

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

ORDER

By Order issued November 17, 2011 (“Rate Order”), the Commission granted Big Rivers Electric Corporation (“Big Rivers”) an increase in its wholesale base rates to generate additional annual revenues of \$26,744,776.¹ A petition for rehearing was filed by Big Rivers on December 6, 2011, raising four issues. The Commission issued an Order on December 8, 2011 granting rehearing on all four issues. Kentucky Industrial Utility Customers, Inc. (“KIUC”) then filed a motion on December 14, 2011 to dismiss the rehearing and vacate our December 8, 2011 Order, on the basis that it had already filed an appeal with the Franklin Circuit Court challenging the Rate Order and, as a result, the Commission lacked jurisdiction to grant Big Rivers’ petition for rehearing.

The Commission denied KIUC’s motion by Order dated February 14, 2012. In a March 8, 2012 ruling, the Franklin Circuit Court held that the Commission did have jurisdiction to hear the issues raised on rehearing by Big Rivers and the Court remanded the case back to the Commission for further proceedings. On April 12, 2012, in response to the Court’s March 8, 2012 ruling, we expanded the scope of our rehearing to include the three issues raised by KIUC in its appeal of the Rate Order and

¹ Big Rivers had sought an increase of approximately \$39.95 million.

we modified the procedural schedule previously established for the rehearing of this case.

The Commission directed Big Rivers and KIUC to file testimony on their respective rehearing issues, and an opportunity was provided for all other parties to also file testimony. After conducting discovery, the Commission held an evidentiary hearing on September 12, 2012. At that rehearing, the Commission ruled that the only evidence to be considered on rehearing would be that which was in existence at the time the Rate Order was issued. Rehearing briefs were filed by Big Rivers, KIUC, the Attorney General (“AG”), and Kenergy Corp., one of Big Rivers’ member-owner cooperatives. The record is now complete and the matter now stands submitted for a decision.

BIG RIVERS’ REHEARING ISSUES

Big Rivers made the following four claims in its request for rehearing, each of which are addressed in detail below:

1. The Rate Order did not allow recovery of Big Rivers’ rate case expenses;
2. There was an error of \$450,000 in the calculation of Big Rivers’ depreciation expense in the Rate Order;
3. Depreciation expense should be allowed on Big Rivers’ utility plant recorded as Construction Work in Progress (“CWIP”) at the end of the test year; and
4. The Rate Order should be revised to correct an erroneous statement in the section addressing the “smelter Times Interest Earned Ratio (“TIER”) adjustment charge revenues.”

Rate Case Expenses

As pointed out by Big Rivers, the Rate Order inadvertently omitted recovery of Big Rivers' expenses incurred in conjunction with the preparation of its application and the prosecution of its case up through August 2011 ("rate case expenses").² Big Rivers originally proposed an adjustment of \$281,719, based on estimated rate case expenses of \$898,930.³ In response to an ongoing data request,⁴ Big Rivers updated its actual rate case expenses throughout the course of the original proceeding. The final update, filed on August 18, 2011, reflected total actual rate case expenses of \$1,976,030.⁵

For this rate case, Big Rivers employed the legal services of the Owensboro, Kentucky, firm of Sullivan, Mountjoy, Stainback and Miller, PSC, and the Washington, D.C., office of Hogan Lovells US LLP ("Hogan Lovells"). On rehearing, none of the parties challenged Big Rivers' claim that the Rate Order did not allow for the recovery of any rate case expenses. However, KIUC and the AG did oppose Big Rivers' request to recover the full amount of its expenses, claiming that Big Rivers did not properly manage its rate case expenses, specifically the expenses it was charged by Hogan Lovells. KIUC and the AG particularly take exception to the hourly fees charged by Hogan Lovells, which were roughly three times the highest hourly rates charged by Big Rivers' Kentucky law firm. KIUC argues that Big Rivers' rate recovery should be limited

² The Commission's typical practice for many years has been to allow the utility to amortize its rate case expenses over a three-year period and include the annual amortization expense in determining the utility's required revenue increase.

³ Big Rivers' March 1, 2011 application, Volume III, Exhibit Wolfrom-2, Reference Schedule 2.13, $(\$898,930 / 3 - \$17,924) = \$281,719$. A total of \$17,924 of the expense was incurred during the test year.

⁴ Item 52 of First Information Request of Commission Staff, dated Feb. 18, 2011.

⁵ Big Rivers' update to Item 52 of First Information Request of Commission Staff, filed Aug. 18, 2011.

to the amount of the estimate included in its application, based to a great extent on Big Rivers' initial refusal to provide unredacted copies of the invoices submitted by Hogan Lovells.⁶ KIUC claims that this refusal prevented all intervenors and Commission Staff from reviewing the invoices to determine whether the charges were appropriate or necessary.⁷ In his brief, the AG proposes that Big Rivers' rate case expenses be limited by applying an hourly rate more in line with those of local or regional law firms to the hours billed by Hogan Lovells, to the extent that the total Hogan Lovells charges of \$897,200 exceed the \$174,000 original estimate included in Big Rivers' application.⁸

Big Rivers claims that its rate case expenses were reasonable and necessary, including the fees charged by Hogan Lovells. Big Rivers states that Hogan Lovells has a great deal of experience working with Big Rivers, specifically citing the firm's work with issues involving the Midwest Independent System Operator, Inc., the "unwind transaction" proceeding, and its familiarity with the aluminum smelter contracts and "smelter issues."⁹ Big Rivers cites two primary reasons why its actual rate case expenses exceed the estimate in its application: (1) It underestimated the level of expenses, in general, that it would incur during the course of this case; and (2) It had not anticipated the degree of complexity that the case would take on, which caused the role of Hogan Lovells to be greatly expanded beyond what was expected prior to filing

⁶ KIUC's post-hearing brief at 26.

⁷ *Id.* Big Rivers did not file the largely unredacted copies of these invoices until after the evidentiary rehearing.

⁸ The AG provided no estimate of the amount of the resulting level of rate case expenses.

⁹ Big Rivers' rehearing brief at 5-6.

its application.¹⁰ Big Rivers points out that it provided periodic updates of its actual rate case expenses up to the month that briefs were filed and that none of the intervenors took issue with the amount of those expenses at any time during the initial phase of this case.¹¹ It argues that, consistent with its longstanding practice, the Commission should permit recovery of the actual level of rate case expenses incurred as reported in its August 18, 2011 update. Based on that actual expense of \$1,976,030, with \$17,924 of that amount recorded in the test year, the resulting adjustment, based on a three-year amortization, is \$640,753.

Based on a review of the record, the Commission finds that the concerns raised about Big Rivers' rate case expenses are legitimate. Although Big Rivers did file mostly unredacted copies of its legal invoices after the evidentiary rehearing, the rate case expenses it seeks to recover are more than double its original estimate, the expenses for Hogan Lovells are more than five times the original estimate, and there was a lack of meaningful oversight of those expenses by Big Rivers as they were being incurred. As pointed out during the evidentiary rehearing, the review process employed by Big Rivers was performed primarily for the purpose of ensuring the accuracy of the amounts it was billed by outside counsel and rate case consultants, with little effort to evaluate the reasonableness of the charges.¹² While Hogan Lovells appears to possess both the experience and expertise claimed by Big Rivers, the mostly unredacted invoices show that much of the work it performed for Big Rivers during the initial phase of this rate

¹⁰ *Id.*, at 6-7.

¹¹ *Id.*, at 10.

¹² September 12, 2012 hearing video at generally 11:12:50 – 11:19:50.

case was in conjunction with tasks such as reviewing and drafting data responses and data requests, tasks that have not been shown to require its specialized level of experience or expertise.

In conclusion, the Commission finds that while Big Rivers should not be limited to its original estimate of \$898,930 for rate case expenses, its request to recover actual expenses that are more than double its original estimate has not been shown to be reasonable and necessary. Consequently, in determining the appropriate level of rate case expenses to be recoverable by Big Rivers, there must be some reduction from the actual amount of \$1,976,030 for which it seeks recovery. Therefore, for ratemaking purposes, we will reduce the amount charged Big Rivers by Hogan Lovells in excess of the original estimate by 20 percent, from \$897,200 to \$752,546. This reduces the total rate case expenses allowable for ratemaking purposes to \$1,831,376. Based on a three-year amortization and recognizing the amount already reflected in the test year, this results in an adjustment of \$592,535.

The Commission also notes that Big Rivers, as the applicant in this case, bears the burden of proof, and had it not filed unredacted copies of its legal invoices, none of those expenses would have been included for recovery in rates. In future rate cases, any request for recovery of rate case expenses must be supported by unredacted copies of invoices. In addition, there must be a showing that the use of highly compensated counsel was essential for the particular tasks being performed.

Depreciation Error

Big Rivers claims that our Rate Order contained an error which understated its adjusted depreciation expense by \$450,000. None of the intervenors contested this

claim and neither does the Commission. Accordingly, we will correct that error and restate Big Rivers' test year depreciation expense, as adjusted. This correction results in adjusted test year depreciation expense of \$40,668,778, an increase of \$450,000 above the amount of \$40,218,778 contained in the Rate Order.

Depreciation Expense on Test Year-end CWIP

The Rate Order denied Big Rivers' request to recover depreciation expense on its test year-end CWIP. In doing so, the Rate Order stated: "Going beyond the end of test year plant-in-service balances is inconsistent with the concept of a historical test year and a violation of the broad 'matching principle' described previously in this Order."¹³ On rehearing, Big Rivers states that depreciation expense should be allowed on two components of its test year-end CWIP: (1) Plant that was providing service at test year-end but had not yet been transferred on its books from CWIP to plant in service; and (2) Plant that was not in service at test year-end, but was placed in service by September 1, 2011, the date new rates became effective. The expense for these two categories, \$359,678 and \$1,284,476, respectively, would result in an additional increase in depreciation expense of \$1,644,154. Big Rivers claims that, with the limits on its annual Margins for Interest Ratio ("MFIR"), it has little "maneuvering room" between its allowable maximum margin and the minimum margin it must realize to meet the required MFIR of 1.10, and that recovering, or not recovering, this additional expense could significantly impact its financial results.¹⁴

¹³ November 17, 2011 Order, at 20.

¹⁴ Direct Testimony on Rehearing of Mark A. Hite ("Hite Testimony") at 12.

In support of its request, Big Rivers cites prior cases in which the Commission allowed recovery of depreciation expense on year-end CWIP balances, or in which Big Rivers contends the recovery was allowed.¹⁵ It also emphasizes that none of the plant in CWIP for which it seeks recovery of depreciation expense generates any revenue.¹⁶

The Commission is not persuaded by Big Rivers' arguments. As shown in the discovery on this issue, the circumstances in the cases cited by Big Rivers in which depreciation on test year-end CWIP was allowed by the Commission are distinguishable from those in this case. In the 1990 rate case of Louisville Gas and Electric Company ("LG&E"),¹⁷ the distinguishing issue was the commercialization of a base load generating unit, for which the magnitude of the cost resulted in a significant increase in LG&E's rate base and its depreciation expense. In the 2010 rate case of Delta Natural Gas Company, Inc.,¹⁸ \$2,809 in depreciation expense on the test year-end CWIP balance was less than one-tenth of one percent of the revenue increase, a di minimus amount. In the 2009 rate cases of Kentucky Utilities Company and LG&E,¹⁹ the parties had reached a non-unanimous settlement which did not address depreciation expense. The Commission's analysis in those cases addressed only the issues raised by the AG, the party that did not agree to the revenue requirement terms of the settlement.

¹⁵ Direct Testimony on Rehearing of John Wolfrom at 11-15.

¹⁶ Hite Testimony at 14.

¹⁷ Case No. 90-158, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company (Ky. PSC Dec. 21, 1990).

¹⁸ Case No. 2010-00116, Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates (Ky. PSC Oct. 21, 2010).

¹⁹ Case No. 2009-00548, Application of Kentucky Utilities for an Adjustment of Base Rates (Ky. PSC July 30, 2010), and Case No. 2009-00549, Application of Louisville Gas and Electric Company for an Adjustment of Electric and Gas Base Rates (Ky. PSC July 30, 2010).

Depreciation expense was not one of the issues raised by the AG and, in ultimately accepting the revenue level in the settlement, the Commission's Orders made no findings regarding depreciation on test year-end CWIP.

Big Rivers points out that none of the utility plant included in its test year-end CWIP balance for which it seeks recovery of depreciation expense is revenue-producing plant. It claims, therefore, that there are no corresponding adjustments that can be made to revenues to be "matched" with its proposed depreciation expense adjustment. In this regard, Big Rivers is viewing the matching principle as it applies to a historic test year too narrowly. The manner in which the Commission has employed the matching principle takes a broad view of the test year, considering all items of revenue, expense, and capital costs. The Commission's interest is not limited to whether specific items of plant are revenue producing. Rather, our interest is in whether all components that may impact a utility's revenue requirement are, to the greatest extent reasonably possible, reported for the same time period, or from an accounting perspective, for the same reporting period. This is not a recent development; the Commission has long viewed the matching principle in such a broad manner. As Big Rivers pointed out in a data response, the Commission stated in an order in the 1990 LG&E rate case that:

...if a historic test period is used, adjustments for post-test year plant additions should not be requested unless ***all*** revenues, expenses, rate base, and capital items have been updated to the same period as the plant additions.²⁰
(Emphasis added).

Going beyond the end of test year plant-in-service balances without similarly going beyond the test year to adjust revenues, rate base, etc., is inconsistent with the concept of a historical test year and a violation of the broad "matching principle"

²⁰ Case No. 90-158, December 21, 1990 Order at 4-5.

described in our Rate Order. For this reason, we will affirm our earlier decision and limit the depreciation expense adjustment to the amount derived by applying Big Rivers' depreciation rates to its test year-end plant in service balances.

Statement Regarding Smelter TIER Adjustment Charge Revenues

The Rate Order, at page 6, under the heading "Smelter TIER [Times Interest Earned Ratio] Adjustment Charge," stated in the third sentence that "the financial model relied upon by Big Rivers in conjunction with the Unwind Transaction did not include any Smelter TIER Adjustment revenues." In its rehearing request, Big Rivers claims that (1) the cited financial model was not in evidence in this case; and (2) the Commission's statement is erroneous in that the financial model in question did include Smelter TIER Adjustment revenues in each of the years 2011 through 2023. Big Rivers seeks rehearing to have this finding eliminated from the Rate Order, and to have any other findings or conclusions contained in the Rate Order be modified, as appropriate, based on the elimination of the challenged finding.

Through discovery, Big Rivers affirmed that the financial model it had used in conjunction with the Unwind Transaction did not include any Smelter TIER Adjustment revenues in projecting its financial results for 2009 and 2010, which are the two years reflected in the test year used in this case, the 12 months ended March 31, 2010. It also clarified that its concern was that the statement indicated that the financial model contained no Smelter TIER Adjustment revenues, although the model included such revenues for each of the 13 years subsequent to 2010.²¹

²¹ Response to Item 3 of First Information Request of Commission Staff, filed Mar. 22, 2012.

In its rehearing brief, Big Rivers recommended that the statement in the Rate Order be revised to read as follows: “The financial model relied upon by Big Rivers in conjunction with the Unwind Transaction did not include any Smelter TIER Adjustment revenues in the years 2009 and 2010.” (Emphasis added). No other party took exception to Big Rivers’ position on this issue, and no other party addressed this issue in a rehearing brief.

Having considered the matter, we conclude that Big Rivers’ suggested revision to the statement is accurate and reasonable and should be adopted. Accordingly, we will revise the Rate Order to reflect this change.

Effective Date of New Rates

At the September 12, 2012 evidentiary rehearing, Big Rivers referred to the additional revenues that might be granted on rehearing as being granted retroactive to the September 1, 2011, the effective date of the new rates approved by the Rate Order.²² The parties were requested to address this issue in their rehearing briefs, and Big Rivers and KIUC did address the issue.

Big Rivers states that the Commission has the authority to retroactively correct errors in its orders and cites Case No. 10498,²³ in which the Commission granted a rate increase by Order dated October 6, 1989 and an October 17, 1989 Order which corrected an error in the earlier order and granted an additional rate increase with the same effective date as the earlier order. Big Rivers claims that correcting the \$450,000 error in its depreciation expense and awarding it rate case expenses are corrections of

²² September 12, 2012 hearing video at 14:09:40.

²³ Case No. 10498, Adjustment of Rates of Columbia Gas of Kentucky, Inc. (Ky. PSC Oct. 6, 1989).

the types of errors that should be made retroactive. It also claims that denying depreciation on projects in CWIP at the test year-end is an error in applying the matching principle to a historical test year.

KIUC contends that any modification of Big Rivers' rates resulting from rehearing must be made on a prospective basis. It relies on the language of KRS 278.270 to argue that changes in rates are to be prospective only. That statute reads:

Whenever the commission, upon its own motion or upon complaint as provided in KRS 278.260, and after a hearing had upon reasonable notice, finds that any rate is unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any of the provisions of this chapter, the commission shall by order prescribe a just and reasonable rate to be followed in the future. (Emphasis added)

KIUC cites a February 2, 2007 ruling against the Commission by the Kentucky Court of Appeals concerning a decision to require refunds of rates paid by payphone service providers to telecommunications companies ("Telcos"). After finding that the Telcos' rates did not comply with tariff guidelines of the Federal Communications Commission, the Commission adjusted the rates downward and required the Telcos to refund the difference between the old and new rates retroactive to the date of the order approving the old rates. Citing KRS 278.270, the Court stated that:

In light of the General Assembly's comprehensive rate-making scheme, including only a narrowly defined circumstance under which refunds can be ordered, the filed rate can only be lawfully altered prospectively. KRS 278.270, supra. Under the requirements of the statute, the rate the PSC authorized BellSouth to charge payphone service providers remained in full force and effect until the Commission modified it by its order of May 2003. Consequently, as a matter of law, BellSouth was never overpaid; no credits accrued; and no refunds were owed.

Determining the effective date for Big Rivers' new rates involves an analysis of both the filed rate doctrine and our authority to correct clerical errors back to the date of the error. The filed rate doctrine provides that "when the legislature has established a comprehensive ratemaking scheme, the filed rate defines the relationship between the regulated utility and its customer with respect to the rate that the customer is obligated to pay and that the utility is authorized to collect."²⁴ Once the Commission establishes a rate by order, that order "shall continue in force until the expiration of the time, if any, named by the commission in the order, or until revoked or modified by the commission, unless the order is suspended, or vacated in whole or part, by order or decree of a court of competent jurisdiction." KRS 278.390.

Citing these requirements, KIUC argues that the rates in the Rate Order became the filed and lawful rates for service rendered by Big Rivers on and after September 1, 2011 and that they can be changed prospectively only, not retroactive to that date. However, Kentucky Courts have also recognized that the filed rate doctrine does not infringe on the Commission's authority to correct clerical mistakes in its orders, and that those corrections can be made retroactively to the date of its original order.

In the case of *Union Light, Heat & Power Co. v. Public Service Comm'n.*, 271 S.W. 2d 361, 365-366 (Ky. 1954), Kentucky's then highest court held that:

An administrative agency unquestionably has the authority, just as has a court, to reconsider and change its orders during the time it retains control over any question under submission to it. It has been held that an administrative agency has the power to amend or correct its records by nunc pro tunc entries.

²⁴ *Cincinnati Bell v. Kentucky Public Service Comm'n.*, 223 S.W.3d 829 (Ky. App. 2007).

Some years later, the Kentucky Court of Appeals affirmed a Commission order entered without notice or hearing, reducing a previously approved rate and requiring refunds, when the record showed the previously approved rate resulted from a mathematical error.

It is well settled that administrative agencies, as well as courts, have sufficient authority to correct obvious clerical errors in their orders, so long as the mistake is plainly shown in the record.²⁵

Here, the omission of an adjustment in the Rate Order to reflect Big Rivers' rate case expenses is shown by the record, and Big Rivers' request for such an adjustment was not challenged prior to the date of that order. In addition, no party challenges Big Rivers' claim that the Rate Order contains an error in its depreciation expense calculation. Such errors can be corrected retroactively without violating the filed rate doctrine.

Limited exceptions to the filed rate doctrine have also been recognized by federal courts. The U.S. Court of Federal Claims recognized that:

When determining whether a FERC order violates either the filed rate doctrine or the rule against retroactive ratemaking, this court inquires whether, *as a practical matter*, the [parties] ... had sufficient notice that the approved rate was subject to change." Significantly, notice does not mean that the rule against retroactive ratemaking does not apply; rather, notice, such as that provided by a refund effective date, "changes what would be purely retroactive ratemaking into a functionally prospective process by placing the relevant audience on notice at the outset that the rates being promulgated are provisional only and subject to later revision. (Internal quotations and citations omitted).²⁶

²⁵ Mike Little Gas Co. v. Public Service Comm'n., 574 S.W. 2d 926, 927 (Ky. App. 1978).

²⁶ Pacific Gas and Electric Co. v. The United States, 105 Fed. Cl. 420 (Fed. Cl. 2012). (Quoting *Public Utilities Commission of the State of California v. FERC*, 988 F.2d 154, 164 (D.C.Cir.1993).

Here, Big Rivers sought rehearing of the Rate Order within the time allowed under KRS 278.400. Thus, all parties to the case were on notice that there was a claim that one expense adjustment had been omitted and that another contained a mathematical error. While the Commission typically addresses and corrects these types of errors quickly, we were unable to do so because of KIUC's immediate appeal of the Rate Order to Franklin Circuit Court and its challenge of our jurisdiction to proceed with this case administratively. The Court ultimately remanded the rate case back to the Commission, ruling that:

The timely filing of the petition for rehearing at the Commission . . . converted the Commission's order from a final to a non-final order This Court should not attempt to wade into a dispute which has not been finally resolved by the administrative agency with primary jurisdiction in this matter.

As the Court has acknowledged that the Rate Order was not final, the filed rate doctrine does not prevent the correction of clerical errors retroactive to the September 1, 2011, the effective date of the rates approved therein.²⁷

Having considered the parties' arguments and the applicable legal standards, the Commission finds that the correction of these two clerical errors, one an error of omission and the other a mathematical error, that are plainly shown by the record, should be accomplished by adjusting Big Rivers' rates retroactively. The errors were not the result of any action or inaction by Big Rivers, and in this instance it is reasonable to correct the rates effective as of September 1, 2011.²⁸

²⁷ Upon remand from the Court, all issues raised on appeal, including the rate case expense and depreciation error, were set for hearing to ensure that due process was afforded to all parties.

²⁸ Recovery of the amounts Big Rivers is to collect retroactive to September 1, 2011 is discussed in a later section of this Order, titled "Revenue Recovery Mechanism."

KIUC'S REHEARING ISSUES

There are three KIUC rehearing issues, which were part of its appeal of our Rate Order to Franklin Circuit Court. As stated earlier, the Court remanded these issues to the Commission for its consideration on rehearing. The issues, which we address in detail below, are: (1) the appropriate depreciation rates for Big Rivers; (2) the revenue allocation and treatment of the Rural class subsidy; and (3) the demand-side management expense allocation.

Depreciation Rates

In its case-in-chief, KIUC contested the results of Big Rivers' depreciation study and recommended adoption of an alternative set of depreciation rates based on modifications to Big Rivers' depreciation study. In our Rate Order, we authorized the use by Big Rivers of the depreciation rates resulting from its study.²⁹ KIUC requests, on rehearing, that we reverse that earlier decision and authorize Big Rivers to use the depreciation rates recommended by KIUC.

KIUC claims, as it did in the initial phase of this proceeding, that Big Rivers' depreciation study contained numerous inconsistencies and inaccuracies³⁰ and that the study's sponsor, Mr. Ted Kelly of Burns & McDonnell ("B&M"), substituted his judgment for that of Big Rivers' management regarding the useful lives of Big Rivers' generating units.³¹ KIUC contends that the useful lives included in Big Rivers' depreciation study were substantially shorter than the useful lives Big Rivers submitted to the Rural Utilities

²⁹ November 17, 2011 Order at 20.

³⁰ Supplemental Rehearing Testimony and Exhibits of Lane Kollen, at 4.

³¹ *Id.*, at 10.

Service, its principal lender. KIUC states that its depreciation expert's "study corrected the remaining service lives and used the estimates developed by Big Rivers' own management rather than substituting his own judgment."³²

KIUC cites mathematical and process errors contained in a draft of the Big Rivers depreciation study, which Big Rivers had invited KIUC to review prior to the filing of the rate application in this case, as reason to question the reliability of the proposed depreciation rates.³³ KIUC concludes that the depreciation study sponsored by Mr. Kelly on behalf of Big Rivers is fundamentally flawed and unreliable, and that the Commission should reverse its earlier decision on the appropriate depreciation rates for Big Rivers.³⁴

Big Rivers states that the depreciation rates contained in the study prepared by Mr. Kelly and submitted on its behalf as part of its rate application are clearly supported by the evidence in the record of this proceeding. Big Rivers denies KIUC's claim that Big Rivers provided retirement dates or estimated service lives to B&M and that B&M then ignored that data. Contrary to KIUC's claim, Big Rivers asserts that it never provided B&M with retirement dates or estimated service lives for Big Rivers' property.³⁵

Big Rivers argues that since it did not develop estimates of remaining service lives of its generating units, there is no basis for KIUC's claim that its depreciation expert "corrected" the remaining service lives by using estimates developed by Big

³² *Id.*, at 14.

³³ *Id.*, at 13.

³⁴ *Id.*, at 14.

³⁵ Rehearing Rebuttal Testimony of Ted J. Kelly on Behalf of Big Rivers Electric Corporation, at 5.

Rivers' management, rather than the estimates developed by B&M.³⁶ Big Rivers further states that it did not provide B&M with life spans, as claimed by KIUC, nor did Big Rivers provide probable retirement dates to B&M. Finally, Big Rivers contends that the retirement dates used by KIUC's depreciation expert were maximum retirement dates, which causes his results to be biased, incomplete and unusable.³⁷

Based on a review of the issue of depreciation studies, the Commission finds that much of the information submitted into evidence on rehearing is not new; it was previously provided in the initial phase of this proceeding. We reject KIUC's assertions that Big Rivers' depreciation study does not constitute credible evidence and that the estimated useful lives recommended in that study are arbitrary. Big Rivers' expert, B&M, developed estimated service lives based on numerous factors including a B&M engineer assessment, maintenance reports, forced outage reports, and capital budgets. All of these factors supported B&M's adoption of useful lives shorter than the maximum potential lives proposed by KIUC.

As set forth in the Rate Order, our original decision to approve Big Rivers' depreciation study was based substantially on our finding that, "due to the problem of early retirements experienced by Big Rivers since closing the Unwind Transaction, there is a clear need to utilize shorter service lives."³⁸ KIUC has presented no evidence on rehearing to persuade us that this finding was erroneous. Big Rivers' depreciation study fully justifies the use of service lives that are shorter than the maximum potential lives. While the Commission understands KIUC's request for Big Rivers to use the maximum

³⁶ *Id.*, at 6.

³⁷ *Id.*, at 12.

³⁸ November 17, 2011 Order at 20.

service lives, which would result in lower depreciation expense and lower rates, KIUC's proposal is not credible under the facts presented in this case. Therefore, we will affirm our prior decision to authorize Big Rivers to use its proposed depreciation rates based on the depreciation study filed on its behalf by B&M.

Rural Subsidy

In our Rate Order, citing the principal of gradualism, we established rates that reduced the subsidy paid by the Smelter class to the Rural class by \$2.4 million, from \$13.5 million to \$11.1 million.³⁹ On rehearing, KIUC requests that the Commission reconsider that decision and eliminate the subsidy in its entirety,⁴⁰ arguing that unique circumstances exist for Big Rivers and the Smelters which would make eliminating the subsidy in the interest of all customers. The first such circumstance cited by KIUC is Big Rivers' large concentration of risk associated with serving the Smelters. KIUC characterizes this risk as problematic because the Smelters' profitability is directly tied to the price of aluminum, with electricity as their primary production input factor. KIUC claims the subsidy increases the potential for the Smelters to become uneconomic, which would contribute to the potential loss of Smelter load and the loss of revenues to Big Rivers. KIUC further states that this loss would be borne by Big Rivers and its remaining customers.⁴¹

The second unique circumstance KIUC cites is the volatility of the London Metal Exchange's price for aluminum. KIUC contends that this volatility contributes

³⁹ *Id.*, at 29-30.

⁴⁰ Direct Rehearing Testimony of Stephen J. Baron ("Baron Rehearing Testimony") at 3.

⁴¹ *Id.*, at 5-6.

significantly to the operational risk of the Smelters, and risk to Big Rivers and its remaining customers.⁴² KIUC states that, if Big Rivers were to lose the Smelter load and were forced to sell the excess energy in the wholesale market, rates for its Rural class would need to be increased by more than 55 percent to make up the revenue shortfall.⁴³ KIUC contends that if the Smelter load is lost, the Rural class would suffer financial harm that would far exceed the benefit it currently receives from the subsidy, and it characterizes the subsidy as “penny-wise and pound-foolish.”⁴⁴

On rebuttal, Big Rivers states that the Commission’s decision to eliminate the Rural subsidy gradually is “fair, just and reasonable.”⁴⁵ Big Rivers asserts that KIUC’s arguments were available for the Commission’s consideration in its original deliberation and that the November 17, 2011 Order considered the “unique characteristics” of the Smelter load on its system.⁴⁶ It does not agree with KIUC’s claim that the loss of the Smelter load would increase rates for Rural class customers by more than 55 percent. Big Rivers argues that it has previously addressed flaws in some of the assumptions used in the analysis developed by KIUC regarding the 55 percent increase.⁴⁷ Finally, Big Rivers argues that “in the unwind transaction, the smelters agreed to pay non-cost-of-service-based rates.”⁴⁸

⁴² *Id.*, at 7-8.

⁴³ *Id.*, at 8-9.

⁴⁴ *Id.*, at 9.

⁴⁵ Rehearing Rebuttal Testimony of John Wolfram (“Wolfram Rehearing Rebuttal”) at 5.

⁴⁶ *Id.*

⁴⁷ *Id.*, at 6.

⁴⁸ *Id.*, at 8.

In his rehearing brief, the AG expressed his support for the revenue allocation as set forth in the Rate Order, stating that it is consistent with the mandate of KRS 278.030(1) that rates be fair, just, and reasonable.

Based on a review of the record on this issue, the Commission finds no basis to modify the revenue allocation approved in the Rate Order. That revenue allocation reduced the Smelter subsidy by \$2.4 million. The Smelters voluntarily signed long-term power contracts in 2009 which provided for the payment of rates to Big Rivers that would be above cost-of-service. As KIUC has acknowledged, there is no statutory requirement that rates be set based solely on cost of service; determining cost of service is an exercise in judgment; and factors other than cost of service, such as gradualism, can be considered when setting rates.⁴⁹ The Commission has long employed the principal of gradualism in moving rates to reflect cost of service, and we find no reason to depart from that principal in this case.

Demand-Side Management Expense and Revenue Allocation

The Rate Order found that the \$1 million in demand-side management (“DSM”) expense allowed for ratemaking purposes was being assigned only to the Rural class.⁵⁰ KIUC now claims the Rate Order did not fully accomplish that objective. It states that while the Commission adjusted the class cost-of-service study (“COSS”), the specific assignment of the \$1 million would be effective only if the Rural class were paying its full cost of service without subsidies.⁵¹ On rebuttal, Big Rivers disagreed with KIUC, stating

⁴⁹ KIUC Rehearing Brief at 13.

⁵⁰ November 17, 2011 Order at 29.

⁵¹ Baron Rehearing Testimony at 15.

that the Commission can directly assign a particular cost to a class of customers even if that class continues to receive a subsidy.⁵²

The AG, in his rehearing brief, stated that he disagreed with KIUC's position that a portion of the \$1 million DSM costs was assigned to the Smelters. The AG asserted that there is no need for the Commission to change its findings on this point.⁵³

Based on a review of the DSM allocation issue, the Commission partially agrees with KIUC's position, to the extent that we did not accomplish our goal of allocating the entire \$1 million in DSM cost to the Rural class by assigning that cost to the Rural class in the COSS. However, the Commission does not agree that a particular cost cannot be directly assigned to a class of customers if that class continues to receive a subsidy. The \$1 million DSM expense can be allocated fully to the Rural class by first allocating the additional revenue increase, not including the \$1 million DSM expense, to each class based on a targeted subsidy reduction. Then, as a second step, the \$1 million DSM expense is added to the revenue increase to be allocated to the Rural class under the first step. This approach was generally supported by KIUC's witness at the September 12, 2012 rehearing.⁵⁴

Based on our decision to not modify the \$2.4 million subsidy reduction, we will allocate the total revenue increase of \$27,787,311,⁵⁵ excluding the \$1 million DSM expense, to each rate class to produce the Rural class subsidy reduction approved in

⁵² Wolfram Rehearing Rebuttal at 10.

⁵³ *Id.*, at 11.

⁵⁴ September 12, 2012 hearing video at 15:16:35.

⁵⁵ This is the original increase amount of \$26,744,776 granted in the November 17, 2011 Order plus the additional increase of \$1,042,535 granted with this Order.

the Rate Order, and then add \$1 million to the amount of the Rural class rate increase to provide for recovery of the DSM expense. This methodology results in the following rate increases by class: \$11.63 million to the Rural class, \$1.97 million to the Large Industrial Customer class, and \$14.2 million to the Smelter class.

REVENUE RECOVERY MECHANISM

Big Rivers proposed a methodology for recovering the difference between the revenue it collected under the rates in effect since September 1, 2011 and the revenue it would have collected absent the two errors in the Rate Order.⁵⁶ Big Rivers recommends that the difference be divided by the number of months remaining between the date of this Order and August 1, 2013, and that its members be billed this monthly amount on a revenue-proportionate basis through July of 2013. The Commission finds that Big Rivers' proposal is a reasonable method for recovery of the under-collection of revenue since September 1, 2011 attributable to the omission of rate case expenses and the depreciation expense error in the Rate Order. To implement this methodology, Big Rivers must submit the following information to the Commission not later than February 8, 2013:

1. The amount of revenue collected between September 1, 2011, and the date of this Order under the rates approved in the Rate Order (net of refunds made as a result of Big Rivers implementing its proposed rates prior to the issuance of the Rate Order), by rate schedule, and by member cooperative;

⁵⁶ Rehearing Brief of Big Rivers Electric Corporation at 29-30.

2. The amount of revenue it would have collected between September 1, 2011, and the date of this Order under the rates approved herein, by rate schedule, and by member cooperative;

3. The kWh sales by month to each rate class from September 1, 2011 through the date of this Order; and

4. For each month, beginning March 1, 2013 and ending July 31, 2013, the amount each member cooperative will be billed to allow Big Rivers to recover the difference between the amounts provided in parts (1) and (2) above.⁵⁷

After it verifies Big Rivers' calculations, the Commission will issue a final order in this rehearing which will authorize both the amounts Big Rivers is to collect from its member cooperatives and the length of time over which it will collect these amounts.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The November 17, 2011 Rate Order should be modified by increasing the amount of revenue granted therein to Big Rivers from \$26,744,776 to \$27,787,311, an increase of \$1,042,535, to allow for recovery of the level of rate case expenses determined herein to be reasonable and the correction of the mathematical error in the calculation of the depreciation expense adjustment in the Rate Order as discussed herein.

⁵⁷ Big Rivers is to include the workpapers necessary to verify its calculations of each of the amounts it is required to file with the Commission.

2. Big Rivers' rehearing request to increase its depreciation expense allowed for ratemaking purposes to include depreciation expense on plant contained in its test year-end Construction Work In Progress should be denied.

3. The finding in the Rate Order regarding the financial model Big Rivers used in conjunction with the Unwind Transaction should be revised as discussed herein.

4. KIUC's rehearing requests to have Big Rivers' rates calculated on the basis of depreciation rates proposed by KIUC, rather than those proposed by Big Rivers, and to modify the revenue allocation and Rural class subsidy, should be denied.

5. KIUC's rehearing request to revise the methodology for allocation of the \$1 million DSM expense should be granted as discussed herein.

6. The rates approved herein should be effective for service rendered by Big Rivers on and after September 1, 2011.

7. Big Rivers should file with the Commission not later than February 8, 2013, the information described in the Revenue Recovery Mechanism section of this Order.

IT IS THEREFORE ORDERED that:

1. The November 17, 2011 Rate Order is modified to (a) grant Big Rivers an additional increase in annual revenues of \$1,042,535 above the revenue increase granted therein; (b) reflect the revised allocation of the \$1 million DSM expense; and (c) correct the finding related to the financial model Big Rivers used in conjunction with the Unwind Transaction, as discussed in the findings above.

2. The rates in the appendix to this Order are approved for service rendered by Big Rivers on and after September 1, 2011.

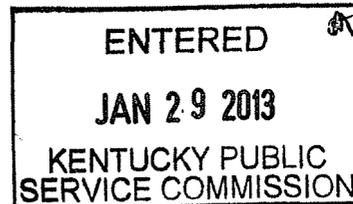
3. Big Rivers' request to modify the November 17, 2011 Order to include depreciation expense on plant contained in its year-end Construction Work In Progress is denied.

4. KIUC's requests to modify the November 17, 2011 Order to adopt the KIUC proposed depreciation rates and to revise the revenue allocation to eliminate the Rural class subsidy are denied.

5. Within 20 days of the date of this Order, Big Rivers shall file with this Commission, using the Commission's electronic Tariff Filing System, new tariff sheets setting forth the rates and charges approved herein and reflecting their effective date and that they were authorized by this Order.

6. Not later than February 8, 2013, Big Rivers shall file the information described in the Revenue Recovery Mechanism section of this Order.

By the Commission



ATTEST:

Executive Director

A handwritten signature in black ink, written over a horizontal line. The signature is cursive and appears to be the name of the Executive Director.

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2011-00036 DATED **JAN 29 2013**

The following rates and charges are prescribed for the customers in the area served by Big Rivers Electric Corporation. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

RURAL DELIVERY SERVICE
FORMERLY SCHEDULE C.4.d(2)

Demand Charge	\$ 9.697
Energy Charge per kWh	\$.029736

LARGE INDUSTRIAL CUSTOMER
FORMERLY SCHEDULE C.7.c(2)(b)

Demand Charge	\$ 10.50
Energy Charge per kWh	\$.024508

COGENERATION/SMALL POWER PRODUCTION SALES – OVER 100 kW
FORMERLY SCHEDULE 9f(3)(1)

Demand Charge - Weekly	\$ 2.238
Energy Charge per kWh	\$.029736

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