

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

**In the Matter of:**

**APPLICATION OF KENTUCKY            )**  
**UTILITIES COMPANY FOR AN        ) CASE NO. 2014-00372**  
**ADJUSTMENT OF ITS ELECTRIC     )**  
**RATES                                    )**

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

**March 6, 2015**

1                                   **DIRECT TESTIMONY OF KEVIN C. HIGGINS**

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 Louisville Gas and Electric Company ("LG&E). These  
14                   facilities purchase in excess of 80 million kilowatt-hours annually from LG&E.

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 Kentucky Utilities Company's ("KU") 2009 base rate  
22                   case, Case No. 2009-00548 and LG&E'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 LG&E's revenue  
13 requirement; and

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

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

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

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

22

23

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 in service through  
5 December 31, 2015. On December 16, 2014, this bill was passed by the Senate, and it  
6 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, LG&E's rate case has been filed under the assumption that bonus tax  
6 depreciation would not be available after 2013. Since it is now known that bonus tax  
7 depreciation is applicable through the end of 2014, and through the end of 2015 in some  
8 circumstances, it is necessary to properly reflect the ratemaking impact of this tax  
9 change, which effectively reduces LG&E's rate base for plant added in 2014 and 2015.

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

12 A. Yes. In response to a request for information, LG&E indicated that, relative to its  
13 filed case, customers would receive a \$4 million electric revenue requirement benefit if  
14 LG&E elects to take the bonus depreciation deduction in both 2014 and 2015, compared  
15 to a \$3 million electric revenue requirement benefit if LG&E elects to take the bonus  
16 depreciation deduction in 2014 but opts out in 2015. In addition, there is an incremental  
17 benefit to customers of \$1 million through the ECR rate mechanism in the forecasted  
18 period as a result of taking the bonus depreciation deduction in both years, but a \$2  
19 million benefit if bonus tax depreciation is not elected in 2015.<sup>1</sup>

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

---

<sup>1</sup>LG&E Response to AG 1-26 and Attachment LGE\_AG 1-26a. While my testimony focuses on LG&E's electric revenue requirement impact, there is also a \$2 million reduction to the gas revenue requirement as a result of recognizing bonus tax depreciation under both scenarios.

1 A. The extension of bonus tax depreciation illustrates one of the hazards of using a  
2 forecasted test period: material changes in circumstances can have implications for  
3 revenue requirement that were not anticipated when the test period projections were put  
4 together. LG&E's revenue requirement for the forecasted test period ending June 30,  
5 2016 should be adjusted to reflect the optimal ratepayer impact of taking bonus tax  
6 depreciation into account. LG&E has indicated that the optimal ratepayer impact would  
7 result from LG&E electing bonus tax depreciation in both 2014 and 2015. To the extent  
8 this analysis is revised, I continue to recommend that the optimal ratepayer outcome be  
9 reflected in LG&E's revenue requirement.

10 The extension of bonus tax depreciation also has implications to the results  
11 reflected in the base period ended February 28, 2015. LG&E has indicated that, by April  
12 14, 2015, it will update the base period information reflecting actual data through  
13 February 1, 2015.<sup>2</sup> I would expect this updated filing would reflect the bonus tax  
14 depreciation impacts as well.

## 16 Inflation

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

19 A. Yes. In responses to requests for information, LG&E explained that it includes  
20 annual inflation of 2.0% for non-labor costs in those segments of its Business Plan where  
21 better information is not available. In cases where the general inflation rate is used, it is  
22 typically applied to the most recent full year of actual results, which is 2013 in this case.  
23 Effectively, this 2.0% annual inflation rate would compound over the duration of the

---

<sup>2</sup> Direct Testimony of Kent W. Blake, p. 26, lns. 13-16.

1 forecast. While LG&E has acknowledged that it utilized an inflation assumption, the  
2 Company was not able to quantify the amount of inflation included in its forecasted test  
3 period revenue requirement.<sup>3</sup>

4 **Q. Have you estimated the amount of inflation included in LG&E's forecasted test**  
5 **period electric revenue requirement?**

6 A. Yes, I have. I estimate that 2.0% average annual inflation, compounded over the  
7 period between mid-2013 and mid-forecasted test period, results in a compounded  
8 average inflation rate of 5.1%. That is, in instances where LG&E has applied an inflation  
9 escalator to O&M expense segments, these costs would be inflated by approximately  
10 5.1% from the average 2013 level of costs.

11 In responses to requests for information, LG&E provided five factors that it takes  
12 into consideration when developing its Business Plan, as well as the amounts of non-fuel,  
13 non-labor O&M expense that these factors comprise. These factors are: known contracts,  
14 specific scopes of work, variable costs based on levels of production, storm outage  
15 restoration costs, and bad debt expense.<sup>4</sup> In order to estimate the amount of generic  
16 inflation included in the forecasted test period revenue requirement, I subtracted the  
17 amounts attributable to these factors from total electric non-fuel, non-labor O&M  
18 expense. I assumed that the remaining non-fuel, non-labor O&M expense, to which the  
19 more specific forecasting factors did not apply, was potentially subject to LG&E's  
20 generic inflation assumption. Using this method, I estimated that approximately \$1.2  
21 million of non-fuel, non-labor O&M expense inflation was included in LG&E's

---

<sup>3</sup> LG&E Responses to Kroger RFIs 1-7 and 2-5.

<sup>4</sup> LG&E Responses to Kroger RFIs 1-7(b) and 2-7. I have assumed that the amounts provided by LG&E in response to Kroger RFI 2-7 are for electric only, for the purpose of estimating the amount of inflation included in LG&E's proposed forecasted test period electric O&M expense.



1 forecasted test period electric revenue requirement calculation. This calculation is  
2 presented in Exhibit NT-1.

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

5 A. From a ratemaking perspective, I have two serious concerns with LG&E's  
6 inclusion of inflation in its forecasted test period revenue requirement.

7 First, at a broad policy level, I have concerns about regulatory pricing  
8 formulations that reinforce inflation. This occurs when *projections* of inflation are built  
9 into formulas that are used to set administratively-determined prices, such as utility rates.  
10 Such pricing mechanisms help to make inflation a self-fulfilling prophecy. As a matter  
11 of public policy, this is a serious concern. It is one thing to adjust for inflation after the  
12 fact; it is another to help guarantee it. For this reason, I believe that regulators should use  
13 extreme caution before approving prices that guarantee inflation before it occurs.

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

15 A. A related, but distinct, concern involves the building of this "cost cushion" into  
16 the Company's test period costs. Allowing this type of systemic uplift in rates goes well  
17 beyond the basic rationale advanced by advocates for using a projected test period, which  
18 is to ameliorate the effect of regulatory lag on the recovery of investment in new plant.

19 **Q. Please explain.**

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

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

8 The best evidence of what it costs LG&E for non-labor O&M is the Company’s  
9 actual costs recorded in the historical period, adjusted for certain known and measurable  
10 changes. The cost increases represented by LG&E’s inflation assumption may or may  
11 not come to fruition. In any case, LG&E should be expected to strive to improve its  
12 O&M efficiency on a continuous basis, and thereby lessen the net impact of inflation on  
13 its O&M costs. It is not reasonable to simply gross up the Company’s historical period  
14 costs by an inflation factor and pass these costs on to customers.

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

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

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

3 A. Yes. I have reviewed the Minutes of the Federal Open Market Committee for  
4 December 16-17, 2014. The published Minutes of that meeting indicate that the Fed's  
5 central tendency forecast for Core personal consumption expenditures (PCE) inflation is  
6 1.5% to 1.8% for 2015 and 1.7% to 2.0% for 2016.<sup>5</sup> The Congressional Budget Office  
7 January 2015 forecast for Core inflation is 1.8% to 2.1% in 2015 and 1.9% to 2.2% in  
8 2016.<sup>6</sup>

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

11 A. I recommend removing general inflation, which I estimate at \$1.2 million, from  
12 LG&E's forecasted test period non-labor O&M expense.

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

14 A. Yes, it does.

---

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

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

**Kroger Estimated Impact of Removing Non-Fuel, Non-Labor O&M Inflation - Louisville Gas & Electric Company**

Line No.		(\$000)	Ann. Inflation	Months Inflation	Notes/ Data Source
1	<b>Business Plan Factors</b>				<i>a</i>
2	Known contracts	\$47,818			<i>a</i>
3	Specific scopes of work	\$52,414			<i>a</i>
4	Variable costs based on levels of production	\$21,604			<i>a</i>
5	Storm outage restoration costs	\$2,548			<i>a</i>
6	Bad debt expense	\$3,502			<i>a</i>
7	Total Quantified Factors	\$127,886			<i>b</i>
8	Total Non-Fuel, Non-Labor O&M Expense	\$151,492			<i>c</i>
9	Non-Fuel, Non-Labor O&M Subject to Inflation Assumption	\$23,606			<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	\$22,456			<i>f</i>
13	<b>Estimated Impact of Removing Inflation</b>	<b>(\$1,150)</b>			<i>g</i>

Notes/Data Sources

- a* LG&E Response to Kroger RFIs 1-7(b) and 2-7.
- b* Sum of Lines 2 - 6.
- c* LG&E Response to Kroger RFI 2-6.
- d* (Line 8 - Line 7)
- e* Derived from LG&E 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