COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY	)	
UTILITIES COMPANY FOR AN	)	CASE NO. 2012-00221
ADJUSTMENT OF ITS ELECTRIC	)	
RATES	)	

PREFILED DIRECT TESTIMONY OF
KEVIN C. HIGGINS
ON BEHALF OF THE KROGER CO.

October 3, 2012

DIRECT TESTIMONY OF KEVIN C. HIGGINS

Introduction

Q. Please state your name and business address.

A. My name is Kevin C. Higgins. My business address is 215 South State Street, Suite 200, Salt Lake City, Utah, 84111.

Q. By whom are you employed and in what capacity?

A. I am a Principal in the firm of Energy Strategies, LLC. Energy Strategies is a private consulting firm specializing in economic and policy analysis applicable to energy production, transportation, and consumption.

Q. On whose behalf are you testifying in this proceeding?

A. My testimony is being sponsored by The Kroger Co. ("Kroger"). Kroger is one of the largest retail grocers in the United States, and operates over sixty stores and other facilities in the territory served by Kentucky Utilities Company ("KU"). These facilities purchase in excess of 100 million kilowatt-hours (kWh) annually from KU.

Q. Please describe your professional experience and qualifications.

A. My academic background is in economics, and I have completed all coursework and field examinations toward a Ph.D. in Economics at the University of Utah. In addition, I have served on the adjunct faculties of both the University of Utah and Westminster College, where I taught undergraduate and graduate courses in economics. I joined Energy Strategies in 1995, where I assist private and public sector clients in the areas of energy-related economic and policy analysis, including evaluation of electric and gas utility rate matters.

Prior to joining Energy Strategies, I held policy positions in state and local government. From 1983 to 1990, I was economist, then assistant director, for the Utah Energy Office, where I helped develop and implement state energy policy. From 1991 to 1994, I was chief of staff to the chairman of the Salt Lake County Commission, where I was responsible for development and implementation of a broad spectrum of public policy at the local government level.

Q. Have you previously testified before this Commission?

A. Yes. I filed testimony in the Duke Energy Kentucky Energy Efficiency Plan docket, Case No. 2008-00495; the Kentucky Utilities Company 2008 base rate case, Case No. 2008-00251; the Louisville Gas and Electric Company 2008 base rate case, Case No. 2008-00252; the Commission's generic DSM docket, Administrative Case No. 2007-00477; the Duke Energy Kentucky 2006 base rate case, Case No. 2006-00172; the East Kentucky Power Cooperative 2006 base rate case, Case No. 2006-00472; the Kentucky Utilities Company 2003 base rate case, Case No. 2003-00434; and the Louisville Gas and Electric Company 2003 base rate case, Case No. 2003-00433.

Q. Have you testified previously before any other state utility regulatory commissions?

A. Yes. I have testified in approximately 150 other proceedings on the subjects of utility rates and regulatory policy before state utility regulators in Alaska, Arkansas, Arizona, Colorado, Georgia, Idaho, Illinois, Indiana, Kansas, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Utah, Virginia, Washington, West Virginia, and Wyoming. I have also filed affidavits in proceedings at the Federal Energy Regulatory Commission.

<u>Overview and Recommendations</u>

Q. What is the purpose of your testimony in this proceeding?

A. My testimony addresses the following issues:

(1) The spread of any change in KU's revenue requirement across customer classes;

(2) The proper adjustments to Storm Damage expense and Injuries and Damages expense for the test period; and

(3) The ratemaking treatment of off-system sales margins.

Q. Please summarize your conclusions and recommendations.

(1) KU's rate spread proposal is generally based on an across-the-board equal percentage increase coupled with the removal of 15 percent of the inter-class subsidies in current rates. This degree of subsidy removal should be considered the minimum reasonable amount. A more robust movement toward cost-based rates, e.g. 25 to 33 percent subsidy removal, would also be reasonable and would represent a more genuine commitment to aligning class rates with cost causation. If the Commission adopts an alternative rate spread, I recommend that it result in each class being no further from cost-based rates than occurs in KU's proposal.

(2) If the revenue requirement approved by the Commission is less than that requested by KU, then the Commission should give even greater consideration to increasing the amount of subsidy removal beyond the 15 percent recommended by KU.

(3) The test period expenses for Storm Damage expense and Injuries and Damages expense should be adjusted to reflect the true ten-year average levels for these expenses (adjusted for inflation) rather than the Company's filed proposal, which double-

weights the last nine months of 2011. The net impact of these two adjustments is to decrease the Kentucky jurisdictional revenue requirement by $332,436.

(4) The Commission should adopt a rider that tracks deviations in KU's off-system sales margins relative to the baseline margins approved in a general rate proceeding, and either credits or charges customers for a reasonable portion of this deviation. This proposed rider can be patterned after a similar rider approved for Kentucky Power. I recommend that the benefit or cost of this deviation be apportioned 70 percent to customers and 30 percent to the Company.

Rate Spread

Q. What general guidelines should be employed in spreading any change in rates?

A. In determining the spread of any revenue change, it is important to align rates with cost causation, to the greatest extent practicable. Properly aligning rates with the costs caused by each customer group ensures fairness by minimizing cross subsidies among customer classes. It also sends proper price signals, which improves efficiency in resource utilization.

At the same time, it may be appropriate to use the principle of "gradualism" to mitigate the impact of moving to cost-based rates for customer groups that would experience significant rate increases. However, the use of "gradualism" should not prevent a long-term strategy of moving in the direction of cost causation, nor should it result in spread decisions that result in permanent cross-subsidies from other customers.

Q. What general approach to electric rate spread does KU recommend?

A. As described by KU witness Robert M. Conroy, the Company is proposing a multi-step approach to spreading its proposed rate increase. First, KU allocated the increase across all rate schedules in an equal percentage. Second, KU adjusted the revenue allocation to eliminate 15 percent of the subsidy received/(provided) between rate classes. Finally, given that the Rate PS Secondary class had a significantly higher rate of return than the other classes, KU made a further adjustment to lower the allocation to this class of customers.[1]

Q. What is your assessment of KU's proposed approach to rate spread?

A. The 15 percent subsidy removal proposed by KU is extremely modest and should be considered the minimum reasonable reduction in inter-class subsidization undertaken in this proceeding. A more robust reduction in inter-class subsidization, e.g. 25 to 33 percent, would also be reasonable and would demonstrate a more genuine commitment to moving toward cost-based rates. If the Commission adopts an alternative rate spread, I recommend that it result in each class being no further from cost-based rates than occurs in KU's proposal.

Q. What do you recommend if the revenue requirement approved by the Commission is less than that requested by KU?

A. If the revenue requirement approved by the Commission is less than that requested by KU, then the Commission should give even greater consideration to increasing the amount of subsidy removal beyond the 15 percent recommended by KU. If the overall revenue requirement is reduced relative to KU's proposal, greater subsidy removal can be achieved without increasing the rate impact on any class beyond what KU recommends in its initial filing.

[1] Direct testimony of Robert M. Conroy, pp. 28-29.

<u>Adjustment to Storm Damage Expense</u>

Q. Please describe KU's method for calculating its storm damage expense.

A. The Company's adjustment to storm damage expense is based on a "ten year average" of inflation-adjusted expenses. However, as noted on KU Reference Schedule 1.15, and confirmed in KU's response to The Kroger Co.'s Data Request 1.4, the methodology used by KU to compute the ten-year average storm damage expense is a normalization adjustment that includes the nine months from April to December 2011 in both the 12 months ending December 2011 and the 12 months ending March 2012.

Q. Is the Company's method appropriate for calculating a ten-year average?

A. No. The Company's method double-weights expenses incurred during the last nine months of 2011 by including them in both the twelve months ended December 2011 and twelve months ended March 2012 figures.

Q. Please explain your adjustment to storm damage expense.

A. My adjustment uses a true ten-year average of inflation-adjusted expenses, without double-counting any time periods, to calculate the normalized level of storm damage expense, using expenses incurred during the years 2002 through 2011. This adjustment is presented in Higgins Exhibit 1.

Q. What is the revenue requirement impact of your adjustment to Storm Damage expense?

A. The impact of this adjustment is to decrease the Kentucky jurisdictional revenue requirement by $296,881.

Adjustment to Injuries and Damages Expense

Q. Please explain your adjustment to Injuries and Damages expense.

A. As with the Company's treatment of Storm Damage expense, the methodology used by KU to compute the ten-year average storm damage expense is a normalization adjustment that includes the nine months from April to December 2011 in both the 12 months ending December 2011 and the 12 months ending March 2012. Thus, the Company's approach double-weights expenses incurred during the last nine months of 2011 by including them in both the twelve months ended December 2011 and twelve months ended March 2012 figures.

As with my adjustment to Storm Damage expense, my adjustment to Injuries and Damages expense a true ten-year average of inflation-adjusted expenses, without double-counting any time periods, to calculate the normalized level of storm damage expense, using expenses incurred during the years 2002 through 2011. This adjustment is presented in Higgins Exhibit 2.

Q. What is the revenue requirement impact of your adjustment to Injuries and Damages expense?

A. The impact of this adjustment is to decrease the Kentucky jurisdictional revenue requirement by $35,555.

Ratemaking Treatment of Off-System Sales Margins

Q. What ratemaking treatment has KU proposed for off-system sales margins?

A. KU's test period off-system sales margins are credited against the revenue requirement that is proposed to be recovered from customers. Based on my review of

KU's tariff, it is my understanding that, as a general matter, to the extent that actual off-system sales margins in the rate-effective period deviate from the level of off-system sales margins used in setting rates, the difference is either absorbed by or retained by the Company.

In this proceeding, KU is proposing to adjust the test period margins significantly downward for the purpose of setting rates. KU argues that such an adjustment is justified because post-test-period actual margins have fallen off relative to the test period margins. According to KU witness Paul W. Thompson, the Company expects this trend to continue due to low natural gas prices and the changing structure of its generating fleet.[2]

Such an adjustment, if approved, would reduce the Company's exposure to the risk that off-system sales margins in the rate-effective period may remain significantly below test period levels. At the same time, if the adjustment is approved and off-system sales rebound, the full benefit of the rebound in sales would accrue to the Company and not to customers.

Q. Do you have any comments regarding the Company's proposed adjustment?

A. Yes. The post-test-year off-system sales margins reported by KU appear to confirm the Company's contention that margins are declining relative to the test period. However, at the same time, I find the adjustment proposed by the Company to be troubling from a big-picture perspective. The use of a test period is intended to capture a large number of cost and revenue items, many of which are interrelated, and most of which are subject to some degree of variability going forward. Off-system sales margins, in particular, are subject to considerable variability from year to year, as shown in the table presented on page 14 of Mr. Thompson's testimony. Selectively adjusting a single

[2] Direct testimony of Paul W. Thompson, pp. 14-16.

item from the test period, such as off-system sales margins, when its trajectory is downward and the adjustment would produce a more favorable outcome for the utility than use of test period values, introduces the potential for structural bias in the ratemaking process. The utility has a considerable information advantage over other parties with respect to its own operations, and is in the best position to advocate for selective departures from test period values when it serves its financial interest to do so.

Q. What course of action do you recommend?

A. One means to mitigate against this potential structural bias, at least as it pertains to off-system sales margins, is to introduce a tracking mechanism that would track deviations in KU's off-system sales margins relative to the baseline margins approved in a general rate proceeding, and either credit or charge customers for a reasonable portion of this deviation. I recommend that the benefit or cost of this deviation be apportioned 70 percent to customers and 30 percent to the Company. This sharing ratio would pass most of the deviation in margins through to customers, while retaining a healthy financial incentive for the utility to maximize its off-system sales margins.

In the case at hand, if KU's adjustment to off-system sales margins is approved, and off-system sales rebound, customers would enjoy the benefit of 70 percent of the incremental margins if my proposal is adopted. Significantly, even if KU's adjustment is <u>not</u> approved, the adoption of this mechanism would mitigate the impact *on the Company* of a reduced level of margins, in that 70 percent of the reduction in margins would be charged to customers.

Q. Is there precedent in Kentucky for such a rider?

A. Yes. There is such a rider in Kentucky Power's tariff. It is called Tariff S.S.C. – the System Sales Clause. Tariff S.S.C. establishes a monthly baseline for off-system sales margins. When actual monthly margins deviate from the baseline, 60 percent of the difference is credited or charged to customers, and 40 percent of the difference is retained or absorbed by Kentucky Power. Based on my review of the record pertaining to this rider, it is my understanding that this sharing ratio has also been set at 50/50 and 70/30 at various times in the past.

I believe the basic structure of Tariff S.S.C. forms a reasonable template for establishing a similar rider for KU. While I am recommending adoption of the 70/30 sharing ratio because I believe it best balances the interests of customers and shareholders, I also consider the 60/40 sharing ratio currently in effect for Kentucky Power to be within the range of reasonableness.

Q. Does this conclude your direct testimony?

A. Yes, it does.

VERIFICATION

STATE OF UTAH)
) SS:
COUNTY OF SALT LAKE)

The undersigned, **Kevin C. Higgins**, being duly sworn, deposes and says that he is a Principal in the firm of Energy Strategies, LLC, that he has personal knowledge of the matters set forth in the foregoing testimony and exhibits, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

____
Kevin C. Higgins

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 26th day of September, 2012.

Danika Holmes (SEAL)
Notary Public

My Commission Expires:
2.07.2015

Notary Public
DANIKA HOLMES
Commission #606101
My Commission Expires
February 07, 2015
State of Utah

Kroger Adjustment to Storm Damage Expense
Reflecting Ten-Year Average, 2002 to 2011.

Line No.		
1	KU As-Filed Storm Damage Provision [1]	$4,107,435
2	Ten-Year Average Storm Damage Expense [2]	$3,791,890
3	Kroger Adjustment to Storm Damage Provision	($315,545)
4	Kentucky Jurisdictional Allocator	94.085%
5	Kentucky Jurisdictional Adjustment	($296,881)

Data Sources:

1. As-Filed KU Reference Schedule 1.15.
2. Attachment to KU Response to Kroger Data Request 1.5.

AS-FILED KU METHOD
Adjustment to Reflect Normalized Storm Damage Expense
For the Twelve Months Ended March 31, 2012

1. Storm damage provision based upon ten year average -- Calculated by KU	$	4,107,435
2. Storm damage expenses incurred during the 12 months ended March 31, 2012		4,994,206
3. Adjustment		(886,771)
4. Kentucky Jurisdiction		94.085%
5. Kentucky Jurisdictional adjustment	$	(834,318)

Year		Expense (a)		CPI-All Urban Consumers		Amount
2012	$	4,994,206		1.0000	$	4,994,206
2011		3,998,403		1.0069		4,025,992
2010		2,626,597		1.0387		2,728,246
2009		5,225,248	(b)	1.0558		5,516,817
2008		6,951,799	(b)	1.0520		7,313,293
2007		2,035,291		1.0924		2,223,352
2006		4,113,534		1.1235		4,621,555
2005		2,539,379		1.1598		2,945,172
2004		4,120,482		1.1990		4,940,458
2003		1,434,000		1.2310		1,765,254
Total					$	41,074,345
Ten Year Average					$	4,107,435

(a) 2012 expense is for 12 months ended March 31, 2012.
All other years expenses are for calendar year.

(b) 2008 and 2009 expenses do not include 2008 Wind Storm and 2009 Winter Storm expenses that were recorded as regulatory assets.

Data Source: As-Filed KU Reference Schedule 1.15.

TEN-YEAR AVERAGE
Kroger Adjustment to Reflect Normalized Storm Damage Expense
For the Twelve Months Ended March 31, 2012

1. Storm damage provision based upon ten year average -- As corrected by Kroger	$	3,791,890
2. Storm damage expenses incurred during the 12 months ended March 31, 2012		4,994,206
3. Adjustment		(1,202,316)
4. Kentucky Jurisdiction		94.085%
5. Kentucky Jurisdictional adjustment	$	(1,131,199)

Year		Expense (a)		CPI-All Urban Consumers		Amount
2011	$	3,998,403		1.0069	$	4,025,992
2010		2,626,597		1.0387		2,728,246
2009		5,225,248	(b)	1.0558		5,516,817
2008		6,951,799	(b)	1.0520		7,313,293
2007		2,035,291		1.0924		2,223,352
2006		4,113,534		1.1235		4,621,555
2005		2,539,379		1.1598		2,945,172
2004		4,120,482		1.1990		4,940,458
2003		1,434,000		1.2310		1,765,254
2002		1,460,495		1.2590		1,838,763
Total					$	37,918,902
Ten Year Average					$	3,791,890

(a) Expenses are for calendar year.

(b) 2008 and 2009 expenses do not include 2008 Wind Storm and 2009 Winter Storm expenses that were recorded as regulatory assets.

Data Source: Attachment to KU Response to Kroger 1.5.

Kroger Adjustment to Injuries & Damages Expense
Reflecting Ten-Year Average, 2002 to 2011

Line No.		
1	KU As-Filed Injury/Damage Provision [1]	$2,174,114
2	Ten-Year Average Injury/Damage Expense [2]	$2,134,137
3	Kroger Adjustment to Injuries/Damage Provision	($39,977)
4	Kentucky Jurisdictional Allocator	88.94%
5	Kentucky Jurisdictional Adjustment	($35,555)

Data Sources:
1. As-Filed KU Reference Schedule 1.16.
2. Data Source: Attachment to KU Response to Kroger Data Request 1.7.

AS-FILED KU METHOD

Adjustment for Injuries and Damages Expense

<u>For the Twelve Months Ended March 31, 2012</u>

1. Injury/Damage provision based upon ten year average -- Calculated by KU	$	2,174,114
2. Injury/Damage expenses incurred during the 12 months ended March 31, 2012		3,560,504
3. Adjustment		(1,386,390)
4. Kentucky Jurisdiction (Ref. Sch. Allocators)		88.938%
5. Kentucky Jurisdictional adjustment	$	(1,233,028)

Year		Amount (a)	CPI-All Urban Consumers		Adjusted Amount
2012	$	3,560,504	1.0000	$	3,560,504
2011		3,080,346	1.0069		3,101,601
2010		2,451,761	1.0387		2,546,644
2009		1,840,625	1.0558		1,943,332
2008		1,226,235	1.0520		1,289,999
2007		1,178,212	1.0924		1,287,079
2006		1,690,654	1.1235		1,899,450
2005		2,268,036	1.1598		2,630,468
2004		1,080,732	1.1990		1,295,798
2003		1,776,006	1.2310		2,186,263
Total				$	21,741,138
Ten Year Average				$	2,174,114

(a) 2012 expense is for 12 months ended March 31, 2012.

All other years expenses are for calendar year.

TEN-YEAR AVERAGE
Adjustment for Injuries and Damages Expense
For the Twelve Months Ended March 31, 2012

1. Injury/Damage provision based upon ten year average -- As corrected by Kroger	$	2,134,137
2. Injury/Damage expenses incurred during the 12 months ended March 31, 2012		3,560,504
3. Adjustment		(1,426,367)
4. Kentucky Jurisdiction (Ref. Sch. Allocators)		88.938%
5. Kentucky Jurisdictional adjustment	$	(1,268,582)

Year	Amount (a)	CPI-All Urban Consumers	Adjusted Amount
2011	$ 3,080,346	1.0069	$ 3,101,601
2010	2,451,761	1.0387	2,546,644
2009	1,840,625	1.0558	1,943,332
2008	1,226,235	1.0520	1,289,999
2007	1,178,212	1.0924	1,287,079
2006	1,690,654	1.1235	1,899,450
2005	2,268,036	1.1598	2,630,468
2004	1,080,732	1.1990	1,295,798
2003	1,776,006	1.2310	2,186,263
2002	2,510,515	1.2590	3,160,738
Total			$ 21,341,372
Ten Year Average			$ 2,134,137

(a) Expenses are for calendar year.

Data Source: Attachment to KU Response to Kroger Data Request 1.7.