

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY)
UTILITIES COMPANY FOR AN) **CASE NO. 2014-00371**
ADJUSTMENT OF ITS ELECTRIC)
RATES)

PREFILED DIRECT TESTIMONY OF
NEAL TOWNSEND
ON BEHALF OF THE KROGER CO.

March 6, 2015

1 **DIRECT TESTIMONY OF NEAL TOWNSEND**

2 **Introduction**

3 **Q. Please state your name and business address.**

4 A. My name is Neal Townsend. My business address is 215 South State Street, Suite
5 200, Salt Lake City, Utah, 84111.

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

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

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

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

15 **Q. Please describe your professional experience and qualifications.**

16 A. I have provided regulatory and technical support on a variety of energy projects at
17 Energy Strategies since I joined the firm in 2001. Prior to my employment at Energy
18 Strategies, I was employed by the Utah Division of Public Utilities as a Rate Analyst
19 from 1998 to 2001. I have also worked in the aerospace, oil and natural gas industries.

20 **Q. Have you previously testified before this Commission?**

21 A. Yes. I filed testimony in KU's 2009 base rate case, Case No. 2009-00548 and
22 Louisville Gas and Electric Company's 2009 base rate case, Case No. 2009-00549.

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

1 A. Yes. I have testified in utility regulatory proceedings before the Arkansas Public
2 Service Commission, the Illinois Commerce Commission, the Indiana Utility Regulatory
3 Commission, the Michigan Public Service Commission, the Public Utilities Commission
4 of Ohio, the Public Utility Commission of Oregon, the Public Utility Commission of
5 Texas, the Utah Public Service Commission, the Virginia Corporation Commission, and
6 the Public Service Commission of West Virginia. A more detailed description of my
7 qualifications is contained in Attachment A, attached to this testimony.

8
9 **Overview and Recommendations**

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

11 A. My testimony addresses the following issues:

12 (1) The recognition of the impact of bonus tax depreciation on KU's revenue
13 requirement; and

14 (2) KU's inclusion of inflation in calculating its forecasted test period non-labor
15 O&M expenses.

16 **Q. Please summarize your conclusions and recommendations.**

17 (1) I recommend that KU's revenue requirement should be reduced to reflect the
18 optimal ratepayer impact of extended bonus tax depreciation as a result of the passage of
19 the Tax Increase Prevention Act of 2014.

20 (2) I recommend that general inflation should be removed from KU's non-fuel,
21 non-labor O&M expense.

1 **Bonus Tax Depreciation**

2 **Q. What is bonus tax depreciation?**

3 A. Bonus tax depreciation refers to a greatly accelerated tax deduction for
4 depreciation that has been permitted pursuant to several statutes signed into law in recent
5 years to stimulate the economy. Bonus tax depreciation was permitted in the early 2000s
6 and reintroduced in 2008 and 2009 pursuant to the Economic Stimulus Act of 2008 and
7 the American Recovery and Reinvestment Act of 2009. Generally, these acts permitted a
8 first-year depreciation tax deduction equal to 50 percent of the cost of qualified property.
9 According to the provisions of the American Recovery and Reinvestment Act of 2009,
10 bonus tax depreciation was initially scheduled to end on December 31, 2009.

11 **Q. Was bonus tax depreciation extended beyond 2009?**

12 A. Yes. Bonus tax depreciation was subsequently extended by the passage of new
13 legislation. First, on September 27, 2010, the Small Business Jobs Act was signed into
14 law. This act extended 50 percent bonus tax depreciation through December 31, 2010.
15 Then, on December 17, 2010, the Tax Relief, Unemployment Insurance and Job Creation
16 Act of 2010 was signed into law. This act increased bonus tax depreciation from 50
17 percent to 100 percent for qualified property acquired and placed into service on or after
18 September 9, 2010 through December 31, 2011. In addition, 50 percent bonus tax
19 depreciation was extended from January 1, 2012 through December 31, 2012. Then, with
20 passage the American Taxpayer Relief Act of 2012, 50 percent bonus tax depreciation
21 was extended through December 31, 2013.

22 **Q. Has bonus tax depreciation been extended beyond December 31, 2013?**

1 A. Yes. The US House of Representatives passed the Tax Increase Prevention Act of
2 2014, HR 5771, in early December 2014, which among other things, extends 50 percent
3 bonus tax depreciation through December 31, 2014, and also allows for bonus tax
4 depreciation under certain circumstances for qualified property placed into service
5 through December 31, 2015. On December 16, 2014, this bill was passed by the Senate,
6 and it was signed into law by the President on December 19, 2014.

7 **Q. How does bonus tax depreciation impact ratemaking for regulated utilities?**

8 A. Bonus tax depreciation is a form of accelerated tax depreciation. Regulatory
9 authorities, including this Commission, have long recognized that utility depreciation for
10 tax purposes differs from utility book depreciation used in ratemaking. The timing
11 difference between tax depreciation and book depreciation is recognized through the
12 recording of accumulated deferred income tax (“ADIT”). Generally, the tax benefits of
13 accelerated depreciation are not passed through *directly* to ratepayers, but rather certain
14 indirect benefits are recognized through the determination of rate base. According to the
15 conventions of income tax normalization, the benefit of a utility’s ADIT is viewed as a
16 source of zero-cost capital to the utility as part of the ratemaking process. Consequently,
17 the ADIT that results from accelerated tax depreciation is booked as a credit against rate
18 base, thereby reducing revenue requirements for customers.

19 Even though bonus tax depreciation affects rates through the same mechanics as
20 standard accelerated depreciation, its impact is more dramatic than standard accelerated
21 depreciation in the years immediately following the placement of the qualifying plant into
22 service. This is because bonus tax depreciation causes a much greater increase in ADIT,
23 which in turn, produces a much greater credit against rate base for any given amount of

1 new plant in service. This, in turn, reduces the revenue requirement relative to what it
2 would have been if bonus tax depreciation were not applicable.

3 **Q. Why is the extension of bonus tax depreciation relevant for this proceeding?**

4 A. Bonus tax depreciation has a material impact on utility revenue requirements.
5 Currently, KU's rate case has been filed under the assumption that bonus tax depreciation
6 would not be available in 2014. Since it is now known that bonus tax depreciation is
7 applicable through the end of 2014, it is necessary to properly reflect the ratemaking
8 impact of this tax change, which effectively reduces KU's rate base for plant added in
9 2014.

10 **Q. Has KU provided information regarding the revenue requirement impact of
11 extending bonus tax depreciation?**

12 A. Yes. In response to a request for information, KU indicated that the optimal
13 outcome for ratepayers would result from KU electing to use bonus tax depreciation in
14 2014, but not in 2015. According to KU's response, under this scenario, KU's filed
15 revenue requirement increase would be reduced by \$4 million, and there would also be an
16 incremental decrease to ECR rate mechanism in the forecasted period of \$2 million.¹

17 **Q. What is your recommendation to the Commission on recognizing the revenue
18 requirement impact of extended bonus tax depreciation?**

19 A. The extension of bonus tax depreciation illustrates one of the hazards of using a
20 forecasted test period: material changes in circumstances can have implications for
21 revenue requirement that were not anticipated when the test period projections were put
22 together. KU's revenue requirement for the forecasted test period ending June 30, 2016
23 should be adjusted to reflect the optimal ratepayer impact of taking bonus tax

¹ KU's response to AG 1-27 and Attachment to KU_AG_1-27a.

1 depreciation into account. The extension of bonus tax depreciation also has implications
2 to the results reflected in the base period ended February 28, 2015, based on 2014
3 additions to plant in service. KU has indicated that, by April 14, 2015, it will update the
4 base period information reflecting actual data through February 1, 2015.² I would expect
5 this updated filing would reflect the bonus tax depreciation impacts as well.

6
7 **Inflation**

8 **Q. Has the Company included any inflation assumptions in the development of its**
9 **forecasted test period non-fuel, non-labor O&M expenses?**

10 A. Yes. In responses to requests for information, KU explained that it includes
11 annual inflation of 2.0% for non-labor costs in those segments of its Business Plan where
12 better information is not available. In cases where the general inflation rate is used, it is
13 typically applied to the most recent full year of actual results, which is 2013 in this case.
14 Effectively, this 2.0% annual inflation rate would compound over the duration of the
15 forecast. While KU has acknowledged that it utilized an inflation assumption, the
16 Company was not able to quantify the amount of inflation included in its forecasted test
17 period revenue requirement.³

18 **Q. Have you estimated the amount of inflation included in KU's forecasted test period**
19 **revenue requirement?**

20 A. Yes, I have. I estimate that 2.0% average annual inflation, compounded over the
21 period between mid-2013 and mid-forecasted test period, results in a compounded
22 average inflation rate of 5.1%. That is, in instances where KU has applied an inflation

² Testimony of Kent W. Blake, p. 25, lns. 9-12.

³ KU Responses to Kroger RFIs 1-7 and 2-5.

1 escalator to O&M expense segments, these costs would be inflated by approximately
2 5.1% from the average 2013 level of costs.

3 In responses to requests for information, KU provided five factors that it takes
4 into consideration when developing its Business Plan, as well as the amounts of non-
5 labor O&M expense that these factors comprise.⁴ These factors are: known contracts,
6 specific scopes of work, variable costs based on levels of production, storm outage
7 restoration costs, and bad debt expense. In order to estimate the amount of generic
8 inflation included in the forecasted test period revenue requirement, I subtracted the
9 amounts attributable to these factors from total non-fuel, non-labor O&M expense. I
10 assumed that the remaining non-fuel, non-labor O&M expense, to which the more
11 specific forecasting factors did not apply, was potentially subject to KU's generic
12 inflation assumption. Using this method, I estimated that approximately \$2.1 million of
13 non-fuel, non-labor O&M expense inflation was included in KU's forecasted test period
14 revenue requirement calculation. This calculation is presented in Exhibit NT-1.

15 **Q. Please explain your concerns regarding the inclusion of general inflation**
16 **assumptions in a forecasted test period.**

17 A. From a ratemaking perspective, I have two serious concerns with KU's inclusion
18 of inflation in its forecasted test period revenue requirement.

19 First, at a broad policy level, I have concerns about regulatory pricing
20 formulations that reinforce inflation. This occurs when *projections* of inflation are built
21 into formulas that are used to set administratively-determined prices, such as utility rates.
22 Such pricing mechanisms help to make inflation a self-fulfilling prophecy. As a matter
23 of public policy, this is a serious concern. It is one thing to adjust for inflation after the

⁴ KU Responses to Kroger RFIs 1-7(b) and 2-7.

1 fact; it is another to help guarantee it. For this reason, I believe that regulators should use
2 extreme caution before approving prices that guarantee inflation before it occurs.

3 **Q. What is your second major concern?**

4 A. A related, but distinct, concern involves the building of this “cost cushion” into
5 the Company’s test period costs. Allowing this type of systemic uplift in rates goes well
6 beyond the basic rationale advanced by advocates for using a projected test period, which
7 is to ameliorate the effect of regulatory lag on the recovery of investment in new plant.

8 **Q. Please explain.**

9 A. The primary justification for utilizing a projected test period is to allow a utility
10 with expanding rate base the ability to avoid regulatory lag; that is, the use of a projected
11 test period is intended to provide a utility a better opportunity to recover its investment
12 cost than might occur with an historical test period.

13 By including inflation in its non-labor O&M expenses, KU is attempting to go
14 well beyond simply aligning the test period with its projected 2015-16 investment to
15 mitigate regulatory lag; the Company is also attempting to gain an additional benefit by
16 inflating its baseline costs by applying an inflation factor. KU should not be rewarded for
17 the use of a forecasted test period with a windfall mark-up of its baseline costs. The
18 Commission should not allow the utilization of a forward-looking test period to also
19 become a vehicle for utility recovery of such “pseudo costs.”

20 The best evidence of what it costs KU for non-labor O&M is the Company’s
21 actual costs recorded in the historical period, adjusted for certain known and measurable
22 changes. The cost increases represented by KU’s inflation assumption may or may not
23 come to fruition. In any case, KU should be expected to strive to improve its O&M

1 efficiency on a continuous basis, and thereby lessen the net impact of inflation on its
2 O&M costs. It is not reasonable to simply gross up the Company's historical period costs
3 by an inflation factor and pass these costs on to customers.

4 **Q. What are the limited situations in which projected inflation should be considered in**
5 **ratemaking?**

6 A. The United States experienced major inflation during the late 1970s. In that type
7 of severe increasing-cost environment, some consideration for O&M inflation in a
8 forecasted test period would probably be necessary. However, we are very far from such
9 a cost environment. Inflation in the United States has been at very low levels for several
10 years. The prospects for core inflation, which excludes the relatively volatile pricing
11 components of energy and food, remain subdued.

12 **Q. Can you cite to any independent sources to support your contention that the**
13 **prospects for core inflation remain subdued?**

14 A. Yes. I have reviewed the Minutes of the Federal Open Market Committee for
15 December 16-17, 2014. The published Minutes of that meeting indicate that the Fed's
16 central tendency forecast for Core personal consumption expenditures (PCE) inflation is
17 1.5% to 1.8% for 2015 and 1.7% to 2.0% for 2016.⁵ The Congressional Budget Office
18 January 2015 forecast for Core inflation is 1.8% to 2.1% in 2015 and 1.9% to 2.2% in
19 2016.⁶

20 **Q. What alternative for establishing non-labor O&M expense for the forecasted test**
21 **period do you recommend?**

⁵ Minutes of the Federal Open Market Committee December 16-17, 2014, Table 1.

⁶ The Budget and Economic Outlook: 2015 to 2025, Table 2-1, inflation forecast for Core PCE price index and Core consumer price index.

1 A. I recommend removing general inflation, which I estimate at \$2.1 million, from
2 KU's forecasted test period non-labor O&M expense.

3 **Q. Does this conclude your direct testimony?**

4 A. Yes, it does.

5

Kroger Estimated Impact of Removing Non-Fuel, Non-Labor O&M Inflation - Kentucky Utilities Company

Line No.		(\$000)	Ann. Inflation	Months Inflation	Notes/ Data Source
1	Business Plan Factors				<i>a</i>
2	Known contracts	\$76,970			<i>a</i>
3	Specific scopes of work	\$43,381			<i>a</i>
4	Variable costs based on levels of production	\$32,891			<i>a</i>
5	Storm outage restoration costs	\$2,082			<i>a</i>
6	Bad debt expense	\$6,798			<i>a</i>
7	Total Quantified Factors	\$162,122			<i>b</i>
8	Total Non-Fuel, Non-Labor O&M Expense	\$205,637			<i>c</i>
9	Non-Fuel, Non-Labor O&M Subject to Inflation Assumption	\$43,515			<i>d</i>
10					
11	Compounded Inflation Rate Applied to Av. 2013 Actuals (Jul '13 - Dec '15)	5.12%	2.00%	30	<i>e</i>
12	2013 Non-Fuel, Non-Labor O&M Prior to Inflation	\$41,395			<i>f</i>
13	Estimated Impact of Removing Inflation	(\$2,121)			<i>g</i>

Notes/Data Sources

- a* KU Responses to Kroger RFIs 1-7(b) and 2-7.
- b* Sum of Lines 2 - 6.
- c* KU Response to Kroger RFI 2-6.
- d* (Line 8 - Line 7)
- e* Derived from KU Response to Kroger RFI 2-5. Inflation calculated from mid-2013 through mid-Forecast Test Period, compounded monthly. $(1+(0.02/12))^{30-1}$
- f* Line 9/(1+inflation rate)
- g* Line 12 - Line 9