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January 26, 2009

Express Mail

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

RE: **Owen Electric Cooperative, Inc.**  
**PSC Case No. 2008-00154**

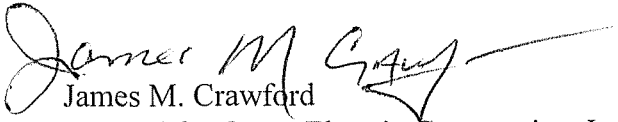
RECEIVED  
JAN 27 2009  
PUBLIC SERVICE  
COMMISSION

Dear Mr. Derouen:

Please find enclosed the original and ten (10) copies of Owen Electric, Inc.'s Notice of Substitution of Testimony. Please feel free to call if you have any questions or concerns.

Respectfully yours,

CRAWFORD & BAXTER, P.S.C.

  
James M. Crawford  
Counsel for Owen Electric Cooperative, Inc.

JMC/mns

Enclosures

RECEIVED

JAN 27 2009

PUBLIC SERVICE COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF OWEN ELECTRIC )
COOPERATIVE, INC., FOR ADJUSTMENT OF ) CASE NO. 2008-00154
RATES )

NOTICE OF SUBSTITUTION OF TESTIMONY

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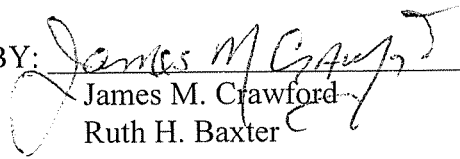
Comes now the Applicant Owen Electric Cooperative, Inc., by counsel, and gives notice that it is substituting the testimony of Robert Hood with the attached testimony of Mark Stallons, and as grounds therefore, states as follows:

- 1. Robert Hood retired from Owen Electric Cooperative, Inc., on January 5, 2009;
2. Mark Stallons was hired as President/Chief Executive Officer with Owen Electric Cooperative, Inc., on January 5, 2009;
3. That Mark Stallons will be testifying in place of Robert Hood as he is the current Chief Executive Officer of Owen Electric Cooperative, Inc.; and,
4. That the testimony of Mark Stallons is similar in nature to that of Robert Hood.

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Attorney for Applicant  
Owen Electric Cooperative, Inc.

BY:   
James M. Crawford  
Ruth H. Baxter

CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of the foregoing Notice of Substitution of Testimony was mailed postage pre-paid on this the 26<sup>th</sup> day of January, 2009, to:

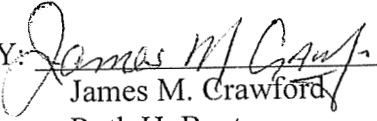
Mr. Jeff Derouen, Executive Director  
Kentucky Public Service Commission  
211 Sower Boulevard  
Frankfort, Kentucky 40602

Hon. Quang Nguyen  
Kentucky Public Service Commission  
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Frankfort, Kentucky 40602

Hon. Paul Adams  
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Office of Rate Intervention  
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Attorney for Gallatin Steel

BY:   
James M. Crawford  
Ruth H. Baxter

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

**In the Matter of:**

<b>APPLICATION OF</b>	)	
<b>OWEN ELECTRIC COOPERATIVE, INC.</b>	)	<b>CASE NO.</b>
<b>FOR ADJUSTMENT OF RATES</b>	)	<b>2008-00154</b>

**PREPARED TESTIMONY OF MARK A. STALLONS**

**Q1. Would you please state your name and business address.**

A1. Mark A. Stallons, with a business address of 8205 Highway 127 North, Owenton, Kentucky 40359.

**Q2. What is your occupation?**

A2. President & CEO for Owen Electric Cooperative (“Owen Electric”).

**Q3. How long have you been employed at Owen Electric?**

A3. I was employed on January 5, 2009, as President & CEO.

**Q4. What is your education and work experience?**

A4. I graduated from Ohio Northern University in 1979 with a Bachelor of Science degree in electrical engineering and from the University of Dayton in 1986 with a Masters in Business Administration. I have worked in the electric industry for over 19 years with two years at an investor-owned utility (“IOU”) and seventeen years at various electric cooperatives in Illinois, Michigan, and most recently Kentucky. My utility experience includes operations, engineering, marketing, customer service, and management areas. I am a registered professional engineer in the State of Ohio.

**Q5. Are you familiar with the contents of the Notice Application of Owen Electric which has been filed with this Commission to commence this Case?**

A5. Yes

**Q6. Please state whether the statements of facts contained in this Notice are true.**

A6. Yes. To the best of my knowledge and belief, the statements of facts contained in this Application are true.

**Q7. Are you familiar with the exhibits which are filed with and from a part of the Notice Application of this Case?**

A7. Yes. I am familiar with them. In my opinion, the factual materials contained in this Application are correct.

**Q8. When was the last General Rate Application filed by Owen Electric?**

A8. The last General Rate Application filed by Owen Electric was in 1982, in Case No. 8618.

**Q9. What is the purpose of this Notice of Application of Owen Electric to this Commission?**

A9. To align our customer charge with our fixed cost to enable energy innovation, efficiency, conservation, and demand response efforts and to obtain a time interest earned ratio ("TIER") of 2.0.

**Q10. What considerations were given to increase the rates and charges of Owen Electric?**

A10. The purpose of this Application is to support the fact that Owen Electric needs the requested rate relief that is being sought in this rate application. Owen Electric has filed this application due to its need to meet certain financial ratios as required by its mortgage agreements with its lenders: the Rural Utilities Service ("RUS") and the National Rural Utilities Cooperative Finance Corporation ("CFC"). According to these mortgage agreements, Owen Electric is required to maintain a Net TIER of 1.25 and an Operating TIER of 1.1. In addition, this application is necessary for Owen Electric to continue to pay capital credits and maintain adequate equity and cash reserves.

**Q11. What is the Test Year used by Owen Electric for its financial data compiled to the Commission in the Application?**

A11. The twelve months ended December 31, 2007 was selected as the Test Year. The management and Board of Directors of Owen Electric review the operations and TIER on a monthly basis. Noting the steady decline in margins and TIER, the Board of Directors authorized an Application to be prepared to increase rates and charges sufficient to obtain a TIER of 2.0.

**Q12. How was the proposed increase in revenues of \$3,991,675 allocated to rates?**

A12. Owen Electric and Jim Adkins have prepared a Cost of Service Study and based its rate design on this study.

**Q13. Why was a TIER of 2.0 requested?**

A13. The financial condition of Owen Electric Cooperative has deteriorated substantially since 2003. In order to continue meeting the debt service obligations, operating costs and maintain the minimum joint mortgage agreement requirements, it was necessary to request a TIER of 2.0 in this Application.

**Q14. What role did the Board of Directors play in evaluating the need for a rate increase?**

A14. The Board of Directors for Owen Electric reviews the financial statements of the cooperative on a monthly basis and closely monitors the Cooperative's financial status. Additionally, they receive training at NRECA meetings on a regular basis in order to adequately execute their responsibilities and to provide the Cooperative with well trained and informed board leadership.

**Q15. In your opinion, are the adjusted rates requested in this Case by Owen Electric Cooperative necessary to maintain the financial integrity of the Cooperative?**

A15. Yes. To enable Owen Electric to maintain its financial integrity, it is necessary that it be permitted to increase its rates as proposed in this Application.

**Q16. In your opinion, are retail rate design modifications necessary to promote energy efficiency investments?**

A16. Yes. Since June 2008, I have served on an Energy Efficiency & Demand Response Task Force working with the National Rural Electric Cooperative Association. Our goal is to create a road map outlining how rural electric cooperatives can expeditiously promote a culture of energy innovation including energy conservation, energy efficiency, and demand response. The existing cooperative rate structure has been identified as a major barrier in creating this energy innovative culture. In order to create proper incentives to promote energy innovation, the right retail rate environment must exist. More specifically, fixed costs should be recovered through fixed charges and variable costs should be recovered through variable charges. For most distribution cooperatives, following this principle would result in higher customer charges, higher demand charges, and lower energy charges.

**Q17. Do current retail rate designs provide any disincentives for Owen Electric to aggressively pursue energy innovation, efficiency, conservation, and demand response efforts with its members?**

A17. Yes. Owen Electric's current retail rate design does not align the interests of the Cooperative and its members with respect to energy innovation, efficiency, conservation, and demand response efforts. Owen Electric's current residential customer charge is \$5.64 per member per month which is well below the \$21.92 indicated by its most recent cost of service. This \$5.64 monthly charge does not even cover Owen Electric's member related costs let alone any margins. Under its current rate design, Owen Electric collects all of its margins and a significant portion of its member related fixed costs through an energy charge assessed on a kWh basis. Thus, any reduction in kWh sales due to energy innovation, efficiency, conservation, and demand response efforts results in the Cooperative not recovering fixed cost and margin, which financially harms the Cooperative. It is not reasonable to expect Owen Electric to aggressively pursue energy innovation such as conservation, energy efficiency, and demand response programs when every reduction in sales has a negative financial impact on Owen Electric. This link



between sales and fixed cost and margin recovery is referred to in the electric utility industry as the “throughput incentive”.

**Q18. Please explain the “throughput incentive”.**

A18. Between rate cases, utilities have a financial incentive to increase retail sales of electricity relative to historic levels that were used for calculating their base rates. This incentive exists because there is usually significant incremental fixed cost and margin recovery on incremental sales. For sales above the historic levels that were used for calculating its base rates, all revenue above the variable cost of producing the incremental kWh would be incremental revenue for the utility. This incentive for utilities to maximize the “throughput” of electricity across their wires in an attempt to increase fixed cost and margin recovery is referred to as the “throughput incentive”. Similarly, utility profits decline when sales are below the historic levels that were used for calculating their base rates, which could result from energy innovation, efficiency, conservation, and demand response efforts. Every kWh lost as a result of energy innovation programs reduces margins and diminishes financial stability, regardless how cheap the efficiency, conservation, or demand response efforts. The effect of this throughput disincentive is greater for distribution-only utilities, such as rural electric cooperatives, because the revenue impact of electricity sales reduction is disproportionately larger for utilities without generation resources. It is critical to address this throughput incentive if regulators and customers want utilities to become actively involved in energy innovation such as efficiency, conservation, and demand response programs.

**Q19. How can this “throughput incentive” be mitigated for rural electric cooperatives?**

A19. The easiest way for a rural electric cooperative to mitigate the throughput incentive is to allow it to increase its customer charge to a level that is justified based on cost of service. This would assure a revenue stream that flows into the cooperative regularly and that is not linked to the level of sales. One result of such a change is that the energy charge would be reduced as fixed cost and margin recovery was removed from the customer charge. The straight fixed variable rate design that is common in the natural gas industry takes this to the extreme with all of a utility’s fixed cost recovered through a monthly

customer charge. This completely breaks the link between the recovery of fixed cost and margins and the level of kWh sales, as there is no fixed cost or margin recovery in the energy charge assessed on a kWh basis.

**Q20. What costs are typically classified as member-related in a cost of service study and should be recovered through the customer charge?**

A20. The customer charge recovers the cost of the minimum amount of equipment that the cooperative must install to provide a member with access to the electric grid. Without this minimum amount of equipment, members would not be able to receive electric service. Unfortunately, the cost of the poles, wire, transformers, service drops, meters and substations necessary to provide a member with access to the electric grid are not cheap. For example, the 15 kVa transformer that is used for most residential members costs about \$815. A mile of single phase distribution line costs about \$30,000 per mile, which includes both the poles and the wire. On average, Owen Electric has about \$2,884 per customer invested in the distribution plant necessary to provide a member with electric service. These represent fixed costs to the cooperative; that is costs that do not change regardless of the amount of electric energy purchased by members. So if members use less electricity, either because they have taken steps to conserve energy or because they went to Florida on vacation, these costs to the cooperative do not change and must be recovered for the cooperative to remain financially sound.

**Q21. How much of a typical member's bill is for the cooperative's distribution facilities?**

A21. Based on the last cost of service study that the cooperative did, about 20% of a typical member's bill is for the cooperative's distribution facilities and about 80% is for the energy that the cooperative purchases from its supplier. Thus, reducing member usage through energy innovation, efficiency, conservation, and demand response programs has the potential to generate significant energy bill reductions for customers. Furthermore, with increases in the cost of copper, steel, cement, coal and natural gas, both the cost of the generating plants and transmission lines and the cost of the fuel for producing electric energy are likely to increase in the future. With these expected increases in the cost of purchased power, energy innovation, efficiency, conservation and demand response

would benefit both the cooperative and its members, and Owen Electric would be willing to aggressively pursue innovative energy reduction methods if it were not harmed financially by doing so.

**Q22. Why would reducing the customer charge and recovering these costs through a kWh charge cause financial problems for the cooperative and result in more variable energy bills for customers?**

A22. If some of the costs of the minimum system necessary to provide a member with access to the electric grid are recovered through a kWh charge rather than through the customer charge, members who use a small amount of electric energy would not pay the costs that they impose on the system and would receive a subsidy from members who use a lot of electric energy. With these fixed costs recovered through the kWh charge, the cooperative would recover more fixed cost than it actually needed when weather was extremely hot or cold and kWh sales were high. The cooperative would recover less fixed cost than it needed when weather was mild and kWh sales were low. This would result in member energy bills being higher than necessary when weather was extreme and lower than necessary when weather was mild. With a low customer charge, the cooperative is betting on extreme weather, and the cooperative wins and the member loses when extreme weather actually occurs. Rather than making bets on weather, a better outcome for both the cooperative and for its members is for the cooperative to recover these fixed costs through a fixed monthly charge that does not vary with kWh sales and with weather.

**Q23. Would recovering the cost of the minimum system necessary to provide a member with access to the electric grid through a monthly customer charge provide the right environment for energy innovation, efficiency, conservation, and demand response?**

A23. Yes. If a cooperative recovers a significant amount of its fixed costs through an energy charge on each kWh sold rather than through a monthly customer charge, energy innovation, efficiency, conservation, and demand response would result in reduced energy sales and in some of these fixed costs not being recovered by the cooperative. Thus, reduced sales resulting from all forms of energy innovation would harm the

cooperative financially. However, if these fixed costs are recovered through a monthly customer charge, the cooperative would continue to recover these fixed costs regardless of the level of kWh sales, and the cooperative could get much more aggressive in assisting members with energy reduction efforts without harming itself financially.

A rate where the fixed costs and margin of the distribution cooperative are recovered through a fixed charge on the member's bill encourages the cooperative to put the goal of energy efficiency and load reduction as a priority. This rate design would align the goals of all of the parties and would result in the Commission, Attorney General, Sierra Club, the Governor's Energy plan, the members, and the distribution cooperative working toward the same goal. That goal is to reduce energy usage, carbon emissions, and ultimately the energy bill of the member.

**Q24. Shouldn't the customer charges for all utilities in Kentucky be about the same?**

A24. No. Rural electric cooperatives have much fewer members per mile of line and cannot spread fixed distribution costs over as many members as an IOU. For example, Owen Electric currently has about 13 members per mile of line while Kentucky Utilities ("KU") has about 35 customers per mile of line and Duke Energy-Kentucky ("Duke") has about 46 customers per mile line. If a mile of single phase distribution line costs about \$30,000 to install, this mile of line would represent a cost of about \$2,300 per member for Owen Electric, about \$850 per customer for KU, and about \$650 per customer for Duke. Similarly, in a rural area, it is difficult for a transformer to serve more than a single account, while in an urban area a transformer could serve four or more accounts. These differences in ability to spread fixed costs result in much higher member related costs for distribution cooperatives compared to IOU's and the resulting customer charges could be very different.

**Q25. Would a lower customer charge combined with a higher energy charge benefit fixed and low income members?**

A25. Based on our experience and a recent analysis of the kWh usage of members who have received LIHEAP assistance in the last year, a lower customer charge combined with a

higher energy charge would not benefit most fixed and low income members. For fixed and low income members to benefit from a lower customer charge and higher energy charge, these members would need to have an energy usage that is significantly lower than the class average. Generally, this is not the case for low income members. The housing stock in which many low income members are living is relatively inefficient from an energy usage standpoint, so their energy usage is frequently the class average. The inefficient energy usage of the dwelling in which they live has typically resulted in the price of the dwelling being discounted to a level that low income members can afford. For fixed income members, it is our experience that, because they have a stock of appliances similar to other members and are frequently home all day, they generally have usage levels in the neighborhood of the class average and would not significantly benefit from such a change.

In Owen Electric Cooperative's case when you examine the usage of our low-income members, you see that these members have bills that are comparable to the average member. There are a couple of reasons for this. First, these members live in homes or manufactured homes that are typically older than the average. These homes are poorly insulated and have appliances that do not meet Energy Star standards.

A recent study conducted by East Kentucky Power Cooperative shows that Owen Electric members who received LIHEAP assistance in 2008, used on average 1198 kWh's per month while all of our remaining members used on average 1248 kWh per month. The facts show that increasing our member's customer charge as opposed to increasing the energy charge will not adversely affect our lower income members. A four percent difference in monthly energy usage is not significant.

**Q26. Who are the low usage members who would benefit from a lower customer charge and a higher energy charge?**

A26. For most rural electric cooperatives, their low-usage members are loads like boat docks, garages, electric fences, stock tanks, vacation homes, hunting camps, fishing camps and services run to barns in case they might be needed. All of these loads typically consume

very few kilowatt hours during the course of a year and the usage is sporadic. However, even though kWh sales may be low to these members, the cooperative still incurs significant fixed costs in installing the minimum system requirements necessary to serve these loads. Furthermore, these loads usually are not located near roads and existing distribution lines and may cost more than the average minimum system. A lower customer charge and a higher energy charge would result in these low-usage members being subsidized by other cooperative members who have above-average usage. Such a rate structure would send a signal that it is relatively inexpensive to provide the physical equipment necessary to provide service to these low-usage members, and this is definitely not the case in rural areas.

**Q27. In your 17 years of experience with electric cooperatives please describe your experience with the customer charge.**

A27. In the late 1990s with the advent of customer choice legislation, electric cooperatives began to understand the need to unbundle and realign rates with actual cost drivers. One aspect of the realignment included increasing the customer charge to reflect the actual fixed costs of providing electric service. In southern Illinois at Egyptian Electric Cooperative where I managed prior to coming to Owen Electric, the customer charge is \$24.00. With the advent of renewable energy, distributed generation, and net metering, over the past few years in Illinois, the urgency to increase the customer charge has accelerated. If the customer charge does not adequately fund the fixed costs of the cooperative when a member installs a wind or solar generation system, the other cooperative members end up subsidizing the member who installs the distributed generation system. To avoid this inequity, Illinois cooperatives are increasing their customer charge.

**Q28. Based upon your experience with the Energy Efficiency and Demand Response Task Force what are the electric cooperatives serving on the task force recommending in regards to the customer charge?**

A28. The electric cooperatives serving on the task force recognize that the throughput incentive must be eliminated in order to aggressively promote energy innovation,

efficiency, conservation, and demand response programs. Therefore, the task force strongly recommends that the customer charge be increased to cover the actual fixed costs of providing service to their members. Below please find a list of the electric cooperatives serving on the task force and their present customer charge:

United Cooperative Services	Texas	\$17.30
Cass County Electric Cooperative	North Dakota	\$12.00 City & Village \$16.00 Rural
Rappahannock Electric Cooperative	Virginia	\$10.00
Shenandoah Valley Electric Cooperative	Virginia	\$13.76
Northeastern REMC	Indiana	\$15.00
Shelby Electric Cooperative	Illinois	\$29.00
Egyptian Electric Cooperative	Illinois	\$24.00
Iowa Lakes	Iowa	\$28.50
Tri-County EMC	Georgia	\$25.00
Flint Energies	Georgia	\$20.00
Owen Electric	Kentucky	\$ 5.64

**Q29. How are electric cooperatives different?**

A29. Electric cooperatives serve areas that were not profitable in the 1930's and collectively today remain non-profitable for IOU's to serve.

Electric cooperatives serve geographical areas that have an average member per mile density that is much less than IOU's. As a result, electric cooperative's fixed cost per member is much higher than IOU's.

Electric cooperatives are member-owned, member-regulated, and member-managed for the exclusive benefit of our members versus IOU's who are managed for the benefit of the investors.

The mission of electric cooperatives is to improve the quality of life of our member owners and to provide reliable service at a reasonable cost. The Mission of IOU's is to maximize the return to their investors.

Our values are integrity, innovation, commitment to community, commitment to employees, and stewardship.

The bottom line is that electric cooperatives exist for the sole purpose of serving our members. Every month our management team reports to a board of directors comprised of our members. Electric cooperatives do the right thing because it is best for our members.

**Q30. Please describe Owen Electric's efforts in the energy innovation including conservation, efficiency, and demand response.**

A30. Owen Electric Energy works hard to help our members become more energy efficient. We have given out thousands of compact fluorescent light bulbs (CFLs), perform energy audits over the entire system, and offer rebates on energy efficient home building practices and existing home improvements. We conduct energy efficiency seminars and for many groups and organizations such as Community Action agencies, senior citizen groups, and schools in addition to hosting energy efficiency "best practices" workshops for area builders and HVAC contractors.

We are committed to helping our members meet the energy challenges of the future. Unfortunately, an extensive number of our customers cannot fully take advantage of the many programs and incentives that Owen Electric offer. They simply do not have the disposable cash necessary to invest in their homes. For these programs to be fully utilized, the Commission needs to consider supporting rate designs that allow



cooperatives to have a mechanism to fund these programs. There are a couple of possible solutions. One, the Commission could allow a charge to be placed on the bill similar to the demand side management (“DSM”) surcharge. For example, a reasonable per meter charge would allow the cooperative to have funds available to make investments.

A second method would be for the Commission to allow a higher TIER to be recovered by the cooperative. In our recent rate case, we agreed to a TIER of approximately 2.0. If a TIER of 2.5 were recovered, then the additional funds could be used for the efficiency investments. In either instance, the cooperative will make the additional investments with the members to reduce usage. All parties benefit from this scenario. Members’ bills will be reduced, emissions are reduced, and the cooperative does not start a cycle of decreased sales leading to increased rates because rates are recovered through fixed charges.

**Q31. What are your conclusions regarding this rate case proceeding?**

A31. In an age of rising fuel costs, increasing environmental costs, tight power supply markets, and increasing generation construction costs it is imperative that the customer charge be realigned to match fixed costs so that energy innovation, efficiency, conservation, and demand response can be aggressively pursued without placing the electric cooperative in financial peril. We look forward to working with the Commission in implementing rate designs that help our members reduce their energy bills through energy innovation efforts including efficiency, conservation, and demand response. Energy innovation is a win-win proposition for our members and for the cooperative. In order to begin accomplishing this vitally important goal we ask that the commission approve our request to increase our customer charge to \$11.20.

**Q32. Does this conclude your testimony in this case?**

A32. Yes, it does.

Affiant, Mark A. Stallons, states that the answers given by her to the foregoing questions are true and correct to the best of her knowledge and belief.



Mark A. Stallons, President & CEO

Subscribed and sworn to before me by the affiant, Mark A. Stallons, this 26<sup>th</sup> day of January, 2009.

Notary Shawna Coladron  
State-at-Large

My Commission expires 7-7-2010.