required to provide all the revenues required to offset shortfalls arising from insufficient off-system sales."

- There is no reduction in debt principal as suggested by the Commission in their fifth guideline for a Revised Workout Plan.

- There is no evidence that serious consideration was given by BREC to the sale or disposal of Wilson to another entity as suggested by the Commission in their sixth guideline for a Revised Workout Plan. The sale or disposal of Wilson at a substantial discount would be significantly less costly for BREC ratepayers and more beneficial to all parties than the proposed Modified Workout Plan. There is no evidence that a cost/benefit analysis of this tradeoff has ever been evaluated much less pursued. The analysis prepared by Mr. Falkenberg and contained in his testimony and exhibits indicates that a sale at a loss of up to approximately half the book value of Wilson would be less costly and certainly less risky for BREC ratepayers.

- There is no evidence that the Modified Workout Plan "...contain(s) much more affirmative support by REA of Big Rivers' efforts to achieve off-system sales" identified by the Commission as the eighth guideline for a Revised Workout Plan in its March 17, 1987 Order.

- The Modified Plan provides for demand rate surcharges for the 1987-1990 time period compared to the original Workout Plan to speed up creditor recovery of foregone principal repayments and additional debt interest arrearages resulting from the Commission's March 17, 1987 decision to not increase existing BREC rates. If the Commission determines that it is appropriate for BREC to recover these arrearages, they should be deferred beyond the three minimum demand charge rate increases identified by BREC in its Modified Workout Plan and not recovered on an expedited basis.

- There is no defined termination point for the Plan. If a date cannot be specifically determined, then some other basis such as achievement of minimum measures of financial health should result in the cessation of the Plan.

- The Plan provides the mechanism for the REA to absolve it's creditor/investor relationship with Big Rivers and to privatize the debt through bank and other investor refinancing.

In summary, the Modified Workout Plan proposed by Big Rivers in this filing does not comply with many of the guidelines established by the Commission in its March 1987 decision in substance or in form. The Plan contains other significant flaws. The Plan is predicated upon a finding by the Commission that the Wilson unit is "used and useful" and, is therefore, a proper and appropriate revenue requirement of the BREC ratepayers. In fact, the Modified Workout Plan is essentially unchanged from the original Workout Plan presented in Case 9613.

Q. **Please comment on the Arthur Andersen & Company study to determine variable power production O&M costs.**

A. There are two obvious uses for the results of a study such as this, providing that the results are acceptable and complete, which they are not. The first use is to establish the floor for a variable smelter rate. The second is to establish the minimum system average selling price for off-system sales. These two uses, of course, pose a philosophical paradox. To wit, which is better - a higher floor for the variable smelter rate or a lower "energy" cost for pricing off-system sales? The answer to this question is obviously dependent upon the price of aluminum and the prices that the off-system market will bear.

The preliminary AA & Co. results indicate a system average variable cost level under their modified NARUC approach of 19.63 mills/kwh including fuel and 5.90 mills/kwh excluding fuel based upon the year ending May 31, 1987.

If BREC were to incorporate the AA & Co. study results into their financial projections included as Revised Exhibits 4 and 5, on an unescalated basis, the off-system sales would actually result in the following annual contributions toward debt service and other fixed costs (mills/kwh):

	BREC Fuel	AA & Co. Var O&M	Total Var Prod O&M	Inter System Sales	Contribution Toward Debt Service and Fixed Costs
1987	12.84	5.90	18.74	16.90	(1.84)
1988	12.81	5.90	18.71	22.03	3.32
1989	12.50	5.90	18.40	21.55	3.15
1990	12.43	5.90	18.33	21.52	3.19

These results are, of course, inconsistent with the BREC assumption of selling off-system at 4.5 mills above the variable rate. In fact, it appears that BREC is currently selling off-system at below variable cost! One of three situations could occur if the AA & Co. study results are accepted for costing off-system sales:

1) The sales projections and revenues would remain the same but profitability would be reduced, or

2) Profitability would remain the same by further marking up off-system sales prices with no loss of projected off-system sales, or

3) Profitability would be reduced due to loss of off-system sales resulting from higher cost based selling prices than projected in the Company's forecasts.

This example illustrates the sensitivity of the Modified Workout Plant to either changes in actual costs from those projected or changes in fixed versus variable costs from those projected.

An additional use for the Arthur Andersen study was to have been to determine the variable cost of supplying energy directly from the Wilson unit. AA & Co., unfortunately, unilaterally decided to inappropriately disengage itself from this task. This is not only unfortunate, but unacceptable. The study currently provides only a <u>system average</u> variable cost. It should also have provided <u>Wilson unit</u> variable cost. It is important to know the relationship between <u>Wilson unit</u> variable costs and <u>system average</u> variable costs. If Wilson unit variable costs are higher than the system average variable costs, then Wilson variable costs are actually shifted to the BREC ratepayers who do not need the unit. This heaps injury upon injury. Not only does the Modified Workout Plan proposal require BREC ratepayers to pay for interest and principal repayments on Wilson debt, it also incorporates a ratepayer subsidization of variable costs to sell off-system.

The Arthur Andersen determination of variable cost in their study reviews the BREC approach, the NARUC approach and a modified NARUC approach. The different approaches reflect conceptual differences as to the definition of "variable cost". AA & Co. has chosen in their modified NARUC approach to align themselves philosophically with the theory that the larger the variation in production the more variable are the costs. This is also true the longer the period. Conceptually, all costs are variable given unlimited production and unlimited time. However, the issue here is to determine the short term variable cost to produce an incremental kwh of energy for sale, not to evaluate the variable cost to produce 3.4 billion kwh. I disagree with the philosophical thrust of their variable cost determination.

Q. Does this conclude your testimony?

A. Yes.

Lane Kollen

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 31st day of July 1987

Barbara J. Trojanowski

Notary Public