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August 11, 2011

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PUBLIC SERVICE
COMMISSION

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 the PUBLIC VERSION of the MAIN BRIEF OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC. I also enclose a copy of the CONFIDENTIAL PAGES to be filed under seal.

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

Very Truly Yours,

Michael L. Kurtz, Esq.
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MLKkew
Attachment
cc: Certificate of Service

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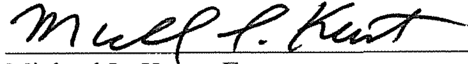
CERTIFICATE OF SERVICE

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 11th day of August, 2011 to the following



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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

RECEIVED
AUG 11 2011
PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

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

MAIN BRIEF OF

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

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August 11, 2011

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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

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Comes now, the Kentucky Industrial Utility Customers, Inc. ("KIUC") representing the interests of Alcan Primary Products Corporation, Century Aluminum of Kentucky, General Partnership, Domtar Paper Co., LLC, Kimberly-Clark Corporation and Aleris International, Inc. and submits its Main Brief as follows:

I. INTRODUCTION

Two years ago Big Rivers catapulted from a transmission company with a negative net worth to an investment grade generation and transmission cooperative with almost $400 million in equity, only to experience a down market in wholesale power prices and filing a $39.2 million (9.1%) base rate increase well before the filing was expected. Having chosen a historical test year in this proceeding, it now advocates revenue adjustments that are not allowable under Commission principles for historical test year filings. In 2009 the Smelters returned to Big Rivers as their long term power supplier and, while

experiencing a rise in the world-wide price of aluminum, now find themselves in a struggle against ever increasing power rates that expose them to closure risk during the inevitable downward cycle of the aluminum market.

The base rate increase sought from the Smelters is $22.5 million (8%) once the fictitious TIER Adjustment revenue reduction is swept away to comport with the reality that no reduction in this charge will take place when base rates are reset in this proceeding or at any time in the foreseeable future. This proposed base rate increase is in addition to the automatic rate increase of $9.5 million the Smelters will absorb on January 1, 2012.[1] The total increase to the Smelters is therefore $32.0 million or 11.3%. This level of rate increase adds to the risk confronting the Smelters and the entire Big Rivers system. The closure of the Smelters would result in the loss of 4,700 jobs, $176 million in annual payroll and almost $12 million in state and local taxes. It would also force Big Rivers to become a highly risky merchant generator which would likely increase rates on all remaining customers by approximately 55%.

The industrial companies comprising KIUC in this case – the two Smelters, Kimberly-Clark, Domtar and Aleris – have proposed a path which does not increase the risk of Smelter closure and that provides Big Rivers with the maximum amount of revenue consistent with its filing and ratemaking principles applicable to a historical test year. Our proposal also includes cost allocation and rate mitigation tools consistent with the Smelter contracts and sound ratemaking. One important rate mitigation tool is the prudent use of the $63 million Commission-created Rural Economic Reserve fund to ease the transition of the Rural Class to cost-based rates. Our proposal not only results in reasonable rates for all consumers, but also addresses the primary concern of the rating agencies, i.e. the Smelter concentration risk.

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[1] On January 1, 2012 the Smelter TIER Adjustment Charge automatically increases from $1.95/mWh to $2.95/mWh. This increases the Smelters' power cost by $7.3 million. Also on January 1, 2012 the Smelters' Section 4.11 costs automatically increase by $2.2 million.

The base rate increase proposed by Big Rivers, because it overstates the revenue deficiency and does not fully address the subsidy quantified in KIUC's cost-of-service study, carries significant risk that could push the economy of Western Kentucky into a much deeper and more difficult financial environment. The purpose of this Brief, therefore, is to advance a path that serves the interests of Big Rivers, its Members and its large customers and does not increase the risk to the economy of Western Kentucky.

The witnesses sponsored by Big Rivers believe that state regulation over power pricing by electric cooperatives is a net negative. We disagree. Only the Commission, not the Big Rivers Board of Directors, has the objectivity and perspective to set rates and allocate costs in a manner that serves the overall economic interests of Kentucky, without parochial political concerns clouding its judgment.

II. ARGUMENT

1. Big Rivers Does Not Face An Emergency Situation Caused By Its Debt Covenants.

The main contention of Big Rivers' rebuttal case is that the $18.562 million rate increase recommended by KIUC is so draconian that the financial viability of the utility is threatened. This claim is directly contradicted by the fact that in July 2011 both Moody's and Standard & Poor's confirmed their investment grade credit ratings of Big Rivers.[2] It is clear from their reports that both rating agencies were well aware of the issues in this rate case before they confirmed Big Rivers' investment grade credit ratings. It appears that the story Big Rivers tells to the rating agencies is that business is sound, but the story it tells to this Commission in order to justify higher rates is one of extreme economic pessimism.

[2] KIUC Cross Exam Exhibits 12 and 13.

At the very outset of his rebuttal testimony Big Rivers' President & Chief Executive Officer made the very serious allegation that bankruptcy was likely due to debt covenant violations if KIUC's revenue requirement adjustments were adopted. Mr. Bailey's Rebuttal Testimony states:

> "Q. *Does the KIUC proposal allow Big Rivers to meet the requirements of its debt covenants?*
>
> *A. No. As discussed in greater detail in the testimony of Mr. Blackburn, the KIUC proposal would not allow Big Rivers to maintain an MFIR of at least 1.10, which it is obligated to maintain under covenants in the documents required by Big Rivers' lenders. In the event that Big Rivers fails to achieve the minimum required MFIR, Big Rivers would likely be in default of its obligations to its lenders and would face potential bankruptcy.*"[3]

This is a gross mischaracterization of Big Rivers' debt covenants. Big Rivers' RUS loan contract and mortgage indenture do not obligate the utility to maintain an MFIR of at least 1.10 (about $5 million in annual margins). Instead, those agreements only require that Big Rivers seek rates from this Commission which are "*reasonably expected*" to yield an MFIR of at least 1.10. Section 4.4 of the RUS loan contract[4] states:

> "*The Borrower shall design and implement rates for utility service furnished by it to maintain, on an annual basis, the Margins For Interest Ratio specified in Section 13.14 of the Indenture.*"

Section 13.14 of the Indenture[5] states:

> "*Subject to any necessary regulatory approval or determination and the approval of the RUS, if required, the Company also shall establish and collect Rates that, together with other revenues available to the Company, are reasonably expected to yield a Margins For Interest Ratio for each fiscal year of the Company equal to at least 1.10 for such period.*"

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[3] Bailey Rebuttal Testimony at p. 7.
[4] KIUC Cross Exam Exhibit 5.
[5] KIUC Cross Exam Exhibit 4

Big Rivers May 2010 pollution control bond prospectus[6] provides additional clarity. It states:

> "*A failure by us to actually achieve a 1.10 MFI Ratio will not itself constitute an Indenture Event of Default under the Mortgage Indenture. A failure to establish Rates reasonably expected to achieve a 1.10 MFI Ratio, however, will be an Indenture Event of Default if such failure continues for 30 days after we receive notice thereof from either the Indenture Trustee or the holders of not less than 20% in principal amount of the outstanding Mortgage Indenture Obligations, unless such failure results from our inability to obtain regulatory approval.*"

Big Rivers is required to seek rates from this Commission that are "*reasonably expected*" to yield an MFIR of 1.10 and the failure to actually achieve an MFIR of 1.10 for any fiscal year is not an event of default. KIUC's proforma adjustments to the historical test year chosen by the utility result in a TIER of 1.24 (which is almost identical to MFIR). A rate case based upon a TIER of 1.24 more than meets the requirement that rates are "*reasonably expected*" to maintain an MFIR of 1.10.

As opposed to the "*reasonably expected*" standard for ongoing compliance with its debt instruments, the only time that Big Rivers' Indenture requires that an MFIR of 1.10 actually be achieved with respect to an historical period is when new debt is going to be issued. The Available Margins Certificate of the Indenture requires that before new debt can be issued, Big Rivers must have actually achieved an MFIR of at least 1.10 for the immediately preceding fiscal year or any twelve consecutive calendar months during the period of fifteen calendar months immediately preceding the refinancing.[7] Big Rivers must refinance $60 million of RUS debt by October 2012 and also expects to borrow an additional $52 million for additional cash reserves at the same time. According to Mr. Blackburn, these financings are expected to close in August 2012.[8]

This means that Big Rivers must earn an MFIR of at least 1.10 (about $5 million in annual margins) for either calendar year 2011 or twelve consecutive months during the fifteen month period

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[6] KIUC Cross Exam Exhibit 6.
[7] Blackburn Rebuttal Testimony at 9-11.
[8] *Id*. at 10.

May 2011 through July 2012. This is an important requirement. But there is no reasonable basis to set rates in this historical test year rate case based upon those future considerations. It would be sheer speculation to increase the $18.562 million revenue requirement calculated by Mr. Kollen based upon claimed future financial needs that are not now known nor measurable. Big Rivers' actual earnings for either 2011 or the period May 2011 through July 2012 will be affected by a myriad of factors, including: cost control, off-system sales pricing, off-system sales volume, weather, general economic conditions, the $7.3 million increase in the Smelter TIER Adjustment Charge beginning January 1, 2012, and others. It may well be that Big Rivers' earnings will substantially exceed a 1.10 MFIR during one of the relevant time periods if the KIUC revenue requirement is adopted. If Big Rivers does face a problem as August 2012 approaches, then some future action by this Commission may be appropriate at that time.

2. The Commission Should Allow A Base Rate Increase No Greater Than $18.562 Million.

The Commission should increase Big Rivers' base rates by no more than $18.562 million, a reduction of at least $20.6 million compared to the Company's requested increase of $39.2 million. In determining the level of base rate increase, KIUC simply asks that the Commission review Big Rivers' proposed revenue requirement as any other utility rate request applying traditional ratemaking principles to each revenue and expense item. Specifically, the KPSC should not allow Big Rivers to file using a historical test year and then apply speculative future adjustments that are contrary to Commission precedent for a historical test year filing to arrive at a predetermined level of revenue.

The Commission should not apply less rigorous scrutiny of the Application in response to Big Rivers' alarmist claims of a credit rating downgrade or bankruptcy. Big Rivers has filed a traditional base rate case, not a request for emergency relief. Big Rivers' proposed revenue requirement contains a total of twenty-eight proforma adjustments, and KIUC has challenged only nine items. These nine

adjustments are summarized in the table below and described in sections (a) through (j).[9] Of those nine items, Big Rivers, through its rebuttal testimony, agreed with all or part of three of KIUC's changes. If Big Rivers' believes the revenues approved by the Commission in this case are inadequate, then Big Rivers has other options for additional relief. But its chosen path in this case must be considered on the basis of established ratemaking principles. KIUC's proposed adjustments to Big Rivers' revenue requirement are summarized in the table below.

BIG RIVERS ELECTRIC CORPORATION
12 Months Ended October 31, 2010

Reconciliation of Revenue Requirement

Line No.	Description	Reference Schedule	Big Rivers Original Amount	KIUC Adjustments Adopted by Big Rivers	Big Rivers Updated Amount	Remaining KIUC Adjustments	KIUC Recommend
		(1)	(2)	(3)	(4)	(5)	(6)
	Proform Adjustments						
1	To annualize revenue & expenses for new industrial customer	2 01	$ (39,145)	$ -	$ (39,145)	n/a	$ (39,145)
2	To adjust mismatch in fuel cost recovery	2 02	(2,225,346)		(2,225,346)	n/a	(2,225,346)
3	To eliminate Environmental Surcharge	2 03	(633,559)		(633,559)	n/a	(633,559)
4	To reflect temperature normalized sales volumes	2 04	126,318		126,318	n/a	126,318
5	To adjust for Non-FAC PPA	2 05	427,156		427,156	n/a	427,156
6	To reflect annualized depreciation expenses	2 06	6,252,651		6,252,651	(6,936,963)	(684,312)
7	To reflect increases in labor and labor overhead expenses	2 07	624,894	(174,679)	450,215	(859.390)	(409.175)
8	To reflect current interest on construction (CWIP)	2 08	515,767	(515,767)	-	(123,784)	(123,784)
9	To eliminate RRI Domtar Cogen Backup revenue & expenses	2.09	(971,257)		(971,257)	n/a	(971.257)
10	To reflect normal non-labor non-outage prod maint exp, incl inflation	2 10	5,660,678		5,660,678	(1,324,395)	4,336,283
11	To reflect normal planned-outage prod maintenance expenses	2 11	2,726,965		2,726,965	n/a	2,726,965
12	To reflect going forward IT support services	2.12	292,194		292,194	n/a	292,194
13	To reflect amortizaton of rate case expenses	2.13	281,719		281,719	n/a	281,719
14	To reflect Midwest ISO related expenses	2.14	5,415,000	(61,556)	5,353,444	n/a	5,353,444
15	To annualize interest on long-term debt	2.15	70,408		70,408	(2.536.730)	(2,466,322)
16	To reflect leased property (Soaper Building Rent)	2.16	(128,368)		(128,368)	n/a	(128,368)
17	To adjust for costs related to LEM Dispatch	2.17	(936,815)		(936,815)	n/a	(936,815)
18	To adjust for costs related to APM	2.18	205,090		205,090	n/a	205,090
19	To eliminate WKEC Lease Expenses	2.19	149,673		149,673	n/a	149,673
20	To eliminate WKEC Unwind-related Expenses (Non-Labor)	2 19	2,357,097		2,357,097	n/a	2,357,097
21	To eliminate WKEC Unwind-related Expenses (Labor-related)	2 19	(7,476,583)		(7,476,583)	n/a	(7,476,583)
22	To eliminate costs for SFPC membership	2.20	(180,775)		(180,775)	n/a	(180,775)
23	To adjust for Midwest ISO Case-related expenses	2.21	(771,118)		(771,118)	(534,259)	(1,305,377)
24	To adjust for Smelter TIER Adjustment Charge	2.22	7,128,947		7,128,947	(7,128,947)	0
25	To eliminate advertising, lobbying, donation and econ dev	2.23	(507,216)		(507,216)	n/a	(507,216)
26	To reflect going forward level of income taxes	2.24	183,084		183,084	n/a	183,084
27	To reflect going forward level of Outside Services	2.25	(1,000,000)		(1,000,000)	n/a	(1,000,000)
28	To reflect commitment to Energy Efficiency Programs	2.26	1,000,000		1,000,000	(1,000.000)	0
29	To reduce transmission expense					(194,000)	(194,000)
30							
31	Total Proforma Adjustments		$ 18,547,460	$ (752,002)	$ 17,795,458	$ (20,638,468)	$ (2,843,010)
33							
34	**Revenue Deficiency**		**$ 39,952,927**		**$ 39,200,925**		**$ 18,562,457**

[9] KIUC Cross Exam Exhibit 3.

a. Big Rivers' Proposed Adjustment To Reduce Test Year TIER Adjustment Revenue By $7.1 Million Is Simple Manipulation And Should Be Denied.

The Smelters have paid the maximum TIER Adjustment Charge of $1.95/MWh for every month of the historical test year ended October 2010, and each and every month since then.[10] The Company's witnesses conceded at hearing that the Smelters will continue to pay the maximum TIER Adjustment Charge for the remainder of 2011 and that there will be no reduction in September 2011 when base rates are reset.[11] The Company's witnesses conceded further at hearing that Big Rivers on January 1, 2012 will raise the TIER Adjustment Charge by another $1.00/mWh to the maximum charge of $2.95/mWh in 2012 allowed under the Smelter Contracts.[12] All of this is confirmed by Big Rivers' financial model which shows the Smelters at the top of the TIER Adjustment Charges for the remainder of 2011 and all of 2012.

One of the most indefensible revenue adjustments Big Rivers seeks is the sleight of hand elimination of $7.1 million of test year TIER Adjustment revenue that it actually collected and that it concedes it will continue to collect. The elimination of this revenue from the test year has the effect of inflating the rate increase on all consumers (Rural, Large Industrial and Smelter).[13] The elimination of this revenue is not a known and measurable change. To the contrary, there will be no change in these TIER Adjustment revenues and thus, there should be no proforma adjustment to eliminate the revenues.

Big Rivers' witnesses attempt to justify this manufactured adjustment by asserting that it is a "*policy*" decision intended to set the Smelters at the midpoint of the bandwidth when the new rates go into effect.[14] On Mr. Seelye's Exhibit 6, the Company claims that the proposed Smelter base rate

[10] Kollen Direct Testimony at p. 6.
[11] Video Transcript (7-26-11; 15:00:01 though 15:00:56
[12] Video Transcript (7-26-11; 11:13:00 though 11:18:22; 7-26-11; 11:14:01 though 11:14:25; 7-26-11; 15:00:01 though 15:00:56; and 7-26-11; 15:00:01 though 15:02:25.
[13] Kollen Direct Testimony at pp. 6-7.
[14] Bailey Rebuttal Testimony at p. 10.

increase of $22.5 million will be offset by a reduction in the TIER Adjustment Charge of $7.1 million. Yet this simply will not and cannot occur. Incredibly, they make this assertion despite their acknowledgement that the Smelters will continue to pay the full $1.95/MWh TIER Adjustment Charge even if the full $39.2 million increase requested in this proceeding is approved. Resetting the TIER Adjustment Charge is not a decision that the Commission can make in this proceeding without changing the terms of the Smelter contracts. This is a manufactured adjustment which the record demonstrates has no validity.

During cross-examination, Big Rivers President, Mr. Bailey conceded that under current market conditions, which are not expected to change in the near term[15], even if the entirety of Big Rivers' proposed increase is approved by the Commission, Big Rivers' TIER will be insufficient to reduce the TIER Adjustment Charge from its current level.[16] Mr. Bailey also agreed that in order for the Smelters to actually receive a $7.1 million TIER reduction Big Rivers would have to earn $18.5 million in margins. "*For the Smelters to get a 7.1 million* (TIER) *reduction and only pay half the TIER you'd have to be earning their full 1.24 TIER*, ($11.4 million in margins) *plus an additional $7.1 million in earnings*."[17] Even if the Commission approved every dollar of Big Rivers' proposed increase, Big Rivers would fall short of this benchmark. Thus, there will not be and cannot be a reduction in the TIER Adjustment Clause.

Big Rivers' Senior Vice President Financial & Energy Services and Chief Financial Officer, C. William Blackburn was equally adamant that the Smelters will not actually receive the $7.1 million reduction. Mr. Blackburn stated during cross-examination that "*the Smelters will return to the ceiling of the bandwidth in September...*" and "*they will be at the top of the bandwidth for the balance of the*

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[15] *Id.* at 17.
[16] Video Transcript (7-26-11; 11:13:00 though 11:18:22)
[17] Video Transcript (7-26-11; 11:14:01 though 11:14:25)

year."[18] Mr. Blackburn agreed with counsel for KIUC when counsel asked "*so even if you get every penny that you ask for the Smelters will remain at the top of the TIER*?"[19] The answer was "*Yes*."

Not only did cross-examination establish these facts, Big Rivers' own budgets and financial forecast testify against its proposed adjustment. The Smelters have paid $1.95/mWh in every month of the test year,[20] have continued to pay the $1.95/mWh in every month since the end of the test year[21] and will continue to pay the full $1.95/mWh for the foreseeable future even if the Commission approves every dollar of Big Rivers' requested increase. Contrary to the assumption that the Smelters will receive a $7.1 million TIER Adjustment Charge reduction, the Company's budgets and accompanying multi-year financial forecast (which assumes that the entirety of the requested $39.2 million base rate increase is approved) do not project a TIER Adjustment Charge reduction from the maximum $1.95/mWh. To the contrary, the forecast reflects the maximum TIER Adjustment Charge of $1.95/mWh in each month during 2011 and then an increase to the maximum of $2.95/mWh for each and every month of 2012.[22] Big Rivers' inappropriate adjustment, including the false representations that the Smelters will be charged $7.1 million less than they paid during the test year and that they will moved to the midpoint of the TIER Adjustment Charge bandwidth, has three important effects: 1) it improperly inflates the base rate revenue requirement to be recovered from all customers (Rural, Large Industrial and Smelter);[23] 2) it understates the Smelter revenue contribution for cost-of-service purposes discussed later in this Brief;[24] and 3) it masks the true level of rate increase sought from the Smelters ($22.5 million in reality not $15.4 million).[25]

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[18] Video Transcript (7-26-11; 15:00:01 though 15:00:56)
[19] Video Transcript (7-26-11; 15:00:01 though 15:02:25)
[20] Video Transcript (7-26-11; 11:11:20 though 11:11:57)
[21] Video Transcript (7-26-11; 11:11:58 though 11:12:10)
[22] Big Rivers Response to KIUC 1-43.
[23] Kollen Direct Testimony at pp. 6-7.
[24] Baron Direct Testimony at pp. 14-20.
[25] *Id.*

KIUC has therefore eliminated this proforma adjustment and restored test year revenue from the TIER Adjustment Charge to the amount actually collected during the test year and that the Company concedes will continue to be collected when the new rates are placed in effect. Eliminating this proforma adjustment reduces the revenue requirement on all ratepayers by $7.1 million.

In analyzing proforma adjustments, the Commission uses the ratemaking standard of "*known and measurable*." Administrative Regulation 807 KAR 5:001, Section 10(1), provides that all applications for general rate adjustment shall be supported by either a "*twelve (12) month historical test period which may include adjustments for known and measurable changes*" or a "*fully forecasted test period.*" Where an applicant bases its application upon a historical test period, as Big Rivers has done in this proceeding, it must provide a "*complete description and quantified explanation for all proposed adjustments with proper support for any proposed changes in price or activity levels, and any other factors which may affect the adjustment.*"[26]

Not only does Big Rivers not attempt to meet the "*known and measurable*" standard but rather readily admits that what it has proposed is the opposite of what is known and measurable. Big Rivers freely admits that once the new rates go into effect, at whatever level, there will not be a reduction in the Smelters' TIER Adjustment Charge.

The Commission requires "*definitive evidence*" to support "*known and measurable*" change to a historical test period.[27] For example in Case No. 2002-00184, In the Matter of the Application of Madison County Utility District; (Order of January 27, 2003), the Commission concluded that a utility's assertion that they will hire new employees after new rates go into effect did not meet the "*known and measurable*" standard. The Commission stated:

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[26] Administrative Regulation 807 KAR 5:001, Section 10(6).

[27] Case No. 2002-00184, In the Matter of the Application of Madison County Utility District; (Order of January 27, 2003), p. 4.

> *"any adjustment to Madison's test-year expense must be known and measurable. Madison currently has not hired the new employees nor has it indicated their hiring other than to state that it will occur subsequent to the effective date of the rates proposed in this case. The Commission has found no evidence in the record definitive enough to find this adjustment known and measurable."*[28]

In addition to violating the "*known and measurable*" standard, Big Rivers' proposed adjustment is not supported by the Smelter Contracts. The TIER Adjustment Charge is determined by Big Rivers based on a formula contained in Section 4.7.5. of the Smelter Contracts. The TIER Adjustment Charge is estimated prospectively on a calendar year basis, subject to a true-up at the end of the calendar year after Big Rivers' annual audit is completed. The Smelter Contracts provide that prior to the beginning of the year and after the end of each calendar quarter, Big Rivers shall estimate the annual amount of TIER Adjustment Charge for the calendar year sufficient to achieve a Contract TIER of 1.24, and subject to the maximum charge for that year, and then invoice the TIER Adjustment Charge monthly without any action by the Commission. If Big Rivers' estimate results in an earned actual Contract TIER greater than 1.24, then Big Rivers is required to refund the amount overcharged as set forth in the Smelter contracts. The Smelter Contract structure is simply a formula, the outcome of which is determined by Big Rivers' actual financial performance. No one, not Big Rivers, the Smelters or the Commission, can pre-determine the TIER Adjustment Charge. Big Rivers' unfounded adjustment to eliminate $7.1 million in test period revenue is simply an attempt to artificially inflate the rate increase for all customers.

Big Rivers defends its adjustment by arguing it needs a "*buffer*" to allow it to charge the Smelters more if needed in the event of adverse economic conditions.[29] The problem with this approach is that it is not supported by either ratemaking principles or the terms of the Smelter Contracts. Rate

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[28] Case No. 2002-00184 (Order of January 27, 2003), p. 8.
[29] Bailey Rebuttal Testimony at p. 10.

making principles do not permit fictitious elimination of test year revenue, and the Smelter Agreements do not permit anyone, including Big Rivers, to pre-set the TIER Adjustment Charge for ratemaking purposes. The Smelters have indeed provided Big Rivers with additional revenue potential in tough economic times – up to $14.2 million a year through 2011 and $21.3 million a year beginning January 1, 2012[30] – and they are not proposing to be excused from this obligation.

Big Rivers also argues that the adjustment should be of no consequence to the Smelters because the purpose of the TIER Adjustment Charge is to allow Big Rivers to earn a 1.24 TIER; and if it earns more than 1.24, it must refund the excess first to the Smelters.[31] It should be obvious that the TIER Adjustment Charge does not guarantee a 1.24 TIER under any circumstances. There is always the possibility, if not real world probability, that Big Rivers will require additional revenue even when the Smelters are paying the maximum TIER Adjustment Charge. That calls for Big Rivers to seek a solution to its financial concerns through a base rate case. One option not available is to manipulate historical test year revenues in order to solve real or imagined problems by extracting more revenues from all ratepayers through an inflated revenue requirement.

b. Big Rivers Depreciation Study Is Unreliable, Flawed And Results In Excessive Depreciation Costs.

Depreciation rates are largely a function of the remaining lives of Big Rivers' various production units. The longer a generating unit is assumed to remain in service, the more time there is to recover the expense. So a longer remaining service life equates to a lower depreciation expense and vice versa.[32]

The depreciation rates proposed by Mr. Ted Kelly of Burns & McDonnell ("B&M") on behalf of Big Rivers are biased because they are based on shorter facility service lives (resulting in higher

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[30] Baron Direct Testimony at p. 16.
[31] Bailey Rebuttal Testimony at p. 17.
[32] Video Transcript (7-27-11; 13:07:20 through 7-27-11; 13:09:40)

depreciation rates) than the management of Big Rivers believes to be correct and shorter than B&M and Big Rivers represented to RUS. The B&M Report, as updated in Mr. Kelly's rebuttal testimony, is also fundamentally inconsistent because it utilizes remaining plant lives as of December 2011 and a depreciation reserve balance as of April 2010. In contrast, KIUC witness Charles King submitted a study that used Big Rivers' estimates concerning facility service lives along with standard best depreciation practices all as of the same time period, April 2010.[33]

As explained by Mr. King,[34] the study Mr. Kelly submitted through his Direct Testimony forecasted a variety of remaining lives for each of Big Rivers' generating plants based on varying assumptions of remaining operating hours and the probability of plant life extensions. From this variety of remaining life estimates, Mr. Kelly selected account remaining lives at the lower end of the spectrum. These remaining plant life estimates are inconsistent with and shorter than those described in the narrative portion of Mr. Kelly's Report.

Superficially, the remaining plant lives Mr. Kelly identified for the Big Rivers generating plants would appear to be the remaining years between 2010, the year of the study, and the year identified in Mr. Kelly's Report as the retirement date of each plant.[35] For example, Mr. Kelly forecasted that the Wilson plant (by far Big Rivers' most expense plant) will survive until 2051, which is 41 years from 2010, the year of the study. Yet, elsewhere in the B&M Report, the remaining unit life of Wilson is recorded as only 35.1 years.[36] The same problem arises with each of the other plants.

This internal inconsistency is further complicated when we examine Mr. Kelly's workpapers. There, we find that Mr. Kelly forecast no less than six different remaining lives for each plant, most of which do not match the remaining life spans in the B&M Report or those that result from subtracting

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[33] King Direct Testimony at p. 11.
[34] *Id*.
[35] These retirement dates are found in the plant-by-plant discussion beginning at page II-4 of B&M's Report.
[36] Table II-2 (page II-3) of the B&M Report.

2010 from the forecast plant retirement dates. These remaining lives reflect alternative assumptions as to the operating hours and the likelihood that Big Rivers will conduct life extension programs, presumably through retrofitting and refurbishing of the plants.[37]

In his Rebuttal Testimony, Mr. Kelly defended his analysis by stating that "[a]*rriving at the remaining lives used in B&M's analysis required the use of judgment...*"[38]..."*Many factors, both quantitative and qualitative, along with the substantial application of judgment went into determining the remaining useful lives of each production facility. The selection of the ultimate remaining lives used to calculate Big Rivers' final depreciation rates required judgment, but...the selection was clearly not arbitrary.*"[39] KIUC agrees that Mr. Kelly's determination of remaining plant lives was not arbitrary, but was in fact deliberately inaccurate or at least misleading. Mr. Kelly inserted shorter useful lives of the generating units in an attempt to artificially inflate depreciation expense.

As discussed in Mr. Kelly's Rebuttal Testimony, the B&M Report used 6 separate assumptions regarding useful lives. These assumed total service lives seemed to be selected in order to use lower useful remaining lives than assumed by Big Rivers in its statements to RUS. For example, in a February 28, 2011 letter to RUS[40] and in a January 2011 Report, B&M projected that the Wilson unit will have a service life lasting until the year 2051; equating to a 65 year total life. In the January 2011 Report, B&M states that Wilson "*is in excellent condition for its age and service requirements. Provided that operation and maintenance continue as is, this unit is estimated to be suitable for ongoing service through the year 2051.*"[41] Despite this representation, Mr. Kelly's depreciation study did not use a 65 year total life for the Wilson unit. It assumed a wide variety of remaining service lives for the Wilson

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[37] King Direct Testimony at pp. 8-9.
[38] Kelly Rebuttal Testimony at p. 4.
[39] Id. at p. 6.
[40] KIUC Cross Exam Exhibit 15 p. 5.
[41] KIUC Cross Exam Exhibit 15, p. 11.

unit, ranging from 57-65 years, and used a total service life somewhere within this range in its calculation of depreciation rates.[42] Mr. Kelly's range of total service lives factors in the possibility that Wilson will not last until its Big Rivers-predicted life for Wilson, but does not include any scenario in which Wilson last longer than Big Rivers-predicted life for the unit.

Each of the Big Rivers power plants has costs in each of the depreciation rate study accounts (Structures, Boiler Plant, Turbine, etc.). The remaining life used for the Wilson unit has a disproportionate impact on the remaining life value for each account because Wilson makes up approximately 60% of the cost included in each account.[43] Therefore, the remaining life assumed for Wilson in any account heavily influences the remaining service life calculation for that account. Of the six studies in Mr. Kelly's rebuttal testimony that were factored into the B&M Report's remaining service life calculation only studies #1 and #4 used a total service life of 65 years for Wilson. When comparing studies #1 and #4 to the depreciation rates set forth in the final B&M recommendation the problem that is created by using shorter total service lives for the Big Rivers' units is apparent. Studies #1 and #4, that used the appropriate 65 year total service life for Wilson, yielded longer remaining service lives for the depreciation accounts. The Table below compares the assumed remaining useful lives used in the B&M Report (Column 1) to the Kelly rebuttal testimony scenarios #1 and #4 (Columns 2 and 3, respectively) that used the proper 65 year total service life for Wilson.[44]

[42] Kelly Rebuttal Testimony at pp. 9-12.
[43] KIUC Cross Exam Exhibit 15.
[44] Kelly Rebuttal Testimony at pp. 9-12.

REMAINING SERVICE LIVES (YEARS)[45]

Gross Plant	(1) Table ES-1 Remaining Life Based On B&M Judgment (Actually Used In Depreciation Study)	(2) B&M Actual Operating Hours (Annual) Remaining Life Analysis #1 (Using A 65 Year Total Life For Wilson)	(3) B&M Actual Operating Hours (Annual) Remaining Life Analysis #4, (Using A 65 Year Total Life For Wilson)
Account 311 - $124,375.974	30	33.8	31.6
Account 312 - $667,206,536	28	34.2	32.3
Account 312 A-K - $574,184,346	28	34.2	32.3
Account 314 - $225,272,354	28	33.6	31.3

This Table shows that the remaining life assumptions that were actually used in the B&M Report are shorter, resulting in higher depreciation rates, than the useful remaining lives included in Mr. Kelly's scenarios that used a 65 year remaining life for Wilson.

We have focused on the Wilson unit for ease of discussion, but Mr. Kelly applied the same flawed and inconsistent mechanics in his treatment of all of Big Rivers' other generating units.[46] Mr. Kelly inappropriately substituted his own judgment in place of the judgment of the Big Rivers' managers regarding the useful life of the generating units without any explanation of the foundation for this decision. We do not suggest that Mr. Kelly was required to follow the guidance of the Big Rivers management on plant life, but he expressed no good reason to ignore it. The generating plant useful lives in the Report submitted to this Commission are also substantially shorter than the useful lives submitted to RUS. It appears that this was a results-oriented approach to artificially inflate the depreciation expense requested in this case.

[45] KIUC Cross Exam Exhibit 14 for Column (1); KIUC Cross Exam Exhibit 15 at p. 12 for Columns (2) and (3).
[46] King Direct Testimony at pp. 8-9.

The B&M Report, as updated in his Mr. Kelly's Rebuttal Testimony, contains another serious flaw. Mr. Kelly updated his original April 30, 2010 study in order to include data out to December 31, 2011. This update had the effect of increasing depreciation rates because the Big Rivers units were approximately a year and half older (than they were on April 30, 2010) and had a year and half less remaining service life. This has the effect of raising depreciation rates unless offset by the corresponding payment by customers of the depreciation expense during the same one and half year period. Unfortunately, Mr. Kelly only included the lower remaining life caused by the update. He failed to factor in the offsetting increase in accumulated depreciation. When confronted with this fundamental inconsistency at hearing, Mr. Kelly could provide no explanation.

> Counsel for KIUC asked: "*You've updated the useful life and made it shorter, because it's a year and half later, but you haven't updated the amount of depreciation consumers have will have paid on the plants [through 2011] because it is a year and half later?*"
>
> Mr. Kelly replied: "*Okay…I'll have to check that, but I assume that would be correct.*"[47]
>
> Later counsel for KIUC asked "*You didn't update the accumulated depreciation since your original study date, did you?*"
>
> Mr. Kelly replied "*No.*"[48]

Mr. Kelly's error has the effect of significantly increasing Big Rivers' proposed depreciation rates. Big Rivers has not corrected this error as of this filing.

These are only two examples of the problems that have plagued the B&M analysis from the start of this proceeding. Prior to filing its Application, Big Rivers invited KIUC to review the B&M analysis. KIUC witness, Charles King discovered that B&M reversed the positive and negative signs in its net salvage factors and failed to subtract removal costs from the salvage proceeds to derive net salvage.[49] Correction of these two errors reduced the proposed depreciation increase from $12 million to $4.33

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[47] Video Transcript (7-27-11; 13:17:45 through 7-27-11; 13:18:07)
[48] Video Transcript (7-27-11; 13:20:40 through 13:20:55)
[49] KIUC Cross Exam Exhibit 16 at p. 6.

million.[50] In emails provided by Big Rivers in discovery, Big Rivers' managers repeatedly express frustration and disappointment with B&M's failure to calculate reliable depreciation rates.[51] These emails show, among other things, that Big Rivers' managers had concerns that the total service life for Wilson of less than 65 years used by B&M was too short.[52] At the end of the process, Mr. Bailey and Mr. Blackburn agreed that they "*can't imagine ever using* [B&M] *again.*"[53]

The evidence in this proceeding shows that B&M analysis is unreliable at best and fundamentally flawed at worst. The Commission should not approve an increase in depreciation rates based on the testimony of Mr. Kelly and the B&M Report.

Mr. King's depreciation study is fundamentally sound and does not suffer from either of the errors discussed above and it does not have a demonstrated history of computational errors. Mr. King used Big Rivers' own management's estimates concerning facility service rather than his own independent judgment. Mr. King's study also does not include a mismatching of remaining useful life and accumulated depreciation like the B&M Report. All of the information used by Mr. King is as of April 30, 2010, the date of the original B&M Report.

The depreciation rates developed by Mr. King are lower than those developed by Mr. Kelly and lower than the currently effective depreciation rates. Mr. Kollen has reflected these lower depreciation rates in his revenue requirements recommendation.

Pursuant to this Commission's "*exclusive jurisdiction over the regulation of rates and service of utilities*" under KRS 278.040(2), there is no legal requirement that the B&M Report be reflected in rates merely because that Report has been approved by RUS. The RUS is a lender, not a regulator.

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[50] *Id.*
[51] KIUC Cross Exam Exhibit 16 at pp. 11-34.
[52] KIUC Cross Exam Exhibit 16 at p. 15.
[53] KIUC Cross Exam Exhibit 16 at p. 33.

Nevertheless, its RUS loan contract places certain restrictions of the actions that Big Rivers may take with respect to depreciation. Section 4.22 of its loan contract prohibits Big Rivers from filing for approval from this Commission depreciation rates that have not been previously approved by RUS.[54] The restrictions agreed to by Big Rivers in its loan contract does not obligate, restrict or limit this Commission's independent ratemaking authority over the depreciation expense which can be charged to consumers in Kentucky.

The adoption of KIUC's recommendation will have no adverse affect on Big Rivers' net margins, TIER or MFIR. The annual depreciation expense that Big Rivers recognizes for financial accounting purposes will reflect the depreciation rates that the Commission approves. If the Commission approves lower depreciation rates, then Big Rivers' depreciation expense will be correspondingly lower and will match the recovery through rates of depreciation expense.

c. Interest Expense And TIER Should Be Reduced For Actual Prepayment On The RUS Series A Note.

The Company calculated the annualized interest expense at the end of the test year and computed the TIER on that interest expense using the Contract TIER of 1.24.[55] However, on April 1, 2011, the Company pre-paid $35 million of the RUS Series A Note.[56] The Company used the funds in the Transition Reserve for this purpose after seeking and obtaining a waiver from CoBank enabling the payment to proceed.[57] This is an actual known and measurable change to the Company's interest expense that the Company failed to reflect in its calculation of annualized interest expense. The effect of this reduction in interest expense should be reflected in the Company's revenue requirement as a

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[54] KIUC Cross Exam Exhibit 5.
[55] The Company's calculation of annualized interest expense is detailed on the Int_WP workpaper supporting Exhibit Wolfram-2 Reference Schedule 2.15 provided in response to KIUC 1-37. See also Kollen Exhibit___(LK-2).
[56] Big Rivers Response to KIUC 2-37
[57] The correspondence between the Company and CoBank was provided in response to KIUC 1-38. See also Kollen Exhibit___(LK-3) and Exhibit___(LK-4).

matter of principle and consistency, particularly given the Company's attempt, with other adjustments, to convert the historical test year to a projected test year on a selective basis rather than on a comprehensive basis.[58]

There is no dispute that this reduction in interest expense actually has occurred so that the Company's interest expense is now lower than the amount reflected in its filing. The Company no longer is paying this interest expense and the revenue requirement should reflect this fact, not the Company's incorrect assumption that it is paying this interest expense. This reduction in interest expense is a known and measurable change about which there is no uncertainty.[59]

The effect of this adjustment is to reduce the revenue requirement for all ratepayers by $2.537 million, consisting of the actual $2.046 million reduction in interest expense ($35 million times 5.845%) plus the contract TIER of $0.491 million (using the contract TIER of 1.24).[60] The Company confirmed the reduction in interest expense in response to KIUC 2-37.

The Company opposes this adjustment, not on any factual or ratemaking basis, but rather on an incorrect claim that the Smelter Contracts control ratemaking for all ratepayers and on an incorrect interpretation of one provision of the Smelter Contracts that defines the calculation of the Contract TIER for purposes of the TIER Adjustment Charge. The Commission should decide this issue on the factual and ratemaking basis that the Company no longer incurs this expense and thus, should not recover the expense and related TIER as if it were.

The Company's opposition to this adjustment is based solely on its claim that "*Section 4.7.5(f) of those Smelter Agreements states that the calculation of Contract TIER is to exclude any Big Rivers'*

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[58] Kollen Direct Testimony at pp. 7-8.
[59] Id. at pp. 8-9.
[60] Id. at p. 9.

margin impact derived from the use of the Transition Reserve," according to Mr. Hite.[61] However, the Company's claim is incorrect. There is nothing in Section 4.7.5(f) that specifies the exclusion of "*any*" … "*margin impact*" derived from the use of the Transition Reserve. Rather, Section 4.7.5(f) is extremely specific as to exclusions from the calculation of the Contract TIER, and reductions in interest expense are not included in those exclusions.

Contrary to the Company's claim, the Smelter contracts do not define or override the Commission's statutory obligation to set just and reasonable rates, nor do the contracts in any way contradict or modify this obligation. Section 4.7.5 of the Smelter contracts defines how the Contract TIER is determined for the sole purpose of calculating the TIER Adjustment Charge. Section 4.7.5(f) does not address the reduction in interest expense from the use of the Transition Reserve to prepay the RUS Series A Note. More specifically, Section 4.7.5(f) addresses only the "*application of funds*" and "*revenue*" (income) from the Rural Economic Reserve, the Economic Reserve and Transition Reserve and excludes both these amounts from the net margins used in the calculation of the Contract TIER. Section 4.7.5(f) states:

> *"(f) It shall be assumed that: The Rural Economic Reserve, the Economic Reserve and the Transition Reserve shall not generate any revenue or tax liability and the application of funds from the Rural Economic Reserve, the Economic Reserve or the Transition Reserve shall not result in any change in the Net Margins of Big Rivers."*

The "*application of funds*" refers to the distribution of any of the Reserve fund amounts to mitigate the rate effects of the loss of Smelter loads. This provision of the Smelter contracts makes it clear that such "*application of funds*," or distributions, to Rural and Large Industrial customers will not affect the Company's net margins for the Contract TIER. This provision is consistent with the fact that

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[61] Hite Rebuttal Testimony at p. 10.

such distributions are not recognized in the income statement, but rather are recognized solely through the balance sheet as a reduction to special funds and a reduction to regulatory liabilities.

The "*revenue*" refers to the interest income on the reserve funds, which is added to the reserve funds and is available for additional distributions to the Rural and Large Industrial customers.

Noticeably lacking in Section 4.7.5(f) is any reference to a reduction in interest expense resulting from the use of the Transition Reserve to prepay debt.

In summary, the Commission should reflect this actual reduction in interest expense and the related TIER. It is known and measurable. It is certain. The Company no longer incurs this interest expense and consumers should not be charged for it.

d. DSM Expenses Should Be Eliminated.

Big Rivers proposes to increase its DSM program spending from approximately $27,000 in 2010[62] to $1 million annually.[63] KIUC recommends that this $1 million proforma adjustment be rejected.

First, Big Rivers is unable to explain where this significant increase in DSM dollars will be spent. Big Rivers does not have a specific DSM plan associated with this $1.0 million increase to test year expenses and cannot provide details regarding such expenditures. In response to KIUC 2-1, Mr. Blackburn states:

> *"Big Rivers has budgeted amounts for energy efficiency and DSM programs for 2011 and 2012, but cannot provide detailed descriptions, monthly tasks, capital expenditures or expenses as requested since these programs are still in the early stages of development, with short-term pilot programs either underway or in the planning phase."*

[62] KIUC Cross Exam Exhibit 9 at p. 3 of 17.
[63] Blackburn Direct Testimony at p. 32.

While the Company provided descriptions of the pilot programs, the Company has no specific plans or expenditures that can be tied to its request for $1.0 million in the test year revenue requirement.[64] Due to the uncertainty associated with DSM expenditures that might be incurred in the future, it is inappropriate to include the $1.0 million expense in the Company's test year.[65] This is not a known and measureable expense.

Second, while Big Rivers states that its intention is to have programs for Industrial customers, most of the programs are for the Rural class and none are for the Smelters.[66] Nevertheless, the Smelters are being asked to pay for nearly 60% of these $1 million in DSM expenditures.[67] The DSM cost recovery mechanism (KRS 278.285) allows utilities to recover the costs of energy efficiency and DSM expenditures through a DSM rider. KRS 278.285 (3) specifically requires that the Commission allocate the costs of DSM programs to the rate class that receives benefits from the program.

> (3) *The commission shall assign the cost of demand-side management programs only to the class or classes of customers which benefit from the programs. The commission shall allow individual industrial customers with energy intensive processes to implement cost-effective energy efficiency measures in lieu of measures approved as part of the utility's demand-side management programs if the alternative measures by these customers are not subsidized by other customer classes. Such individual industrial customers shall not be assigned the cost of demand-side management programs.*

Big Rivers' proposed DSM proforma adjustment does not meet the policy standards established by the Legislature. The most appropriate method to implement DSM cost recovery is through a separate mechanism that can be structured to meet the needs of specific customer classes and avoid improper cost allocations. Big Rivers' filing would circumvent the Legislative mandate that DSM program cost be recovered by the customer class that benefits. It is also suspect that Big Rivers, rather than the distribution

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[64] KIUC Cross Exam Exhibit 9 at pp. 6-9. See also Baron Direct Testimony at pp. 34-35.
[65] Baron Direct Testimony at p. 35-36.
[66] Blackburn Direct Testimony beginning on p. 32.
[67] Seelye Exhibit 6 at p. 1.

co-ops, is proposing a base-rate adjustment to recover DSM expenditures. Obviously, if these costs to fund DSM for the Rural class were recovered from the distribution co-ops, then the Smelters would not be subject to any charge for DSM costs.[68]

Finally, Big Rivers' DSM program does not appear to be a cost-effective means of reducing electric consumption. Big Rivers projects that its $1 million expenditure on DSM programs in 2011, will yield only 3,416 mWh in energy savings in its first year.[69] This equates to $0.29/kWh, or roughly $0.25/kWh more than the average Rural wholesale rate.[70] This extreme inefficiency is due in part to Big Rivers' projection that $365,000 of every $1 million in DSM expenditures will be needed to pay for the administration of the program and not in capital investments in DSM technology.[71] It is safe to assume, based on Big Rivers' meager expenditures on DSM prior to this rate case, that if the Company were paying for DSM, rather than ratepayers, it would not be proposing to buy $1 million worth of 29 cent power.

Big Rivers' proposed proforma adjustment to increase test year operating expenses for unspecified DSM expenditures should be rejected. Instead, the Company should file a DSM cost recovery mechanism that properly tracks actual costs and assigns actual DSM expenditures to the rate classes receiving the benefits, consistent with KRS 278.285(3). When Big Rivers was footing the bill for its DSM program in 2010, it found it prudent to spend only $27,000. Now that Big Rivers has filed a rate case and the Smelters are requested to be responsible for nearly 60% of any increase, Big Rivers proposes to spend $1 million on DSM. As indicated in Big Rivers' response to KIUC 2-3, the Company "*does not have a strong objection to recovering costs through a DSM cost recovery mechanism.*" KIUC recommends that the Commission require Big Rivers' to recover all DSM costs through the appointed DSM statute.

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[68] Video Transcript (7-26-11; 15:20:05 through 15:21:05)
[69] Video Transcript (7-26-11; 15:18:39 through 15:19:33)
[70] Video Transcript (7-26-11; 15:19:20 through 15:19:36)
[71] Video Transcript (7-26-11; 15:22:06 through 15:22:30)

It is important to note that the adoption of KIUC's recommendation will have no adverse affect on Big Rivers' margins TIER or MFIR, because Big Rivers has not yet spent the $1 million in proposed DSM costs. If the Commission denies recovery of these costs, Big Rivers will not spend the $1 million.

e. Current Recovery Of Interest On CWIP Is Not Appropriate.

Big Rivers proposed in its original filing to recover interest on CWIP on a current basis along with the related contract TIER and discontinue its current policy of capitalizing the interest expense on CWIP as Allowance for Funds Used During Construction ("AFUDC"). This proposal has the effect of increasing the revenue requirement by $0.640 million, consisting of $0.516 million in avoided AFUDC (normally a reduction to the interest expense because it is capitalized) and $0.124 million for the related contract TIER.[72]

Big Rivers has accepted KIUC's $0.516 million adjustment to reduce interest expense consistent with retaining AFUDC,[73] but opposes an adjustment to eliminate the $0.124 million for the related contract TIER. Big Rivers is in error on this point. In its filing, it increased interest expense by $0.516 million to reflect a proforma adjustment for the cessation of AFUDC that was a credit or reduction to interest expense during the test year. The increase in interest expense was included in the interest expense on long term debt used to calculate the TIER shown on Exhibit Wolfram-2 page 2 of 2. If the annualized interest expense is properly reduced by the interest expense that is avoided due to retaining AFUDC, then there should be a related reduction in the TIER of $0.124 million.

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[72] Kollen Direct Testimony at p. 10.
[73] Wolfram Rebuttal Testimony at pp. 6-7.

f. Retroactive Deferral And Prospective Amortization Of MISO Rate Case Expenses Is Not Appropriate

The Company proposes to defer $1.603 million that it incurred prior to and during the test year in conjunction with Case No. 2010-00043 and FERC Docket Nos. ER11-15 and ER11-16 ("the MISO rate case"). Of this amount, the Company incurred $0.298 million prior to the test year and $1.305 million during the test year.[74] The Company included $0.534 million in amortization expense in its revenue requirement based on a 3 year amortization of the $1.603 million incurred.[75]

These amounts have long ago been booked and expensed by the Company. Big Rivers now seeks to retroactively defer the amounts that it already expensed and then prospectively amortize the deferred amount over three years commencing when rates are reset on or about September 1, 2011.[76]

The Commission should not authorize the proposed retroactive deferral and prospective amortization expense. First, a portion of the expense was incurred prior to the test year and the Company's request, at least for this portion of the expense, constitutes retroactive ratemaking and is improper. Second, the expense incurred during the test year is non-recurring and simply should be removed from the test year, as the Company has proposed for other non-recurring expense amounts, and not deferred and amortized. Third, the proposed deferral and amortization will create an unnecessary and completely avoidable expense for the next three rate-effective years. Fourth, the Company's proposal could result in over-recovery of this completely avoidable expense. To the extent that rates are not reset precisely at the end of the three year amortization period in order to eliminate recovery of the discretionary expense, the Company would continue to recover a cost that no longer exists.[77]

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[74] Exhibit Wolfram-2 Reference Schedule 2.21.
[75] Kollen Direct Testimony at pp. 11-12.
[76] *Id.* at 12.
[77] *Id.* at pp. 12-13.

In his Rebuttal Testimony beginning on page 11, seeks to support this retroactive deferral based on the Commission's decision in Case No. 90-158 (Order on Rehearing dated September 30, 1991, p. 14) Mr. Wolfram argues that the approved LG&E downsizing costs are analogous to Big Rivers MISO rate case expenses on three points: 1) "*material nature of the costs,*" 2) "*future benefits of making the expenditure*," and 3) "*matching of the benefits with the costs*."[78]

The first and most important point from the 90-158 Order on Rehearing is the Commission reiteration of the point that it made in its initial Order that "*non-recurring costs which are expensed should not be considered for rate-making purposes.*" This is a statement of ratemaking principle. The Commission then accepted this principle based on the specific facts and circumstances of LG&E, the most important of which was that LG&E had made a post-test year proforma adjustment to reduce the historical test year expenses to reflect the savings from downsizing that the Commission accepted and reflected in the revenue requirement. It was within this context that the Commission allowed a deferral and 10-year amortization of the downsizing costs to match the benefits with the costs.

Big Rivers' MISO rate case expenses are not analogous to LG&E downsizing costs because there are no quantified benefits of joining MISO. Unlike LG&E in Case No. 90-158, Big Rivers did not include any post-test year savings in the form of a proforma adjustment to reduce the actual historical transmission O&M expenses.

The only savings cited by Big Rivers in response to KIUC 2-38 are savings from MISO compared to alternative plans. Yet all of the alternative plans, including joining MISO, resulted in cost

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[78] Wolfram Rebuttal Testimony at p. 11. These factors are taken directly from p. 14 of the Commission's Order on Rehearing in Case No. 90-158. The Commission states: "*The Commission finds that, for rate-making purposes, amortization of some of the downsizing costs is appropriate. The Commission remains convinced that, in general, non-recurring costs which are expensed should not be considered for rate-making purposes. However, in this instance the Commission is recognizing the material nature of the costs, the future benefits of downsizing which should be available to the ratepayers and shareholders of LG&E, and the matching of those benefits with the costs.*"

increases to Big Rivers. In fact, the Company included a post-test year adjustment to increase its O&M expense by $5.415 million to reflect the increase due to joining MISO. The Company also included the additional payroll and labor-related overhead costs due to the need for more employees.[79] Thus, unlike LG&E, the Company reflected no savings in the revenue requirement that could be used to "*pay*" for the amortization of any deferred costs.

Big Rivers' proposal to defer costs that it incurred in conjunction with the MISO rate case is more analogous to the recent Duke Energy Kentucky Case No. 2010-00523, decided on July 14, 2011. In that case, Duke-Kentucky filed an application seeking authority to establish a regulatory asset for costs incurred in conjunction with two initiatives undertaken in 2010 by its ultimate parent, Duke Energy Corporation ("Duke Energy"). Those initiatives, the Voluntary Opportunity Severance Plan ("VOP") and the Midwest Office Consolidation ("MWOC") had, through October of 2010, resulted in Duke Kentucky incurring costs of $4,122,293. Based on its estimate of additional related costs to be incurred during November and December of 2010, Duke Kentucky requested authorization to defer for future rate recovery its actual and estimated 2010 costs in the amount of $4.37 million. The Commission denied Duke's request stating:

> *"The point in time has passed when Duke Kentucky could have recorded a regulatory asset for its VOP and MWOC costs and adjusted its expenses and earnings for calendar year 2010. The costs of $4.5 million for the VOP and MWOC were charged to expense in 2010. Generally Accepted Accounting Principles do not permit reversing the accounting entries which recorded such costs as expenses, and recording them as a regulatory asset, until the time when "it is probable of recovery" of such costs. It is generally held that only when a utility's regulator authorizes the deferral of costs is the recovery of those costs considered probable. In this particular instance, the timing of Duke Kentucky's application effectively eliminated any opportunity for it to defer its VOP and MWOC-related costs on its 2010 books of account."*[80]

[79] Big Rivers Response to KIUC 2-38, Part A.
[80] Case No. 2010-00523, Order of July 14, 2011, p. 4.

As in the Duke case, the MISO rate case costs were expensed well before Big Rivers' filing. Big Rivers had the opportunity to file an application to establish a regulatory asset prior to or at the time that these costs were incurred and expensed. Like Duke, Big Rivers should not be given the discretion to reduce operating expenses in one year due to events occurring in the prior year which are within its control.[81]

g. Non-Recurring MISO Expenses Should Be Removed

The Company identified another $0.062 million in non-recurring MISO expenses that it should have removed from the revenue requirement, according to its response to KIUC 2-39. This adjustment should be reflected in the Commission's approved increase.[82]

h. Labor and Labor Overheads Should Be Reduced To Exclude Amounts That Will Be Capitalized.

In its Rebuttal Testimony, the Company agreed with KIUC that its proforma labor expense was overstated because it failed to reduce the proforma labor expense by the amount that will be capitalized to construction work in progress.[83] However, to counteract and minimize the effect of correcting its error, the Company revised and increased its proforma labor expense by annualizing rather than prorating the post-test year payroll increases that went into effect on January 2, 2011, other qualification increases throughout 2011 for salaried employees and the annual and step increases throughout 2011 for bargaining unit employees.[84] This methodology change resulted in an increase in annualized labor expense of $872,521 from $68,708,897 to $69,581,418 (before reduction for the amount that will be capitalized).

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[81] Case No. 2010-00523, Order of July 14, 2011, p. 6.
[82] KIUC 2-39, and KIUC Exhibit___(LK-6).
[83] Hite Rebuttal Testimony at p. 13.
[84] Big Rivers Response to KIUC 2-32(b) cited in Hite Rebuttal at 13.

The Commission should accept KIUC's quantification and reject the Company's late-in-the-game attempt to nullify the correction of the error KIUC identified by changing the methodology only after KIUC filed its Direct Testimony. If the Commission accepts the concept of a post-test year adjustment for payroll increases throughout 2011, then it should use the Company's original methodology, which reflects the prorated payroll increases throughout 2011, rather than the revised methodology which reflects the payroll increases on an annualized basis as of December 31, 2011.

i. Inflation Growth In Non-Labor And Non-Outage Maintenance Expense Projected For 2012 Through 2014 Is Inappropriate.

The Company's projected maintenance expenses for the years 2011 through 2014 and calculated the proforma expense based on the average expense projected for this 4 year period.[85] The Company's calculations include inflation growth on the test year maintenance expense in each year 2011 through 2014. The Company then added the incremental expense associated with specific projects for each year 2011 through 2014. Finally, the Company calculated the 4 year average of the expense calculated in this manner for 2011 through 2014. The inflation-related expense is $2.155 million for the years 2011 through 2014, or 38%, of the $5.661 million proforma adjustment included in the Company's request as filed. The inflation-related expense included in the Company's proforma adjustment is $0.830 million in 2011 alone. The inflation-related expense included in the Company's proforma adjustment for the years 2012 through 2014 is $1.324 million.[86]

KIUC does not object to the non-inflation portion of the adjustment but recommends that the Commission reduce the Company's proforma adjustment by $1.324 million to remove the projected inflation growth for the years 2012 through 2014. The Company's proposal to include inflation growth

[85] Big Rivers Exhibit, Berry-3. The amounts on Exhibit Berry-3 were revised slightly in response to KIUC 2-34; however, KIUC used the amounts included in the Company's revenue requirement as filed because KIUC used the Company's request as the starting point for its analysis.
[86] Kollen Direct Testimony at pp. 15-16.

for 4 years beyond the test year violates any reasonable determination of the test year expense. At most, such an adjustment should be limited to the year immediately following the test year, assuming that all other relevant post-test year adjustments also are made. The Company's proposal to include specific incremental maintenance expense in addition to the test year expense in and of itself provides a significant and reasonable increase in the maintenance expense without the need to resort to multi-year inflation growth extrapolations. In addition, the Company's estimate of inflation during 2012-2014 is not known and measurable; rather, it is arbitrary and the resulting proforma increase in expense appears to have been included for the sole purpose of increasing the revenue requirement.[87]

j. Transmission Of Electricity By Others Expense Should Be Reduced To Reflect Post Test Year Expense Reductions

The Company has reduced the transmission of electricity by others expense since the test year. The Company's 2011 budget and multi-year forecast through 2014 reflect $2.718 million annually for this expense.[88] This is $0.194 million less than the test year amount after adjustments to exclude the expenses paid to E.ON and Kentucky Utilities that are offset by equivalent revenue amounts, according to the response to KIUC 2-28.[89] The Commission should adopt a post-test year proforma adjustment to reflect the reduction in transmission of electricity by others expense. The Company has proposed numerous post test year proforma adjustments, most of which increase the revenue requirement. The Commission should ensure that it also considers post test year adjustments that reduce the revenue requirement.

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[87] *Id.*
[88] Big Rivers' Response to KIUC 1-43 and KIUC 2-28.
[89] Kollen Exhibit___(LK-10) and Exhibit___(LK-11).

3. **KIUC's Cost Of Service Study Shows That The Rural Class Is Receiving An $18.3 Million Subsidy Which Can No Longer Be Prudently Maintained.**

Once the Commission decides a reasonable level of additional revenue, it must allocate the increase among the customer classes. The first step in this process is to determine the appropriate cost-of-service study to be used in this process. "*A rate study is a valuable tool to develop fair, just and reasonable rates. Cost-of-service studies provide a thorough analysis of a utility's expenses and revenues and serve as a starting point for rate-making*".[90] Of course, "*the results of any such* [cost-of-service] *study must be tempered by non-cost factors*".[91] Such non-cost factors should include economic development, job retention and sound economics.

Through the testimony of William Steven Seelye, Big Rivers proposes a cost-of-service study that assigns the Company's revenue requirements to each of its three rate classes: Rural, Large Industrial and Smelters. Big Rivers uses a 12 coincident peak (12 CP) production/transmission demand allocation methodology in its recommended class cost-of-service study.[92] KIUC sponsored a cost-of-service study conducted by Stephen Baron. Mr. Baron's study is more reasonable in two respects. First, the Baron study gives the Smelter's proper credit for the $7.1 million in TIER Adjustment charges that all parties agree the Smelters paid during the test period and will continue to pay when rates go into effect. Mr. Seelye's study does not. Second, Baron's study uses a 6 CP allocation methodology that better assigns costs to cost-causers for a utility with winter and summer peak demands such as Big Rivers.

[90] Proposed Adjustment of Wholesale Water Service Rates of the City of Greensburg, Case No. 2009-00428, August 6, 2010 Order at p. 6.
[91] Application of Kenergy Corporation for Review and Approval of Existing Rates, Case No. 2003-000165, April 22, 2004 Order at p. 17.
[92] Seelye Direct Testimony at pp. 14-15.

a. Big Rivers' Fictitious Assumption That The Smelters Will Receive A Reduction In Their Tier Adjustment Charge When Rates Become Effective On September 1 Should Not Be Reflected In The Cost-Of-Service Study Used To Set Rates.

Although Mr. Seelye's cost-of-service study generally follows traditional cost-of-service methodologies used by utilities in Kentucky, it incorporates Big Rivers' false assumption that the Smelters will receive a $7.1 million rate decrease stemming from a reduction in the TIER Adjustment Charge, when rates go into effect in September. Mr. Seelye pro-formed Smelter revenues during the test year to remove 50% of the current TIER Adjustment revenues. This adjustment reduces test year Smelter revenue in the cost-of-service study by $7.1 million.[93]

As explained earlier in the Brief, it is not disputed by Big Rivers that the Smelters will not receive this rate decrease on September 1. Big Rivers concedes that the Smelters have paid the maximum TIER Adjustment Charge in every month of the test year, have continued to pay the maximum TIER Adjustment Charge in every month since the end of the test year and will continue to pay the maximum TIER Adjustment Charge for the foreseeable future. The elimination of $7.1 million in TIER Adjustment Charges from the Smelters' contribution to rate base makes Mr. Seeyle's cost-of-service study an inaccurate reflection of the true revenue contribution of the Smelters.

As with Big Rivers' proposed proforma adjustment to remove 50% of the Smelter TIER Adjustment revenue from its revenue requirement calculation, the inclusion of this fabricated revenue requirement deficiency in the class cost-of-service study must also be eliminated. The cost-of-service study recommended by Mr. Baron and KIUC gives the Commission a more accurate picture of the cost contribution of the separate rate classes by including the full TIER Adjustment Charge that the Smelters paid in the test period and will continue to pay when rates go into effect.

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[93] Seelye Direct Testimony at p. 24

b. A Winter/Summer 6 CP Cost Of Service Study Is More Appropriate To Measure The Costs Of A Winter-Summer Peaking Utility Than The Company's 12 CP Study.

The second difference between Mr. Baron's and Mr. Seelye's cost-of-service is that Mr. Baron allocates costs among Big Rivers' three rate classes using a 6 coincident peak study ("6 CP") rather than Mr. Seelye's 12 CP approach. Big Rivers has a winter peak demand slightly higher, but roughly equivalent, to its summer months. Big Rivers plans resource additions to meet the annual summer and winter peaks on the system.[94] In recognition of the significance of these peaks KIUC is recommending a summer/winter 6 CP production demand allocation methodology. While the 12 CP methodology is appropriate to allocate transmission related costs, [95] the 6 CP methodology is a more reasonable and accurate means of allocating production demand cost responsibility because it recognizes the significance of meeting customer loads during the three summer months and three winter months for Big Rivers.[96]

Customer demands during the three summer and three winter peak months drive the need for capacity on the Big Rivers system. Customer demands in the off-peak, shoulder months do not. The Big Rivers Integrated Resource Plan confirms this conclusion.[97] The Company's 2010 IRP shows that Big Rivers expects to continue to be a winter peaking utility through the entire forecast horizon (2025).[98] Big Rivers utilizes a 14% planning reserve margin[99] applied to its annual system peak to determine its resource needs. Essentially, at the margin, the winter and summer system peaks determine the resource needs of the system. A summer/winter 6 CP study properly accounts for this reality by allocating capacity costs according to peak demand in these six critical months. The 12 CP study used by Mr. Seelye gives undue weight to demand in the spring and fall months in which average demand is well below peak periods.

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[94] Baron Direct Testimony at p. 12.
[95] _Id_. at p. 12.
[96] _Id_.
[97] _Id_. at 13.
[98] Baron Exhibit__(SJB-2)
[99] IRP at Executive Summary p. ii.

The ultimate goal of either methodology is to determine the costs that are incurred to serve, and should be recovered from, each customer class in developing rates. Rates based on cost-of-service provide appropriate economic price signals to encourage rational resource allocation. In this case, using a 6 CP demand allocation method signals to customers that customer loads during the peak winter and summer months are the principal drivers of generation resource costs on the Big Rivers' system, not customer loads at the time of the system peaks in the off-peak months of March, April, May, September, October and November. This is the same principle underlying Big Rivers' proposed demand response DSM programs.[100]

Other Kentucky utilities have used the 6 CP production demand allocation methodology for class cost-of-service purposes. In Case Number 2008-00409, East Kentucky Power Cooperative, Inc. utilized the 6 CP production demand methodology to allocate costs to rate classes. East Kentucky's cost-of-service study was developed and supported by Mr. Seelye, Big Rivers' witness in this case.

c. Mr. Baron's Cost-Of-Service Study Demonstrates That The Rural Customers Are Receiving An $18.3 Million Subsidy.

Table 1, below, compares the results of the KIUC 6 CP cost-of-service study, with Big Rivers' 12 CP method. Both studies presented in the Table are adjusted to eliminate the Company's proposed $7.1 million pro-forma adjustment.[101]

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[100] Baron Direct Testimony at p. 14.
[101] Baron Exhibit__(SJB-4)

Table 1						
Cost of Service Study Summaries						
					Big Rivers As-Filed	
	KIUC 6 CP COS		KIUC 12 CP Adjusted*		(Seely Ex. 6, Corrected)***	
Rate Class	ROR	$ Subsidy**	ROR	$ Subsidy**	ROR	$ Subsidy**
Rural	-2.49%	$ 18,319,114	-1.48%	$ 13,242,103	-1.48%	$ 11,052,174
Lg Industrial	2.15%	$ 50,193	1.65%	$ 552,120	1.65%	$ (52,587)
Smelter	4.89%	$ (18,369,307)	4.14%	$ (13,794,223)	3.14%	$ (10,999,586)
Total	2.21%	$ 0	2.21%	$ 0	1.60%	$ 0

* Adjusted to reflect full $1.95/mWh Smelter Tier revenues
** Negative value indicates subsidy being paid
*** Response to PSC 3-12

As shown above, Mr. Seelye's cost-of-service shows that the Rural Class is paying $11.0 million below cost. Mr. Seelye's study adjusted to include $7.1 million in Smelter test year TIER Adjustment Charges actually paid shows a Rural Subsidy of $13.2 million. Based on the results of KIUC's recommended 6 CP class cost-of-service study, the Rural class is receiving (at present rates) $18.3 million annually in cost-of-service subsidies. These present subsidies should be significantly reduced in this case by assigning the first $18.3 million of the authorized Big Rivers' revenue increase to the Rural class. The remaining revenue increase should be apportioned to each of the three rate classes on a uniform percentage of base revenue basis, in a manner consistent with the terms of the Smelter Agreements.

Under KIUC's recommendation, the Rural class will still receive an annual subsidy of $6.2 million because the Smelter base rate is contractually linked to the Large Industrial base rate.[102]

[102] Baron Exhibit__(SJB-6)-Revised contains KIUC's proposed revenue increase allocation analysis.

d. The Cost-Of-Service Study Submitted By Mr. Gaines Applies An Unprecedented Methodology Of Completely Ignoring Charges Actually Paid By A Customer In Determining That Customer's Class Cost Of Service And Would Result In Rates Which Are Unlawfully Discriminatory.

Mr. Gaines' study greatly differs from Mr. Seelye's and Mr. Baron's analysis in that he argues that $27.5 million of revenues actually paid by the Smelters during the test year under lawful, Commission approved rates should be ignored in the cost-of-service study.

Mr. Gaines simply subtracted $27.5 million from the Smelter's test year revenues because he asserts that these revenues were never intended to be included in determining just and reasonable rates through a class cost-of-service study. He went even further by "*adding*" $8 million to the Rural class test year revenues and $3 million to the Large Industrial class revenues that these customers received in "*unwind surcredits,*" despite the fact that these customers did not pay these revenues during the test year. Mr. Gaines argues that these $11 million in revenue surcredits, which were actually received by Rural and Large Industrial customers during the test year and used to reduce their payments to Big Rivers, should be ignored for class cost-of-service purposes.[103] After adding phantom revenue to the Rural and Large Industrial classes and ignoring the revenues actually paid by the Smelters, Mr. Gaines then developed a test year class cost-of-service study and concludes that the Rural class is receiving only $156,000 in annual subsidies.[104] This compares to KIUC's calculation that Mr. Baron presented in his Direct Testimony showing that the Rural rate class was receiving $18.3 million in subsidies at present rates and Big Rivers' own class cost-of-service study which showed that the Rural rate class was receiving $11 million in annual subsidies.[105]

There is no dispute that charges eliminated from the Gaines study are part of the lawful, Commission approved Smelter rate. These charges, along with all other charges paid by the Smelters, are

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[103] Baron Surrebuttal Testimony at pp. 3-4.
[104] Exhibit JDG-1
[105] Seelye Direct Testimony at p. 18, line 24.

part of the overall "*rate*" approved by the Commission. A "*rate*" is defined in KRS 278.010(12) as "*any individual or joint fare, toll, charge, rental, or other compensation for service rendered or to be rendered by any utility, and any rule, regulation, practice, act, requirement, or privilege in any way relating to such fare, toll, charge, rental, or other compensation, and any schedule or tariff or part of a schedule or tariff thereof.*" Rates paid to a utility pursuant to a special contract are not excluded from this definition. They are a part of the Commission approved, and therefore legal, "*rate.*"

Further, there is nothing in the Smelter Agreement that states that these charges should be treated differently from any other component comprising the approved Smelter rate. Mr. Gaines' assertion that he is competent to determine which Commission approved rate components should be counted and which should be ignored is without foundation and unprecedented. Irrespective of positions taken by parties during a negotiation, or the foundation or basis for a particular rate element, once the Commission approves the rate it becomes the fair, just and reasonable lawful rate.

There are many examples of negotiated rates that have subsequently become "*lawful rates*" in Kentucky. In the most recent Kentucky Power rate case (KPSC Docket No. 2009-00459) all parties accepted AEP's cost-of-service study which showed that at current rates the residential class was providing the Company with a negative return. As part of a settlement, the Commission approved a revenue allocation which resulted in the residential class paying a return that turned it positive, but was only one fifth of the system average return. Also as part of the settlement, the industrial customers through KIUC agreed to pay a return substantially in excess of the system average and thereby agreed to provide the residential class with a "*subsidy*" payment. Under the logic of Mr. Gaines, in the next Kentucky Power rate case KIUC will be prohibited from utilizing the actual revenues paid by the industrial class for cost-of-service because they "*agreed*" to a subsidy. This result would be absurd for numerous reasons and would effectively preclude settlements in Kentucky.

Adoption of the Gaines cost-of-service methodology—which eliminates $27.5 million in revenue actually paid by the Smelters pursuant to the lawful Commission approved Smelter rate and adds $11 million in revenue credits that were not paid by the Rural and Large Industrial classes under their lawful Commission approved rates—would result in unlawful discrimination. KRS 278.170 (Discrimination as to rates or service—Free or reduced rate services) protects any "*person*", defined as natural persons, partnerships and corporations, from paying rates which subject it to "*any unreasonable prejudice or disadvantage*" or which "*establish or maintain any unreasonable difference*" between "*classes of service*". KRS 278.170(1) provides:

> *"No utility shall, as to rates or service, give any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or disadvantage, or establish or maintain any unreasonable difference between localities or between classes of service for doing a like and contemporaneous service under the same or substantially the same conditions."*

Mr. Gaines would have this Commission embed a permanent subsidy in the Rural and Large Industrial base rates that could never be mitigated or reduced in the rate case allocation process, which would then have the corresponding effect of unlawfully embedding a permanent "*unreasonable prejudice or disadvantage*" in the Smelter rates. The Smelters, Large Industrial and Rural customers all receive "*a like and contemporaneous service under the same or substantially the same conditions*" from Big Rivers – that is, generation and transmission service – and it is unlawful to knowingly charge one class of customers substantially more for the same service. Under current rates Century pays 21.2% more than the Rural class and Alcan pays 16.5% more.[106] While the flagrant cost-of-service inequities Mr. Gaines seeks to perpetuate on the Smelters may seem reasonable to him, the Legislature has seen fit to protect all ratepayers from such injustice. This protection includes even large sophisticated consumers like the Smelters.

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[106] KIUC Cross Exam Exhibit 10

4. <u>KIUC's Allocation And Mitigation Recommendation Will Stabilize The Smelter Power Costs Which Will Benefit Big Rivers And All Of Its Customers, Not Just The Smelters.</u>

KIUC recommends that the Commission eliminate the $18.3 million in Rural subsidies that class currently receives. Eliminating this subsidy will minimize the risk of one or both Smelters terminating their contracts when the next economic downturn and drop in the LME occurs. Smelter closure would be disastrous for Big Rivers, its remaining ratepayers and the Kentucky economy. KIUC's rate mitigation proposal allows the cost-of-service subsidy to be reduced without increasing Rural rates above the rates proposed by Big Rivers.

KIUC's rate allocation and mitigation proposal does not violate any of the contracts or agreements between the Smelters, Big Rivers and Kenergy. These agreements provide, among other things, that the Smelters pay base rates and surcharges tied directly to the rates charged the other direct-service Industrial customers plus three additional charges:[107]

- The Smelters' Base Energy Charge is equal to the Large Industrial Rate (adjusted for a 98% load factor) plus $0.25/MWh;
- The Smelters pay a TIER Adjustment Charge, which is an incremental charge to the Smelters, equal to the amount necessary for Big Rivers to achieve a TIER (interest coverage) of 1.24 for the calendar year; the charge to the Smelters is capped at $1.95/MWh through 2011 and increases to $2.95/MWh for the years 2012-2014;
- The Smelters pay various surcharges pursuant to Section 4.11 of the Retail Agreements which in 2012 will amount to approximately $1.90/MWh in 2012.

Consistent with this arrangement, the Smelter Agreements specifically provide that the Smelters can challenge the allocation of rates to the Non-Smelter ratepayers in Commission proceedings. Section 13.1.1(b) of the Smelter Agreements provides:

> "[The Smelters] *shall have the right to intervene and participate in any proceeding that may affect rates at the KPSC or FERC or before any other Governmental Authority. . . . For avoidance of doubt,* <u>[the Smelters'] *intervention and participation in a regulatory*</u>

[107] Fayne Direct Testimony at pp. 13-14.

proceeding involving cost-of-service issues relating to the rates of the Non-Smelter Ratepayers shall not be considered a challenge to the rate formula." (Emphasis added)

The KIUC proposal is consistent with the Smelter Agreements. The KIUC proposal does not propose any changes to the Retail or Wholesale Agreements; all contract terms are maintained. The KIUC proposal simply addresses the appropriateness of Big Rivers' proposed revenue requirement based on traditional KPSC ratemaking principles and the allocation of the increase based on class cost-of-service. KIUC offers sound reasons for an allocation and rate mitigation recommendation that does not harm Big Rivers and results in the same level rate increase to the Rural customers as Big Rivers itself proposes. And at that level, the rates to Rural customers are among the lowest in the U.S.[108]

The KIUC proposal is fair and in the public interest. The proposal reinforces the underlying intent of the Smelter Agreements which is to sustain the operation of the Smelters without placing an undue burden on the Members. For the long term, we now know that events beyond the control of either party are putting Big Rivers and the Smelters on a collision course and that a long term solution is needed to accommodate Big Rivers' need for more and more revenue and the Smelters' need for a competitive power rate that will in fact sustain their operations. The KIUC proposal is intended to stabilize the Smelter power rate and provide Big Rivers with an adequate amount of additional revenue, consistent with ratemaking principles, while options for this solution can be explored.

a. According To The Credit Rating Agencies, "*Smelter Concentration Risk*" Is Big Rivers' Greatest Credit Weakness.

Big Rivers has painted a picture that without receiving in this case the entire $39.2 million of additional revenue, it will likely lose its investment grade rating which could lead to financial distress and even bankruptcy. For example, Mr. Bailey states on page 8 of his Rebuttal Testimony: *"As I stated in my*

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[108] KIUC Cross Exam Exhibit 10.

initial testimony, there is no leeway in Big Rivers' request for rate relief in this proceeding. (Direct Testimony of Mark A. Bailey, Exhibit 49, p.12.)". Also, Big Rivers' witness Alan Spen also states, "*I strongly believe that Big Rivers needs the full amount of the rate relief it has requested in order to preserve its investment grade credit rating.* [109] Mr. Spen later contradicted his own testimony when he conceded at hearing that several of KIUC's proposed adjustments, specifically adjustments related to DSM expense and the requested increase in depreciation rates, will have no effect on margins, TIER or MFIR and therefore will have no effect on Big Rivers' credit rating.[110] Nevertheless, Big Rivers has generally attempted to alarm the Commission into believing that anything less than full recovery of the requested rate increase will have a dire impact on its credit rating.

Despite this contention, it is clear from Moodys' and Standard & Poor's recent reports that the "*Smelter concentration risk*" is of far greater concern to the rating agencies than the level of increase to be authorized in this case. The Smelter concentration risk is so significant because of the negative impact on the Big Rivers system and its lenders if the Smelters terminate. One means, consistent with the Smelter contracts and Commission principles, of not increasing the Smelter concentration risk in this case is to fully allocate the rate increase among the customer classes based on KIUC's cost-of-service study. Big Rivers' proposal to eliminate only $1.9 million of the current $18.3 million rural subsidy exacerbates the risk because it puts upward pressure on Smelter rates and increases the risk of termination. If the Commission is concerned with a credit rating downgrade, it should focus on lowering the Smelter concentration risk by eliminating the $18.3 million subsidy.

Together, the two Smelters consume about 7.3 billion kWh of electricity and account for about 70% of the Big Rivers system energy requirement. The roughly 7.3 million MWh per year that the two Smelters are required to buy as part of their take-or-pay purchase obligation equates to a net margin

[109] Spen Rebuttal Testimony at p. 5.
[110] See Video Transcript (7-27-11; 10:09:30 through 10:10:30)

contribution from the Smelters of $162 million per year.[111] Lenders and rating agencies are understandably concerned that if one or both Smelters were to shut down operations, it would leave Big Rivers with an enormous amount of unrecoverable capacity costs. This possibility concerns the rating agencies to a far greater extent than the level of increase approved by the Commission in this proceeding. Standard & Poor's July 6, 2011 Report on Big Rivers' credit profile (See KIUC Cross Ex.-13) identifies Big Rivers' primary credit weaknesses. S&P states:

> "*The ratings reflect our view of the following credit weaknesses* ("bullets" in the original have been replaced with numbers for ease of reference):
>
> 1. *We believe that the utility's extreme level of customer concentration and its leading customers' credit profiles represent meaningful credit exposures. The cooperative relies on two customers for about 65% of energy sales to members and 53% of total member and non-member energy sales. These two customers are aluminum Smelters whose operations are vulnerable to economic cycles.*
> 2. *In our opinion, the take-or-pay features of the retail power sales contracts between Big Rivers' distribution cooperative, Kenergy Corp., and the Smelters are weak because the Smelters can terminate their obligations with one-year's notice.*
> 3. *The cooperative and its member distribution cooperatives are subject to state rate regulation that distinguishes Big Rivers from many other cooperatives that have autonomous ratemaking authority. Rate regulation could potentially expose the utilities' financial performance to delayed rate relief or cost disallowances, particularly if Big Rivers needs to reallocate the Smelters' shares of fixed costs to its non-Smelter customers.*
> 4. *Surplus energy sales in volatile wholesale markets account for about 16% of energy sales, are important to the utility's revenue stream, and help support its financial obligations.*
> 5. *The cooperative is adding transmission capacity to increase physical access to wholesale markets. However, even with the additions, we believe the utility lacks the certainty of firm contractual transmission arrangements, which could frustrate the surplus power sales Big Rivers would need to make if the Smelters reduce operations meaningfully or close.*
> 6. *Nearly one-third of the utility's debt either does not amortize before maturity or has limited amortization, which produces highly uneven debt service coverage ratios (DSCRs) and presents a refinancing risk.*

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[111] Direct Testimony of Mathew Morey, p. 16.

7. *In July 2009, Big Rivers regained operational control over generation assets it had not operated for more than a decade and has a limited track record of generation operations."*

Note that items 1 through 5 of S&P's cited credit weakness of Big Rivers are related to the potential of the Smelters shutting down operations. S&P's concerns in items 4 and 5 regarding Big Rivers' reliance on off-system sales revenues defines part of the Smelter concentration risk because if the Smelters were to terminate, Big Rivers would have to rely on off-system sales to an even greater extent. Only items 6 and 7, presumably the least troubling of the seven factors identified by S&P, deal with factors not related to the Smelter concentration risk. This rate case and the level of rate increase requested from the Commission is not mentioned despite the fact that this Report was issued less than three weeks prior to the evidentiary hearing in this case.

Moody's analysis of Big Rivers' credit profile likewise demonstrates that Smelter concentration risk is its primary concern. An entire section of Moody's July 18, 2011 Report entitled, "Concerns About Potential Loss Of Smelter Load Cannot Be Ignored," is devoted to the Smelter concentration risk. The Moody's Report states:

> *"Under historical operating conditions, the two Smelters served by Kenergy can be expected to consume over 7 million MWh of energy annually, representing a substantial load concentration risk. As noted above, this risk is a significant constraint to Big Rivers' rating, making its operating and risk profile rather unique compare to peers."*[112]

In fact, Big Rivers' witness Alan Spen agreed that the Smelter concentration risk is Big Rivers' greatest credit weakness. On cross examination Mr. Spen stated, "*I would say that the Smelter* [concentration] *issue is probably the number one issue for the* [rating] *agencies*"[113]

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[112] KIUC Cross Ex.-12, p. 4 of 8
[113] Video Transcript (7-27-11; 10:25:08)

The primary anxiety of the lenders and rating agencies is that the Smelters will no longer be able to support the Big Rivers system. The KIUC proposal, once the Commission has determined the proper level of additional revenue, is to minimize this risk through the allocation process by eliminating the rural subsidy and using a small portion of the Rural Reserve to mitigate the increase to the Rural Class. The Big Rivers' proposal, on the other hand, while it acknowledges the Smelter concentration risk, appears indifferent to finding a solution. Instead, its proposal to dramatically increase the base rates paid by the Smelters by $22.5 million on September 1, 2011 followed by another $9.5 million rate increase on January 1, 2012 only increases the primary risk identified by the rating agencies.

b. Smelter Termination Would Be Devastating To Big Rivers and Its Remaining Ratepayers.

The concerns voiced by Mr. Spen and the rating agencies are based on the unfortunate reality that if the Smelters cannot continue operations in Western Kentucky, Big Rivers and its ratepayers will face an overwhelming revenue shortfall that will result in sharp rate increases to the remaining ratepayers. The roughly 7.3 million MWh per year that the two Smelters are required to buy as part of their take-or-pay purchase obligation would vanish after a year notice. This net margin contribution from the Smelters averages $162 million per year.[114] Absent sales to the Smelters, Big Rivers would need to seek replacement revenues through a similar level of sales within regional wholesale markets. Thus, the issue is whether Big Rivers, as a merchant generator, could achieve a level of margin contribution from off-system sales in the wholesale energy market equivalent to the margin it receives from the Smelters.

Dr. Mathew J. Morey's testimony addresses how Big Rivers' finances and rates would be impacted by the loss of the Smelter's load. Dr. Morey's analysis concludes that due to high operating

[114] Morey Direct Testimony at p. 16.

costs at some Big Rivers' plants and the frequently low locational marginal price ("LMP"), Big Rivers would only manage to sell into the wholesale market an average of about 4.2 million MWh per year of the 7.3 million MWh per year of lost Smelter sales. Dr. Morey concludes that Big Rivers' margins would deteriorate by approximately $83 million per year if the Smelters shut down and Big Rivers were forced to sell the excess energy in the wholesale market.[115] Making up the shortfall would have to be borne by the remaining customers whose rates would increase by more than 55%.[116]

In KIUC Data Request 1-69, KIUC asked Big Rivers to provide all studies and documents that Big Rivers produced that seeks to quantify the impact on Big Rivers and its Members if one or both Smelter terminated. In response Big Rivers provided general Stress Case Impact Studies conducted by Big Rivers at the requests of Standard & Poor's prior to the "Unwind" transaction. This analysis projected the rate impact of Smelter leaving the Big Rivers system in 2011 using separate sets of assumptions regarding fuel costs, market price, etc. Big Rivers' provided S&P with 11 different scenarios, each resulting in a different projected rate increase to non-Smelter customers stemming from a Smelter exodus from the system.

The 11 different scenarios yielded the following projected increases to Big Rivers' remaining customers: **96%, 72%, 69%, 66%, 60%, 58%, 47%, 44%, 42%, 40% and 7%**[117]. (These values produce an average rate increase of 54.6%).

Both Dr. Morey's analysis and the Big Rivers' analysis for S&P demonstrate that the continued sale of energy to the Smelters should be protected because such sales are in the interests of all customers, not just the Smelters. Smelter rates in excess of cost-of-service are counter to all of these interests.

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[115] Morey Direct Testimony at pp. 4-5.
[116] Fayne Direct Testimony at p. 12.
[117] KIUC Cross Exam Exhibit 11.

c. **It Is Not In the Public Interest For The Smelters To Continue To Subsidize Other Customers, Particularly Commercial And Retail Customers.**

Low electric rates are the greatest factor in determining whether a Smelter continues to operate or shuts its doors. Aluminum manufacturing is perhaps the most energy intensive business in the world. In contrast, electric power costs play a much lesser role in the determining whether commercial, retail and service businesses succeed or fail. The handful of aluminum Smelters that continue to operate in the U.S. are only found in places that have access to low-cost power, whereas commercial/service businesses thrive wherever people are located regardless of the costs of electric power. You will find Burger Kings and Wal-Marts in Hawaii, where power is 23 cents/kWh just as you will find Burger Kings and Wal-Marts in Kentucky where power is 8.5 cents/kWh.[118] You will not find an aluminum Smelter in Hawaii.

What makes Big Rivers' proposed allocation of costs between Rural Class (residential, farm, commercial and small industrial) and the Industrial/Smelters customers more unreasonable is that industrial customers, particularly the Smelters, are drivers of economic growth and create wealth at the local level. As discussed by KIUC witness Professor Coomes, the closure of the Smelters would result in the loss of 4,700 jobs, $176 million in annual payroll and nearly $12 million annually in state and local taxes.[119] Because the aluminum and related manufacturing operations serve primarily national and international markets, they bring new dollars into the regional economy. A shut down of the two Smelters would have large, negative economic and fiscal impacts in Western Kentucky. Terminating Smelter operations would jeopardize the viability of related business activities, both upstream and downstream. Among the supporting industries that would be affected are river barges (that bring in alumina), engineering firms, maintenance contractors, trucking firms, and the other vendors to the

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[118] KIUC Cross Exam Exhibit 10 at p. 1.
[119] Coomes Direct Testimony at p. 5.

smelting plants. Downstream, the Smelters supply raw aluminum to rolling and extruding mills in the region, which are clustered to support wire plants, auto parts plants, can factories, and other heavy aluminum users in the region. The Southwire Rod and Cable Mill, adjacent to the Hawesville Smelter, could be in jeopardy if the Smelters were to close, since its business model depends on direct access to molten aluminum meeting its stringent purity specifications. There would be many other negative impacts that cannot be reasonably estimated. Local real estate and retail markets would likely be depressed, unemployment and crime rates would rise, retraining and social services costs would increase, and many ancillary tax revenues would fall as economic activity in the region diminished.[120]

Dr. Coomes' study shows that the direct impact of a shutdown of Smelter operations would result in the loss of about three quarters of a billion dollars in wages to the region (in 2010 dollars) over the next decade. The impact to local and state tax receipts would also be large. The Smelters represent over $88 million in taxes to Kentucky state and local governments over the next ten years. When the indirect impacts to the region and the Commonwealth are added to the analysis the impact is far more severe. Over a ten year period the residents of Western Kentucky would lose approximately $1.75 billion in payroll and state and local governments would lose over $120 million in tax revenues.[121] During cross-examination former Secretary of the Kentucky Cabinet for Economic Development, Gene Strong, stated that [the loss of one both Smelter] "*would be serious for Kentucky and devastating for Hancock County and Henderson County given the economic conditions that are there today. If you look at Henderson county as an example, they really only attracted 3 new industries in the last 10 years...For a total of about 50 jobs and less than $23 million in investment...So the loss of 400 or 500 at this level would be not just difficult but... almost impossible to replace in the short run and extremely difficult*

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[120] Id. at 6.
[121] Id.

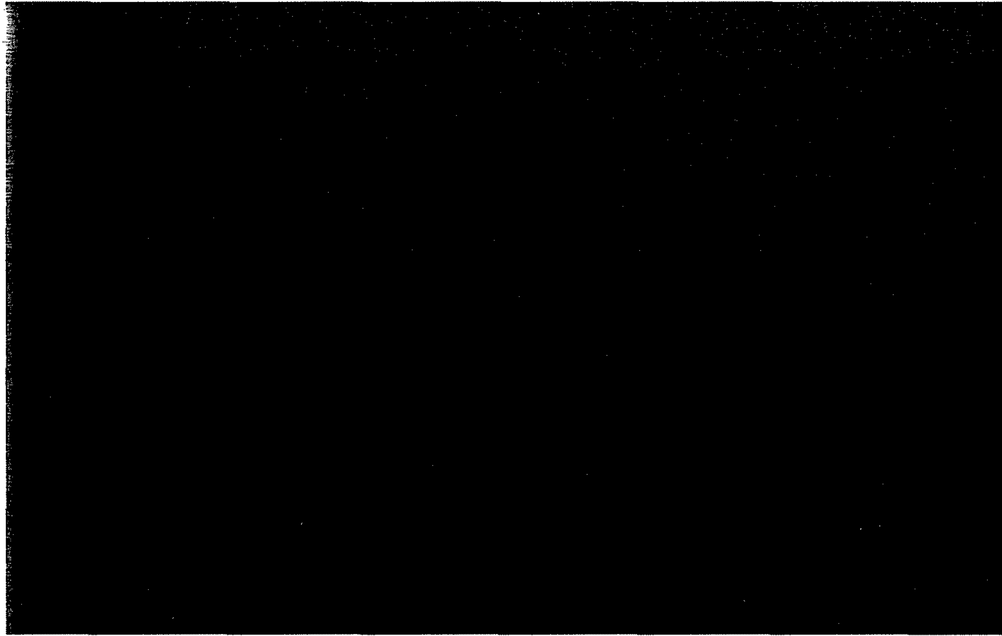
even in the long run."[122]

There is no public policy reason for the Smelters to continue to subsidize commercial and other Rural customers. It is not understandable why the Big Rivers Board of Directors would agree to put the economy at risk by continuing to charge the Smelters excessive rates. The Board is elected by the Rural customers. So the Board is biased in their favor. Alcan has the same one vote as John Doe. This is precisely why the Legislature has entrusted rate setting to this Commission. In the long run, all consumers will be better off if the allocation of the rate increase in this case is guided by sound economics, not the political considerations of the individual Board Members.

d. Smelter Financial Data Shows That Revenue During Times When The LME Is High Is Insufficient To Protect The Smelters From Risk Of Closure When The LME Dips.

Any speculation that the Smelters are currently making extreme profits during this period of relatively high aluminum prices is simply not true.

[122] Video Transcript (7-28-11; 10:08:37 through 10:09:53)



Keep in mind that Big Rivers is seeking a $22.5 million increase from the Smelters in this case (once the false TIER adjustment is excluded from the rate increase), plus the automatic $7.3 million TIER Adjustment Charge increase and $2.2 million in Section 4.11 increases that will occur on January 1, 2012. The total increase to the Smelters would be $31.0 million per year, or 11.3%. Unfortunately, another round of rate increases will shortly follow this rate case when Big Rivers files its application for an environmental surcharge to recover the costs of environmental upgrades necessitated by new EPA regulations. Big Rivers'

current estimates are that wholesale rates could increase by nearly 40% in order to comply with pending EPA regulations.[123] The Smelters are in no position to absorb huge subsidy payments to the Rural class.

e. Stabilizing The Smelter Rate Is A Critical Factor In Minimizing The Risk Of Smelter Closure.

In the U.S. in 1978, there were 34 Smelters, producing more than 4 million metric tons, accounting for about 31% of the world supply. Today, there are only 10 Smelters operating in the U.S., producing about 1.9 million metric tons, which accounts for only 4.2% of the world supply. In every instance, the Smelters shut down primarily because of high power costs.[124]

Most of the Smelters still operating in the U.S. either have self-supply, special contracts or other regulatory treatments that keep costs low. These incentives are designed to retain large energy intensive industries that provide enormous economic returns for the citizens of that state. For example, Ormet in Ohio received $60 million in incentives each of the first two years of a ten year power contract to reduce its power cost. All of the recently announced U.S. Smelter restarts, except for the restart of the fifth potline at Century Aluminum, have resulted from governmental or other actions that promote continuing aluminum Smelter operations by minimizing electric power rates based on a recognition of the significant contribution of such Smelters to local and statewide economies.[125]

Aluminum is a global commodity. It is sold at a price that is based on global supply and demand and established by trading activity on the London Metal Exchange, or LME. An individual Smelter is, in effect, a price taker and cannot set the selling price of the base product; therefore, the success or viability of a specific smelting operation is determined primarily by its cost of production. The cost of production will vary among Smelters based on the cost of raw materials and services as well as the

[123] Big Rivers Response to KIUC 1-73.
[124] Fayne Direct Testimony at p. 9.
[125] Leblanc Direct Testimony at pp. 8-9.

configuration of the plant. However, in general, the cost of alumina, labor and electricity accounts for 75%-80% of the cost, with alumina and electricity each comprising about one-third of the cost of production. The cost of alumina tends to be tied to the LME price. In other words, when the LME is relatively high, the cost of alumina is typically high and vice versa. As a result, it is the cost of electricity that most significantly determines the ongoing success or viability of an aluminum Smelter. Because of transportation costs, the location of a Smelter can make some contribution to the viability of any specific Smelter; but the differences in the cost of transportation are not sufficient to offset electricity prices that are materially higher than those paid by other aluminum Smelters.[126]

As KIUC witness Stephane LeBlanc explained during the evidentiary hearing, Alcan's long-term goal for the Sebree facility is to be at the average point on the world-wide total cost curve, including power. Experience shows that aluminum Smelters that have electricity and production costs that are in the average are able to secure investments for facility upgrades when the LME is high and avoid closure when the LME is low. Mr. LeBlanc stated: "*When you are the* [highest cost Smelter] *during* [periods when the LME is high] *you don't have the funds to invest in your plant to make sure that you* [can survive] *the downturn.*[127] ... *If you are an investor and you have to choose whether to send your money to the good plant or the bad plant you will send your money to the good plant.*"

The risk of closure is real. Mr. LeBlanc stated during cross examination: "*In 2009, during the last downturn* [of the LME]... *We had a command from our headquarters to reduce costs by $42 million. Because they said if you don't do that we cannot guarantee that you will survive this year.*"[128] The Sebree Smelter was able to reduce its operating costs in 2009 by $42 million in order to stay open, but it is important that the two Western Kentucky Smelters are moved toward the average for all

[126] Fayne Direct Testimony at p. 8.
[127] Video Transcript (7-28-11; 16:27:30)
[128] Video Transcript (7-28-11; 16:15:00 through 16:15:46).

production costs (especially electric costs) in order to survive in the long-term. As Mr. LeBlanc stated during cross-examination: "*The most important thing for a Smelter is to make sure that we are not the worst Smelter* [in terms of production costs]*...*"[129] "*If we have other Smelters worse than us, and we have a downturn, you always close the worst one...*"[130] "*So the best protection that we can have to make sure we have a sustainable plant, that we live for more than 5, 20, 25 years is that we make sure that we always stay in the average.*"[131]

For the year 2010, the cost of electricity charged by Big Rivers (via Kenergy) was $45.15/MWh for the Hawesville Smelter and $43.39 for the Sebree Smelter.[132] The average cost for each of the Smelters differs because of the different level of operations at each facility. Even with current rates, the cost of electricity for Sebree and Hawesville is among the highest cost for U.S. Smelters and significantly higher than the average world price (excluding China) of $27/MWh.[133] The Table below shows the relative cost of electricity for the 9 U.S. Smelters in 2011:

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[129] Video Transcript (7-28-11;16:16:23)
[130] Video Transcript (7-28-11;16:16:34)
[131] Video Transcript (7-28-11;16:16:45)
[132] KIUC Cross Exam Exhibit 10.
[133] KIUC HWF Exhibit 1.

Exhibit HWF-1

ALUMINUM SMELTERS
COST OF ELECTRICITY
FOR THE YEAR 2011

	Smelter	Company Owner	Smelter Production (000 TPY)	Cost of Electricity [(1)] ($/MWh)
1	Mt. Holly	Century	229.0	52.26
2	Ferndale	Italco	143.5	49.71
3	Hawesville	Century	199.2	45.22
4	Sebree	Alcan	196.0	43.45
5	New Madrid	Noranda	263.0	39.45
6	Warrick	Alcoa	271.9	31.81
7	Hannibal	Ormet	180.9	24.20
8	Massena West	Alcoa	130.0	23.01
9	Wenatchee	Alcoa	99.9	13.48
	TOTAL USA		**1,713.4**	**37.57**
	GLOBAL (Excl. USA & China)		**25,403.7**	**26.28**

[(1)] For the Hawesville and Sebree smelters, the cost reflected reflects actual charges from Kenergy for the year 2010. For all other smelters, the data was provided by CRU, an independent business analysis and consultancy group focused on mining, metals, power, cables, fertilizer and chemical sectors.

If the rates requested by Big Rivers is approved and both smelters operate at full production, the cost of electricity for the Hawesville and Sebree smelters would be $47.86/M Wh.

As shown above, the Hawesville and Sebree Smelters pay some of the highest electric prices in the U.S. If the rate increase proposed by Big Rivers is approved by the Commission, the cost of electricity to the Smelters is projected to increase to $47.86/MWh in September 2011, making the cost of electricity to the Kentucky Smelters among the highest in the U.S., and therefore, the most vulnerable to closure. Also, the cost of electricity to the Smelters is projected to increase by another $9.5 million ($1.3/MWh) beginning in 2012, just four months after the new rates in this proceeding become effective.[134]

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[134] Fayne Direct Testimony at p. 9.

The Commission cannot produce a long-term solution, but it can help in the interim by not making the situation worse. Continuing the Rural subsidy while approving a rate increase will make matters worse. The KIUC's proposal to substantially reduce the Rural subsidy in this proceeding will give the parties a chance to find a long-term solution.

f. Big Rivers' Rural Customers Already Pay Some Of The Lowest Rates In Kentucky And In The Nation.

Although the two Kentucky Smelters pay some of the highest electric prices of any aluminum Smelter in the nation or in the world, Big River's Rural customers enjoy some of the lowest cost power in the United States. Even with the $14 million rate increase proposed by Big Rivers, electricity rates to residential customers will continue to be among the lowest in the U.S.[135] Under Big Rivers' proposed increase, Rural customers would pay 8.268 cents/ kWh. This compares favorably to the average rate paid by Kentucky residential rate payers of 8.52 cents/kWh,[136] and it is approximately 25% below the U.S. average residential rate of 11.04 cents/kWh.[137] Big Rivers' rural customers have been immune to the drastic rate increases experienced by customers nationally. Amazingly, the rates that Big Rivers' Rural customers pay today are almost 20% lower than the rates they paid in 1994.[138]

It is important to remember that the term "Rural" encompasses all non-direct-serve ratepayers on Big Rivers' system. "Rural" includes residential customers, but it also includes commercial customers and small industrial customers. These customers not only receive a subsidy from the Smelters based on the cost-of-service studies submitted in this proceeding, but Big Rivers bills a total lower rate for generation and transmission service for these customers than they do for the Smelters. During 2010, the

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[135] KIUC Cross Ex.-10, p. 1 of 6.
[136] KIUC Cross Ex.-10, p. 1 of 6.
[137] KIUC Cross Ex.-10, p. 1 of 6.
[138] KIUC Cross Ex.-10, p. 2 of 6.

average Rural rate was $37.26/mWh[139] while Century and Alcan paid average rates of $45.15/mWh and $43.39/mWh respectively.[140] This is a highly unusual rate structure that makes little sense from a public policy standpoint.

g. The Commission Has The Ability To Mitigate The Rate Impact On The Rural Class By Utilizing The $63 Million Commission-Created Rural Economic Reserve Fund.

KIUC is proposing two distinct mitigation adjustments in this case. The first adjustment utilizes the $63 million Rural Economic Reserve fund ("Rural Reserve") to mitigate the KIUC recommended increase to the Rural class such that the resulting increase after mitigation will be equal to the Rural revenue increase proposed by Big Rivers in this case. The Commission established the Rural Reserve in its Order in Case No. 2007-00455 for the purpose of providing rate mitigation for Rural customers. The KIUC proposal would apply the fund strictly for the benefit of Rural customers. KIUC believes that its proposal provides a reasonable application of this fund to partially offset the test year level of subsidies that are being paid by Smelter customers to the Rural rate class.

Big Rivers' stated in its response to KIUC 1-64 that the balance in the Rural Reserve fund will be $63 million by the time new rates in this case become effective in September 2011. Based on Big Rivers' projections, the Rural Reserve would not be required to mitigate FAC and Environmental Surcharge increases until mid-2015. The Rural Reserve fund is projected to be fully utilized by early 2018.

KIUC's recommended Rural increase, before mitigation, is $18.562 million. Big Rivers is proposing a base rate increase to the Rural class of $14.172 million.[141] To fully mitigate KIUC's increase and bring it to the level proposed by Big Rivers, $4.2 million of the $63 million Rural Reserve would be

[139] KIUC Cross Ex.-10, p. 5 of 6.
[140] KIUC Cross Ex.-10, p. 6 of 6.
[141] Seelye's Exhibit 6, page 1 of 3.

required annually.[142] This use of the Rural Reserve fund would result in a Rural base revenue increase of $14.172 million, the same amount proposed by the Company in this case. It is well within the spirit and the letter of the Order that created these funds to begin using the Rural Reserve to mitigate the rate increase to Rural customers in this proceeding.

Using the $63 million Commission-created Rural Reserve to transition the Rural Class to cost-based rates is a prudent use of the funds. The transition could be gradual or abrupt, depending on how much of the Rural Reserve the Commission determines it is reasonable to use.

There is one other mechanism that the Commission should impose in order to mitigate the impact of any rate increase. The Commission should utilize Big Rivers' patronage capital, to the maximum extent possible, to partially offset a portion of the remaining increase.

As explained in detail in Mr. Kollen's Direct Testimony beginning on page 22, patronage capital is the equity ownership or investment of the cooperative's members in the cooperative, according to the Capital Credits Task Force Report ("CCTFR").[143] In general, cooperatives must operate at cost with respect to their tax exempt purposes. That means that any excess of operating revenues collected over operating expenses from the provision of electricity must be allocated to patrons as capital credits, based on their participation, and ultimately returned to patrons. As of October 31, 2010, Big Rivers had a very healthy $385.705 million in members' equity,[144] and a 32.11% members' equity ratio.[145] Nevertheless, Big Rivers does not presently have a plan for the retirement of patronage capital. The Commission should direct the Company to adopt a plan to retire patronage capital to mitigate the effect of rate increases. Mitigation of the effects of rate increases is an appropriate and relevant factor in such a plan,

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[142] Baron Exhibit__(SJB-6) , lines 16-17.

[143] The Capital Credit Task Force Report was prepared jointly by NRECA and CFC. The CCTF Report was issued in January 2005.

[144] RUS Form 12 report provided in Exhibit 37 of Big Rivers' Application.

[145] Exhibit 28 of Big Rivers' Application

particularly given the magnitude of the Company's proposed increases on all customers, including the Smelters.

5. KIUC's Revenue Requirement, Rate Allocation And Rate Mitigation Proposals Result In Fair, Just and Reasonable Rate Increases To All Customer Classes.

The Table below provides a summary of KIUC's primary rate allocation and rate mitigation proposal. This Table shows the rate impact to the Rural, Large Industrial and Smelter customers under KIUC's recommendation to 1) approve a rate increase to Big Rivers of $18.562 million; 2) eliminate the $18.3 million Rural subsidy; 3) spread the remaining portion of the rate increase among the customer classes; and 4) mitigate the rate increase to Rural customers by using the Rural Reserve fund. Although KIUC continues to believe that the Commission should consider using patronage capital distributions to mitigate the rate increase, this mechanism was not used in the Table below:[146]

KIUC Proposed Rate Increases

	Total System	Rurals	Large Industrials	Smelters
Subsidy at Present Rates	-	(18,319,114)	(50,193)	18,369,307
KIUC Proposed Revenue Increase	**18,562,000**			
Eliminate Subsidy to Rurals	18,319,114	18,319,114	-	-
Spread of Increase Remainder	242,886	66,406	22,952	153,527
Step 1 Increase - Rurals Subsidy	18,319,114	18,319,114	-	-
Net Increase	18,562,000	18,385,520	22,952	153,527
Rural Mitigation from RER Fund	(4,213,517)	(4,213,517)	-	-
Net Increase after Mitigation		14,172,003	22,952	153,527

As can be seen in the above Table, KIUC is proposing a slight increase to the Smelter and Large Industrial class, while the Rural class would receive an increase of about $14.1 million - the same Rural

[146] Baron Direct Testimony at p. 31.

increase proposed by Big Rivers. While the KIUC proposal is designed to eliminate much of the $18.3 million in present rate subsidies received by the Rural class and paid by the Smelters, substantial subsidies of $6.1 million will continue to be received by Rural customers at proposed rates due to the Smelter Agreements which requires the Smelters to pay a rate $.25/Mwh above the Large Industrial rate, surcharges and the TIER Adjustment Charge. As a result, the KIUC proposal reflects a continuation of the contract subsidies paid by the Smelters to the Rural rate class. The Table below shows the calculation of the remaining subsidies between the customer classes at KIUC's recommended revenue increases and rate allocation.[147]

Table 4 - Revised
Subsidies Remaining at Proposed Rates

		Total System	Rurals	Large Industrials	Smelters
1	Rate Base - 6 CP	1,170,341,502	390,335,625	96,406,419	683,599,459
2	Net Utility Operating Margin	25,806,684	(9,711,995)	2,075,623	33,443,057
3	Return on Rate Base	2.21%	-2.49%	2.15%	4.89%
4	Subsidy at Present Rates	-	(18,319,114)	(50,193)	18,369,307
5	**Adjusted Total Increase Required**	**18,562,000**			
6	Eliminate Rural Subsidy	18,319,114	18,319,114		
7	Spread of Increase Remainder	242,886	66,406	22,952	153,527
	Step 1 Increase - Rurals Subsidy	18,319,114	18,319,114	-	-
8	**Net Increase**	**18,562,000**	**18,385,520**	**22,952**	**153,527**
9	Income at Proposed Rates (line 2 + line 8)	44,368,684	8,673,525	2,098,575	33,596,584
10	ROR - Proposed Rates (line 9/line 1)	3.79%	2.22%	2.18%	4.91%
11	Net Utility Operating Margin at System ROR	44,368,684	14,797,970	3,654,853	25,915,862
12	**Subsidy at Proposed Rates (line 11 - line 9)**	**-**	**6,124,445**	**1,556,278**	**(7,680,722)**

[147] Baron Direct Testimony at p. 32.

6. Big Rivers' Large Industrial Customer Expansion Rate ("LICX") Should Be Modified So That Current Customers Can Expand Their Existing Contractual Loads By 5 Mw Or More And Continue Taking Service Under The Standard Large Industrial Customer Rate.

Big Rivers currently requires existing large industrial customers whose loads increase, due to expansion, by 5 mW or more, to take service under Rate LICX (Large Industrial Customer Expansion). This tariff also applies to new loads of 5 mW or more as well. Unlike the standard Large Industrial Customer rate ("LIC"), Rate LICX prices expansion power at the price Big Rivers pays for purchases from third-party suppliers. Essentially, this is a market-based rate which was initially established prior to the Unwind when Big Rivers leased its generation to LG&E Energy/E.ON. While the tariff permits Big Rivers to negotiate an alternative contract rate with such a customer, there is nothing in the tariff that requires such a contract or defines its terms, conditions or pricing basis.[148]

These LICX provisions are unreasonable for an existing large industrial customer that may want to expand production. While KIUC does not object to the LICX tariff per se, it does not believe that it should be applicable to existing large industrial customers that may want to expand their usage of power from Big Rivers. The terms of the tariff act to deter economic development and the potential creation of new jobs in Kentucky. Existing customers that may want to expand in Kentucky effectively are forced to take market prices, rather than a standard cost based tariff. This may have been appropriate when Big Rivers' generation was leased, but it is not appropriate now. While it could be argued that the LICX rate deters new loads and the jobs that such customers may bring to the state, KIUC is only recommending in this case that existing customers be permitted to take expansion service for 5 mW or more contractual load increases under the existing LIC rate. This would apply to customers with self generation or cogeneration, unlike the current tariff.[149]

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[148] Baron Direct Testimony at p. 38.

[149] Baron Exhibit__(SJB-9) contains a redlined version of Big Rivers' Schedule LICX reflecting the changes that KIUC is recommending.

No other utility in Kentucky charges large customers a market-based rate. The Legislature long ago rejected the move to a deregulated electric power industry. The LICX provisions are also anti-economic development because market-based pricing is inherently more unpredictable than rates based on cost. While these provisions may have made sense when Big Rivers did not own generation in the pre-Unwind period, these provisions are now outdated and unreasonable.

III. CONCLUSION

The $22.5 million base rate increase to the Smelters proposed by Big Rivers, plus the $9.5 million additional rate increase the Smelters will absorb on January 1, 2012 would be devastating to their finances and increases their risk of closure. If the Smelters are forced to close, then 4,700 hundred jobs will be lost along with $176 million in annual payroll and nearly $12 million in state and local taxes. The high wage, high benefit Smelter jobs will likely never be replaced. Reselling the freed-up Smelter power in the volatile wholesale market would raise rates on remaining ratepayers by about 55%. Big Rivers would likely lose its investment grade credit rating and the crisis would continue to escalate.

The best course of action in this case is to: 1) approve KIUC's reduced revenue requirement of $18.562 million consistent with historical test year regulatory principles (if the increase is "inadequate" in Big Rivers' opinion, then it may file for additional rate relief in the future); 2) the Rural Class should be assigned the first $18.3 million of any rate increase which simply assures that this class pays the full cost that Big Rivers incurs in serving it; 3) any remaining increase is allocated proportionally among all three classes; and 4) the $63 million Rural Reserve fund is used to mitigate the Rural rate increase and ease their transition to cost-based rates. No plan is perfect, but we respectfully suggest that our proposal best serves the public interest, is consistent with the Smelter contracts and Big Rivers' loan agreements, and is reasonable and workable.

Respectfully submitted,

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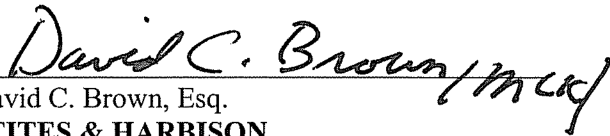

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