COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In The Matter of:

ELECTRONIC APPLICATION OF DUKE ENERGY KENTUCKY, INC. FOR: 1) AN ADJUSTMENT OF THE ELECTRIC RATES; 2) APPROVAL OF AN ENVIRONMENTAL COMPLIANCE PLAN AND SURCHARGE MECHANISM; 3) APPROVAL OF NEW TARIFFS; 4) APPROVAL OF ACCOUNTING PRACTICES TO ESTABLISH REGULATORY ASSETS AND LIABILITIES; AND 5) ALL OTHER REQUIRED APPROVALS AND RELIEF	)	CASE NO. 2017-00321

ATTORNEY GENERAL'S POST-HEARING BRIEF

PUBLIC REDACTED VERSION

Respectfully submitted,

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Comes now the intervenor, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (the "Attorney General" or "AG"), and states as follows for his post-hearing brief in the above-styled matter.

I. STATEMENT OF THE CASE

On August 2, 2017, Duke Energy Kentucky ("Duke" or "Company") filed with the Kentucky Public Service Commission ("Commission") its Notice of Intent to File its application for, *inter alia*, an increase in base rates and approval of Riders. Duke filed its application on September 1, 2017, which consisted of an increase to its electric base rates, multiple riders, and an environmental surcharge mechanism. Duke utilized a Fully Forecasted Test Year ending March 31, 2019, and proposed an initial base rate increase of

$48.6 million, which would result in a new total revenue requirement of $357.5 million. In rebuttal testimony, Duke revised its proposed base rate increase to $30 million.[1]

Five parties were granted intervention: The Attorney General, Kroger, KIUC, Northern Kentucky University ("NKU"), and Kentucky School Boards Association ("KSBA").[2] The Commission held a three-day evidentiary hearing in this matter during March 6th, 7th, and 8th. The Attorney General recommends the Company's proposed rates be denied, and instead the Company's current rates should be reduced by at least approximately $15M, as shown in the chart below. Further, the Attorney General recommends the Commission deny Duke's proposed Rider DCI, Targeted Underground Program, changes to Rider PSM, deferral accounting for planned outage O&M expense, Rider FTR, fixed bill tariff, and the increase in the residential customer charge.

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[1] Lawler Rebuttal Testimony, pg. 3 (February 14, 2018).
[2] Kentucky League of Cities was denied intervention by Commission Order (October 24, 2017).

Duke Energy Kentucky, Inc. Case No. 2017-00321 Base Revenue Requirement Attorney General's Final Recommendations For the Test Year Ended March 31, 2019 ($ Millions)	
Base Rate Increase Requested by Company	
Updated Requested Base Increase- Lawler Rebuttal	30.085
Operating Income Adjustments	
Include Off-System Sales Margins to Reset PSM to $0	(3.826)
Replacement Power Expense	(4.069)
RTEP Charges- Reflected in Lawler Rebuttal	0.000
Planned Outage O&M Expense Normalization	(1.203)
Incentive Compensation Expense Tied to Financial Performance	(1.638)
Increase AMI Levelization Adjustments	(0.858)
Retirement Plan Expense	(1.584)
CMRG Amortization Expense to Reflect 10 Year Amortization Period- Reflected in Lawler Rebuttal	0.000
Amortization of East Bend Reg Asset to Reflect Lower O&M Expense- Net of Amount Reflected in Lawler Rebuttal	(0.030)
Reduce Depreciation Expense by Using ASL vs ELG Methodology	(6.939)
Reduce Depreciation Expense by Removing Terminal Net Salvage for Generating Units	(4.519)
Reduce Remaining Net Salvage Included in Depreciation Expense	(4.630)
Income Tax Expense to Reflect Reduction in Federal Rate- Reflected in Lawler Rebuttal	0.000
Increase Income Tax Expense to Reflect Changes in Deferred Income Taxes- Reflected in Lawler Rebuttal	0.000
Amortization of Excess ADITs- Net of Amount Relfected in Lawler Rebuttal	(6.644)
FIT Credit for Jan. through March 2018- Net of Amount Reflected in Lawler Rebuttal	(0.685)
Income Tax Expense for Research Tax Credits- Reflected in Lawler Rebuttal	0.000
Capitalization Issues	
Reduce Capitalization for Loans to Other Duke Energy Affiliates from Sep 2018 to March 2019	(0.451)
Reduce Capitalization to Reflect Removal of East Bend O&M Reg Asset- Net of Rev. Req. Reflected in Lawler Rebuttal	(1.912)
Remove Deferred DSM Costs from Capitalization	(0.130)
Remove Deferred East Bend Coal Ash ARO Costs from Capitalization- Reflected in Lawler Rebuttal	0.000
Increase Capitalization to Reflect Reduction in CMRG Amortization Expense- Reflected in Lawler Rebuttal	0.000
Increase Capitalization to Reflect Reduction in Depreciation Expense-Use of ASL Methodogy	0.241
Increase Capitalization to Reflect Reduction in Depreciation Expense-Remove Terminal Net Salvage	0.157
Increase Capitalization to Reflect Reduction in Depreciation Expense-Remove Remaining Net Salvage	0.161
Cost of Capital Issues	
Reduce Return on Equity from 10.3% to 8.8%	(6.363)
Final AG Adjustments to Duke Request	**(44.924)**
Decrease After AG Adjustments	**(14.839)**

II. ARGUMENT

A. Return on Equity

In its most recent electric investor-owned rate case Order, the Commission agreed with the Attorney General that, "although interest rates are increasing, they are doing so slowly and are still historically low."[3] Further, the Commission also agreed with the Attorney

[3] Case No. 2017-00179, Order (Ky. PSC Jan. 18, 2017) at 28.

General in that, "models supporting the low interest rate environment should be given more weight than those supporting high interest rate expectations."[4] Duke has not provided any evidence or argument in this case that should dissuade the Commission from maintaining this position. Indeed, Duke has continued to push the same arguments that the Commission explicitly rejected in the most recent investor-owned electric rate case.

Duke witness Dr. Morin noted that he "used projected interest rates" in calculating his CAPM analysis.[5] In comparing Dr. Morin's CAPM results with the CAPM provided by Attorney General Witness Richard A. Baudino, and using the same arithmetic risk premium, the results range from 7.41% to 9.3%.[6] The primary differential between the CAPM results is Dr. Morin's use of forecasted Treasury yields.[7] The use of forecasted interest rates in many of Dr. Morin's analyses unnecessarily inflates his estimated ROEs. For instance, Mr. Baudino noted in his Direct Testimony that use of a current yield in Dr. Morin's historical risk premium study would produce an ROE estimate of 8.85%.[8] Dr. Morin's efforts generally seem to be directed towards inflating his ROE recommendation, evidenced not only by his use of forecasted interest rates and flotation costs, but also by arbitrarily, and exclusively, using the upper half of his ROE range to support his recommended ROE.[9] The midpoint of Dr. Morin's ROE range was actually 9.9%, well below his recommendation.[10] Although Dr. Morin may have worked in approximately 240 cases in the last 30 years, he testified that since 2006 he has not recommended a single ROE below the midpoint of his ROE range.[11]

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[4] *Id.*
[5] March 6, 2018 Video Transcript of Evidence [VTE] at 11:40:15.
[6] Direct Testimony of Richard A. Baudino ("Baudino Direct") (Ky. PSC Dec. 28, 2017) at 38.
[7] *Id*. at 38-39.
[8] Baudino Direct at 40.
[9] Direct Testimony of Roger A. Morin, PhD ("Morin Direct") (Ky. PSC Sept. 1, 2017) at 63.
[10] March 6 VTE at 11:55:45.
[11] March 6 VTE at 11:56:30.

The use of forecasted interest rates to estimate investor-required returns is unnecessary, as "[s]ecurities markets are efficient and most likely reflect investors' expectations about future interest rates."[12] In calculating his estimated and proposed ROE, Mr. Baudino used current interest rates.[13] Mr. Baudino's recommendation is that the Commission "adopt an 8.8% return on equity for Duke Kentucky."[14] The Attorney General agrees. Mr. Baudino's use of the DCF model is appropriate, as evidenced by the Commission's previous consideration of the model and Dr. Morin's use of it.[15] His recommendation is in the upper half of his DCF range of 8.2% - 9.2%, calculated after excluding a low-end result which used average growth rates.[16]

Mr. Baudino's recommendation is based on the fact that, "the U.S. economy is in a low interest rate environment."[17] His recommendation is made with an understanding that the Federal Reserve has indicated it may raise rates several times in 2018.[18] Nevertheless, "that doesn't mean that absolutely will happen."[19] Importantly, the Federal Reserve only controls short-term Federal Funds Rates. The impact on long-term rates, utility bond yields and utility stocks from Federal Reserve's increase of short-term interest rates do not necessarily correspond.[20] Although the Federal Funds rate has been steadily rising in recent years, long-term rates and average utility bond yields have fluctuated.[21] In fact, although the Federal Funds rate was raised throughout 2017, the 20-year Treasury rate started 2017 at 2.75% and

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[12] Baudino Direct at 8.
[13] *Id.*
[14] Baudino Direct at 3.
[15] Morin Direct at 5; See Case Nos. 2017-00179, 2016-00371, 2016-00370, 2013-00148, 2010-00116.
[16] Baudino Direct at 30-31.
[17] *Id.* at 31.
[18] March 8, 2018 VTE at 9:33:20.
[19] March 8, 2018 VTE at 9:34:30.
[20] *See* Baudino Direct at 8-12.
[21] *Id.* at 10.

dipped as low as 2.53% in September, while the average utility bond rate started in January 2017 at 4.24% and decreased to 3.88% in November.[22] The Commission should take note that although the Federal Reserve plans to increase the Federal Funds rate, market data will inevitably determine its actions and the impact of any increase may not necessarily lead to higher long-term or utility bond yields.

The revenue requirement effect of Mr. Baudino's 8.8% return on equity is a reduction to the base revenue requirement of $6.363M, as found in Mr. Kollen's direct testimony.[23] This reduction is in addition to the effect a lower ROE will have on the ESM revenue requirement or the proposed DCI, if approved. The Commission should use the ROE set in this matter for the ESM until Duke's next base rate case.

B. Attorney General's Other Revenue Requirement Adjustments

1. <u>Operating Income Issues</u>

a. <u>Include Off-System Sales Margins And Reset PSM to $0</u>

Attorney General witness Lane Kollen proposes that a projected, test-year amount of off-systems sales be reflected in the revenue requirement. The effect of Mr. Kollen's proposal is a reduction to base revenue requirement of $3.836 million.[24] Duke's critique of Mr. Kollen's proposal is that it "would be a significant departure from the formula Rider PSM that the Commission has approved on multiple occasions since 2007."[25] Of course, this completely

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[22] *Id.*
[23] Direct Testimony of Mr. Lane Kollen ("Kollen Direct") (Ky. PSC Dec. 28, 2017) at 57.
[24] Kollen Direct at 10; The amount of Mr. Kollen's proposal is based on the Company's forecast provided in discovery as a response to AG 2-21.
[25] Rebuttal Testimony of Sarah E. Lawler ("Lawler Rebuttal") (Ky. PSC Feb. 14, 2018) at 7.

ignores the fact that this is Duke's first rate case since 2006.[26] Customers pay for Duke's generation fleet. Including a base amount of off-system sales in the revenue requirement ensures that the customers, not Duke, receive the bulk of the benefits that generation fleet provides. Sharing a portion of *all* off-system sales is unfair to customers. In order to provide Duke an incentive to continue to participate in off-system energy markets, actual off-system sales margins that are more or less than the amount included in the base revenue requirements can be shared through the PSM or another sharing mechanism. This concept provides Duke with an incentive to look for opportunities in energy markets, while guaranteeing that customers receive the benefit from a cost they wholly incur. The Attorney General will provide his position on rider PSM more specifically in a later section of this brief.

b. Replacement Power O&M Expense

Duke included $5.668M in forecasted replacement power expense for the incremental fuel and other expense due to forced derates at its East Bend generating station.[27] These replacement power costs are not recoverable via the FAC.[28] Duke estimated this amount using a probabilistic model called GenTrader.[29] Company witness Wathen claims that using this model is neither more nor less reasonable than using historical average expense to determine the amount to be included in rates.[30] The use of such a probabilistic model is unnecessary and unreasonable to determine a cost that "is inherently uncertain and unknown by its very

[26] *See generally* Case No 2006-00172, An Adjustment of the Electric Rates of the Union Light, Heat and Power Company D/B/A Duke Energy Kentucky, Inc.
[27] Kollen Direct at 10.
[28] *Id.*
[29] *Id.*
[30] March 7, 2018 VTE at 2:22:30.

nature."[31] Further, Duke requests that the delta between actual cost and the amount reflected in rates should be set aside between rate cases using deferral accounting.

AG witness Kollen provided testimony on Duke's Replacement Power O&M expense, stating that the forecasted expense is "wildly excessive compared to actual replacement power expense for East Bend during the last three years."[32] In fact, the estimated forecasted expense provided by Duke was "more than three times the average actual expense over the last three years."[33] Mr. Kollen's recommendation is to use the average replacement power expense for the last three years and for the Commission to approve Duke's request for deferral accounting for actual expense that is greater than or less than the amount included in rates. Mr. Kollen used the last 3 years as a basis for this expense given that Duke did not obtain 100% ownership interest in East Bend until December 31, 2014.[34] Using the last three years' actual expense as the level to reflect in rates reduces the revenue requirement by $4.069M.[35] The Attorney General believes that coupling this level of reasonable, historical expense with deferral accounting is the most reasonable method to ensure the Company is made whole and that customers are adequately protected.

c. RTEP Charges

Mr. Kollen's testimony provided for a $410,346 reduction to the revenue requirement due to what he referred to as "excessive" escalation factors in the forecast RTEP expense.[36] Duke inexplicably used a 7.7% escalation factor for this cost sequentially for three separate

[31] Kollen Direct at 12.
[32] Kollen Direct at 11.
[33] *Id.*
[34] March 7, 2018 VTE at 2:21:45.
[35] Kollen Direct at 12.
[36] Kollen Direct at 13-14.

periods.[37] Although Duke used a 7.7% escalation factor to forecast the test-year amount of the expense to be recovered through the revenue requirement, Duke's actual annual increase in this expense was .7% and 2.2% for the past two (2) periods, respectively.[38] In the rebuttal testimony of Sarah Lawler, the Company noted that it had "reviewed AG witness Kollen's proposed adjustment for RTEP expenses and finds his approach reasonable. Therefore, the Company agrees to reduce its revenue requirement by $410,346 to reflect lower forecasted RTEP expense."[39] As the Company agrees that the RTEP expense in their application is unreasonable, the Commission should use the reduced amount provided by Mr. Kollen and agreed to by Duke in calculating the Company's annual revenue requirement in this matter.

d. Distribution Vegetation Management

Duke's actual expenses for vegetation management from 2012–2016 ranged from $1.774 million to $2.309 million.[40] In this matter, the Company reported base period expenses for these outside services of $1.601 million (which is less than the average expense level over the preceding five years) and requested $4.48 million as its forecasted expense.[41] Mr. Kollen noted that the Company originally based this forecasted expense on indicative bids received from contractors.[42] As a matter of policy, the Attorney General submits that indicative bids should not be relied on to predict forecast test year expenses. Accordingly, Mr. Kollen recommended using the average expense level Duke incurred from 2012–2016, which would reduce vegetation management expenses by $2.4 million, and the revenue requirement by

[37] Kollen Direct at 13; Duke response to AG DR 1-14.
[38] Kollen Direct at 13-14.
[39] Lawler Rebuttal at 5.
[40] Kollen Direct Testimony at 15.
[41] Duke's Response to Commission Staff DR 2-18.
[42] Kollen Direct at 15 (*citing* Direct Testimony of Anthony J. Platz at 18–19).

$2.407 million.[43] However, the Company subsequently provided actual bids it had received for these services, as well as a multiyear contract it has since executed with a contractor.[44] Since the forecast expenses are no longer solely based on indicative bids, but have now been shown to be based on actual costs Duke will incur, the Attorney General accepts the Company's expense amount.

During the hearing, Ms. Edwards testified that faced with rising costs from contractors who provide vegetation management services, the Company conducted an internal cost benefit analysis to determine whether performing these services in house would be more economical.[45] She further testified that the Company found that it would be cost-prohibitive to perform its own vegetation management, and that it would continue to contract these services out to experts.[46] This analysis, provided in a post-hearing data request, shows that the Company estimated the annual cost for circuit trimming by a contractor to be ████ versus the annual cost for internal circuit trimming of ████.[47] This is largely due to the difference between the contractor hourly pay rate and Duke's hourly pay rate. The total annual cost for contract tree trimmer and foreman are listed as ████ and ████, respectively.[48] Duke's comparative annual cost per tree trimmer and supervisor are ████ and ████, also respectively.[49] Ms. Edwards estimated that the lowest classified tree trimmer for Duke makes approximately $15 per hour,[50] but the figures in the provided

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[43] *Id.*
[44] Duke's Response to AG DR 2-1; Rebuttal Testimony of April N. Edwards ("Edwards Rebuttal"), Attachment ANE-Rebuttal-1 (Confidential).
[45] March 7, 2018 VTE at 10:50:40–10:51:20.
[46] *Id.*
[47] Company's Response to Attorney General's Post-Hearing Request for Information, Question 4 (Confidential).
[48] *Id.*
[49] *Id.*
[50] March 7, 2018 VTE at 11:03:55–11:04:20.

spreadsheet show that the average hourly straight time rate for Duke tree trimmers is ■■■■■,

while the average overtime rate is ■■■■■.[51]

Ms. Edwards confirmed that the Company expects vegetation management expenses to be approximately $4 million in 2018, and to increase annually by between 3 to 5 percent.[52] Furthermore, she stated that the market for these services is "extremely competitive",[53] and that "qualified labor resources continue to be limited."[54] The Attorney General maintains that if these expenses are set to continue at this rate, or rise even further as the Company suggests, then the Company should carefully consider bringing these services in house in the future. If the Company needs to reduce its internal rates in order to make this move cost-effective, then that option should also be considered.

e. Planned Outage O&M Expense

Using a six-year average of actual and forecast planned outage O&M expense for East Bend and Woodsdale on an inflation adjusted basis, Duke seeks to recover $8.4M in the test year expense.[55] The Company's calculation uses four years of actual costs, for years 2013-2016 and forecast expense for 2017 and 2018.[56] Mr. Kollen stated in his testimony that although Duke used the forecasted expense for 2018 in its Application, the Company failed to include the forecast for 2019, although notably the Company's test-year in this case extends into 2019.[57] Using the forecast for 2019 in addition to the other six (6) years, which the Company has provided in the record, reduces Duke's revenue requirement by $1,203,297.[58]

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[51] March 7, 2018 VTE at 11:03:55–11:04:20; Duke's Response to AG Post-Hearing DR 1-4 (Confidential).
[52] Edwards Rebuttal at 15; March 7, 2018 VTE at 10:53:50–10:54:05.
[53] Edwards Rebuttal at 6.
[54] Edwards Rebuttal at 15.
[55] Kollen Direct at 16, *citing* Duke's response to Staff DR 1-71 and Staff DR 2-23.
[56] Kollen Direct at 16, *citing* Duke's response to Staff DR 1-71.
[57] Kollen Direct at 16; The forecast expense for 2019 was provided in Duke's response to Staff DR 2-23.
[58] *Id.*

Using the forecast for 2019 in determining a test-year amount of this expense is reasonable in that it is readily available and is a reasonable indication of the actual expense Duke may incur in 2019. Further, Duke provided forecasted planned outage O&M expense for 2020 and 2021 in response to Commission Staff post-hearing data request 1-12. Duke witness Mr. William "Don" Wathen Jr. noted in his rebuttal testimony that Mr. Kollen's test-year expense level for planned outage O&M is acceptable, although he follows up by saying even though the amount may be reasonable, the Company would still insist on the use of deferral accounting.[59]

In addition to a test-year level of planned outage O&M expense, Duke also requests that the Commission provide them the authority to implement deferral accounting for planned outage expense that is more or less than the normalized test-year amount.[60] Mr. Kollen's proposal is to deny the requested deferral accounting because Duke is currently incentivized to keep this expense low between rate cases since it does not have the opportunity to recover cost over-runs.[61] If the Commission approves the deferral accounting, "then this behavioral incentive will shift to encourage more expense, not less."[62] Duke has the ability to reasonably forecast planned outage O&M expense, evidenced by its response to discovery wherein it provided four years of forecasted data.[63] Duke's request for deferral accounting is less about the variability of costs or its inability to forecast expenses, and more about ensuring that the Company has less risk of cost over-runs due to imprudent spending or reckless management.

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[59] Rebuttal Testimony of William "Don" Wathen Jr. ("Wathen Rebuttal") (Ky. PSC Feb 14, 2018) at 16.
[60] *Id.*
[61] Kollen Direct at 17-18.
[62] *Id.*at 18.
[63] Duke response to Commission Staff PHDR 1-12.

In support of Duke's request for deferral accounting associated with planned outage O&M expense, Mr. Wathen states, "the Commission has already approved this exact same type of deferral accounting . . . approving a stipulation in Case Nos. 2016-00370 and 2016-00371."[64] Interestingly, the only reference in the Commission's final Order in Case No. 2016-00370 to generator outage expense, is that the parties agreed to use "four-years' historical expenses and four-years' forecasted expenses" to determine a test-year amount.[65] The calculation proposed in the stipulation was a reduction to the test-year expense in KU's Application.[66] As is usually the case, the proposed stipulation in Case Nos. 2016-00370 and 2016-00371 was the product of arm's-length negotiation with significant give and take. The closest the Commission came in the Order in Case No. 2016-00370 to discussing the deferral accounting Duke is requesting here, is the ultimate approval of the stipulation as modified, which provided:

> 5.8 All Other Relief Requested by Utilities to Be Approved as Filed. The Parties agree and recommend to the Commission that, except as modified in this Stipulation and the exhibits attached hereto, the rate, terms, and conditions contained in the Utilities' filings in these Rate Proceedings, as well as the Companies' requests for CPCNs for their propose Distribution Automation project, should be approved as filed.[67]

There was no specific consideration, apparent apprehension or discussion by the Commission regarding deferral account for generator outage expense in the final Order in Case No. 2016-00370.[68] As Duke's primary argument for approval of a similar cost is that other utilities have received something similar before, albeit in the context of a global and unanimous stipulation, the Commission should reject the Company's request for deferral accounting for planned

[64] Wathen Rebuttal at 13 [emphasis added].
[65] Order Case No. 2016-00370 (Ky. PSC June 22, 2017) at 8.
[66] *Id.* at 11.
[67] See Order Case No. 2016-00370, Attachment Stipulation (Ky. PSC Jun. 22, 2017) at19.
[68] See generally Orders, Case No. 2016-00371 & 2016-00370.

outage O&M expense. The Commission should take heed of Mr. Kollen's comment that, in his experience it is not "really good practice to rely on settlements as precedent."[69]

f. <u>Incentive Compensation Tied To Financial Performance</u>

The Company included in its revenue requirement two items of compensation tied to financial performance, a Short Term Incentive plan ("STI") and a Long Term Incentive plan ("LTI").[70] STI expense, in the amount of $0.751 million, is linked with earnings per share ("EPS"), while $0.883 million in LTI expense, paid in the form of performance shares and restricted stock units, is connected to financial performance as measured by EPS and Total Shareholder Performance ("TSP").[71] If incentive compensation that is bound to financial performance is included in the Company's cost recovery, it would incentivize Duke's executives, managers, and other eligible employees to seek greater and more frequent rate case increases from customers in order to improve Duke's EPS and TSP. This scenario presents an inherent conflict between achieving lower rates for customers on the one hand, and achieving better financial performance, and ultimately greater incentive compensation for eligible employees, on the other hand.

The inclusion of incentive compensation tied to financial performance in the revenue requirement tends to be a self-fulfilling prophecy that ensures the expense is covered regardless of the Company's actual financial performance or its operational, safety and reliability record. The Attorney General maintains that this expense should be borne by Company shareholders, not the ratepayers. The Commission has a well-established precedent of disallowing incentive

[69] VTE March 8, 2018 at 2:42:15.
[70] Kollen Direct at 18 (citing Duke's Response to AG DR 1-18, 1-19, and 1-22).
[71] *Id*.

compensation tied to financial performance.[72] This adjustment results in the reduction of expense by $1.634 million, and a reduction to the revenue requirement of $1.638 million.

g. AMI Benefit Levelization

In Case No. 2016-00152, Duke "filed an application requesting a Certificate of Public Convenience and Necessity ("CPCN") to replace and upgrade its current electric and gas metering infrastructure to a digital Advanced Metering Infrastructure ("AMI") for its electric and combination customers."[73] Duke and the Attorney General "filed a Stipulation and Recommendation ("Stipulation") intended to address all the issues raised in this proceeding."[74] As part of the Stipulation in that matter, Duke and the AG agreed, *inter alia* that the application for the CPCN should be approved as filed and that in its next electric base rate case, Duke should make:

> appropriate adjustment to its test period to reflect the actual costs and associated savings related to the AMI Project, including: 1) the projected deployment costs or actual costs if deployment is completed; 2) ongoing costs of operation; 3) an adjustment to reflect the non-fuel related portion of the Benefit Type: Increases Revenues reflected in DLS-4; 4) an adjustment to reflect the Operation Savings to date if a historical test year, and, if a forecasted test year, the forecasted Operational Savings that would be obtained during that test year; and 5) a pro-forma adjustment to account for the projected ongoing Operational Savings as reflected in DLS-4, adjusted to factor in any Operational Savings degradation that my [*sic*] accrue due to the establishment of an electric AMI opt-out tariff.[75]

[72] Kollen Direct at 19 (referring to the Final Order in Case Nos. 2010-00036 and 2013-00148).
[73] Order, Case No. 2016-00152 (Ky. PSC May 25, 2017) at 1, introduced here as AG hearing exhibit 5.
[74] *Id.* at 2.
[75] *Id.* at 5-6, internal citations omitted.

Duke witness Wathen testified that the Company "made an adjustment to its test year revenue requirement to bring forward certain benefits it projected would result from the deployment of advanced metering infrastructure (AMI)."[76] Mr. Wathen went on to say that the levelized benefit Duke made in this matter was based on the savings from 5 years.[77] This is simply not the agreement. Nowhere in the Stipulation or final Order in Case No. 2016-00152 was it indicated or agreed to that Duke should use 5 years to calculate the levelized benefit to be used in the next rate case. In fact, Duke now points the Commission and the Attorney General to a post-hearing data request response in Case No. 2016-00152 as support for its use of a 5-year period.[78] Respectfully, the Attorney General had already signed and supported the Stipulation before the request and response of any post-hearing data response. The Attorney General never anticipated or agreed to a 5-year period to calculate levelized savings. The Company's use of that response as support for a calculation based on 5 years of savings is inappropriate. In fact, the purpose of the Attorney General's inclusion of the benefit calculation in the Stipulation was that he did not believe the savings would accrue naturally, if at all. The Commissioners noted a similar skepticism.[79] With Duke expected to include the costs of AMI in the test year (which it did), and knowing that the vast majority of total AMI costs would be reflected in that test year (which they were), the Attorney General knew the importance of demanding that the benefits of AMI were properly returned to customers in order for them to realize the cost-benefit ratio presented in Duke's AMI business case.[80]

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[76] Wathen Rebuttal at 8.
[77] *Id.* at 8-9.
[78] Wathen Rebuttal at 9.
[79] See generally Case No. 2016-00152 Confidential VTE.
[80] March 6, 2017 VTE at 1:42:00-1:51:00.

Attorney General witness Mr. Kollen proposed a test-year adjustment attempting to reflect at 15-year levelized benefit from the Company's business case from Case No. 2016-00152.[81] Mr. Kollen noted that Duke proposed a $2.321M reduction to the test year, based on a 5-year net present value savings forecast, reduced by $0.847 million "that it asserts is included in the test year expense forecast without adjustment."[82] Mr. Kollen's calculation represented an additional decrease to the proposed revenue requirement of $1.368M.[83] In addition to disagreeing with the use of 15 years to calculate the levelized reduction, Duke witness Mr. Wathen took issue with Mr. Kollen's calculation, stating that it was his opinion that to reflect Mr. Kollen's intentions would result in a further decrease to the Company's proposed revenue of only $855,383, not $1.368M.[84] Although Mr. Wathen did not seem to provide the Excel spreadsheet used to calculate that amount, Mr. Kollen adopted Mr. Wathen's recalculated amount in errata filed March 6, 2018.[85] Though the Attorney General has not reviewed Mr. Wathen's Excel worksheets, he cannot seem to understand why the amount is so low. For instance, although the post-hearing data request in Case No. 2016-00152 upon which Duke's adjustment in this is case is based, included data for 15 years, Mr. Wathen states that the adjustment presented therein only represented 5 years of savings.[86] Nevertheless, the 5 years of savings presented as "Total Credit Amount Included in TY Revenue Requirement" in that post-hearing data request is more than $4.2M.[87] Mr. Wathen's calculation of 15 years of *only* savings presented in his rebuttal testimony is only $3,176,520.[88]

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[81] Kollen Direct at 23.
[82] *Id.*, internal citations omitted.
[83] Kollen Direct at 23.
[84] Wathen Rebuttal at 9-11.
[85] Kollen Testimony Errata Pages, Case No. 2017-00321 (Ky. PSC March 6, 2018).
[86] March 7, 2018 VTE at 2:25:00-2:25:50.
[87] Case No. 2016-00152, Duke response to Staff-Post Hearing-DR 01-010 PUBLIC Attachment (Ky. PSC Dec. 22, 2016).
[88] Wathen Rebuttal at 11.

It makes no sense that a calculation that includes only 5 years of savings is $1M more than a calculation of almost the same exact date for 15 years, especially since the majority of the savings from the AMI occur in the years out from the test year.[89] Duke made a commitment to provide the entirety of the savings as presented in confidential DLS-4 in Case No. 2016-00152. The Attorney General and the Commission agreed to or approved the proposed CPCN based on Duke's representations.[90] The Commission should hold Duke to those commitments. The Commission should, at a minimum, reduce the Company's revenue requirement an additional $858,000 but the Attorney General urges the Commission to further investigate this matter to ensure customers receive the entirety of the benefit Duke represented they would provide.[91]

h. <u>Retirement Plan Expense</u>

Company Witness Silinski testified that some Duke employees receive both a defined benefit and a defined contribution plan.[92] The Attorney General recommends that for these employees receiving benefits under both plans, the amount of expense included in the proposed revenue requirement for the defined contribution plan should be excluded.[93] This exclusion is consistent with Commission precedent established through several cases over the past two years.[94] This adjustment reduces retirement plan expense by $1.580 million and reduces the Company's revenue requirement by $1.584 million, and includes both the

[89] March 6, 2017 VTE at 1:42:00-1:51:00.
[90] See generally, Case No. 2016-00152 Confidential VTE; Stipulation, Case No. 2016-00152.
[91] March 6, 2017 VTE at 1:42:00-1:51:00.
[92] March 6, 2018 VTE at 12:21:10–12:22:25; *See also* Duke's Response to Commission Staff's Post-Hearing DR 1-3 (which confirmed that 180 Duke employees have both a pension and 401(k) benefit).
[93] Kollen Direct at 23–24.
[94] *Id*. (Referring to Case Nos. 2016-00370 and 2016-00371, and Case No. 2016-00169).

retirement plan expense directly incurred by the Company as well as the charges made from affiliates on behalf of their employees.[95]

i. <u>CMRG Amortization Expense</u>

In Case No. 2008-00308, Duke obtained authorization from the Commission to defer costs associated with the Carbon Management Research Group ("CMRG").[96] The Commission's authorization allowed for the funds expended in carbon management research to be deferred as a regulatory asset, ultimately leading to a deferral of $2M.[97] In its Application, Duke proposed to recover the amount of the regulatory asset "in amortization expense based on an amortization period of 5 years."[98] In his testimony, Mr. Kollen noted that the Applicants in Case No. 2008-00308, including Duke, proposed to amortize the regulatory asset from the funding of CMRG over the life of the project: 10 years.[99] In her rebuttal testimony, Duke witness Sarah Lawler agreed that in its application in Case No. 2008-00308, the Company "stated the intent to amortize this regulatory asset over a ten year period. As such, the Company is modifying its revenue requirement to reflect a ten year amortization period."[100] Although the correct accounting has a negative effect on operating income, there is also an adjustment to capitalization, leading to an increase of $17,612, an amount upon which both Ms. Lawler and Mr. Kollen agree.[101] As this treatment is in accordance with the application and intent in Case No. 2008-00308, the Attorney General agrees with the Company's adjustment in Ms. Lawler's rebuttal testimony.

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[95] Kollen Direct at 24.
[96] Lawler Rebuttal at 4.
[97] *Id.* at 4, Kollen Direct at 24-25, Order Case No. 2008-00308.
[98] Kollen Direct at 25, citing WPD 2.31a.
[99] Kollen Direct at 25.
[100] Lawler Rebuttal at 5.
[101] Kollen Direct at 25 and Lawler Rebuttal at 5.

j. Amortize East Bend O&M Reg. Asset with Lower Expense

In Case No. 2014-00201, Duke obtained Commission approval to establish a regulatory asset to record and reflect deferred O&M expense related to its East Bend generating station. This deferral arose as a result of Duke's acquisition of the remaining 31% ownership interest in East Bend from Dayton Power & Light.[102] The accounting treatment approved by the Commission allowed Duke to defer the O&M expense resulting from its entire ownership of East Bend, netted against the reduction in O&M expense resulting from the planned retirement of the Company's Miami Fort 6 unit.[103] The deferrals have been recorded since January 2015, comprised of actual deferrals through December 2016 and forecasted deferrals since January 2017.[104] Notably, "[a]lthough the Commission authorized these deferrals for accounting purposes in conjunction with approval of a Stipulation between the Company and the AG, it did not authorize future rate recovery . . . [t]his is the Commission's first opportunity in a base rate proceeding to review the deferrals and determine the appropriate rate recovery."[105]

The Company's proposal is an amortization of the regulatory asset over ten (10) years on a levelized basis at an expense of $4.812 million.[106] This amortization used the Company's forecasted cost of debt.[107] Although Duke's Application provided for a return on the regulatory asset at its forecasted cost of debt, the Company nevertheless failed to remove the $39.162M amount from its capitalization.[108] The Company's treatment of this regulatory asset

[102] Kollen Direct at 27.
[103] *Id.*
[104] Kollen Direct at 27.
[105] Kollen Direct at 27-28.
[106] Kollen Direct at 28.
[107] *Id. citing* WPD 2.31.
[108] *Id.*

in its Application would allow Duke a forecasted long-term debt return and weighted-average cost of capital return. This is improper. The Attorney General will address this issue further in the Capitalization section of his brief.

In addition to requesting two returns on the same amount, Duke also improperly inflated the forecasted O&M expense used to calculate the forecast regulatory asset. The forecast deferrals from January 2017 through March 2018 are excessive and unreasonable when compared to the actual expenses incurred and deferred. The excessive O&M expense deferrals were increased even further by the addition of interest at "the average cost of debt to the actual deferrals each month through December 2016 and to the forecast deferrals each month from January 2017 through March 2018."[109] Mr. Kollen provided for a much more reasonable test-year amortization amount using a recalculated regulatory asset value of $35.870M at March 31, 2018, using actual data starting in January 2017 through the most recent month available at the date of his testimony.[110] The Company effectively agreed with Mr. Kollen, although at the time of its submission of rebuttal testimony, Duke had additional months of actual data. Mr. Kollen's adjustment to the Company's application was a reduction to the revenue requirement of $405,732, while Duke's rebuttal position was a reduction of $375,550.[111] The Attorney General posits that either reduction is reasonable, but the Company's Application amount should be rejected.

k. Use ALG Procedure Instead of ELG

[109] Kollen Direct at 28- 29, *citing* Duke response to AG DR 1-23.
[110] Kollen Direct at 30-31.
[111] Kollen Direct at 31; Wathen Rebuttal at 19.

Based upon a depreciation study performed by Company expert Mr. John Spanos, Duke proposes to change its depreciation rates effective at the beginning of the test-year.[112] Duke's current depreciation rates were approved as set forth in a settlement in Case No. 2006-00172.[113] Mr. Kollen notes the "proposed depreciation rates are based on the Equal Life Group ("ELG") procedure instead of the Average Life Group ("ALG") procedure."[114] In Case No. 2006-00172, the Attorney General's witness opposed the use of the ELG procedure, but he subsequently agreed to the resulting depreciation rates in a global settlement of all issues in that proceeding.[115] The Attorney General opposes the use of the ELG procedure in this proceeding.

The use of the ELG procedure, especially in the case of Duke, results in higher depreciation rates than if the ALG procedure is used or maintained. Mr. Kollen notes that it is typically the case that "ELG depreciation rates are significantly greater than the ALG rates using similar depreciation parameters."[116] To evidence this, the Commission need look no further than the example provided by Mr. Spanos in his rebuttal testimony.[117] Although the purpose of Mr. Spanos' example was to evidence how "accurate" the ELG procedure is, it actually provided immense insight into the fact that "ELG, will every time result in higher depreciation rates in early years than the ALG methodology."[118] Mr. Spanos' example not only provides the Commission evidence that ELG leads to higher depreciation rates in early years ($266.67 vs. $200 each year for the first five years), but also illustrates that within the

[112] Kollen Direct at 31.
[113] Kollen Direct at 31-32, *citing* Order Case No. 2006-00172; *see also* Duke response to AG DR 1-34.
[114] Kollen Direct at 31.
[115] Kollen Direct at 31.
[116] Kollen Direct at 33.
[117] Rebuttal Testimony of John J. Spanos ("Spanos Rebuttal") (Ky. PSC Feb. 14, 2018) at 30-34.
[118] March 8, 2018 VTE at 3:54:00.

context of ratemaking, the longer a utility using ELG stays out between rate cases, the more customers pay in depreciation expense than the utility actually incurs.[119] For instance, in Mr. Spanos' example, if rates are not reset after year five and the utility uses ELG, the rates customers pay would reflect a depreciation expense at the previous level of $266.67, although depreciation expense incurred by the utility drops down to $66.67.[120] This creates a situation where "you're almost guaranteed to over recover on your depreciation expense."[121]

Through discovery, Mr. Spanos, on behalf of Duke, provided depreciation rates stemming from his most recent study, but using the ALG procedure.[122] Simply using the ALG procedure rather than ELG results in a significant reduction in test-year depreciation expense. Importantly, a change in methodology to ALG from the Company's proposed ELG still allows Duke to recover the <u>entirety</u> of its gross plant balances through depreciation expense.[123] Adopting ALG has the effect of allowing customers to benefit from lower test-year depreciation expense while ensuring the Company completely covers its depreciation expense, including the time value of money, while minimizing the likelihood, indeed, the high probability, that the Company will over-recover its depreciation expense if the ELG procedure is used.[124] The Commission should adopt Mr. Kollen's proposal denying ELG and accepting the ALG procedure instead. The ALG procedure smooths depreciation rates and is the "dominant procedure used by other electric utilities, including all other electric utilities in the Commonwealth."[125] The Commission should ignore the fact that Duke's current

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[119] March 8, 2018 VTE at 3:54:00-3:58:00.
[120] Spanos Rebuttal at 32, March 8, 2018 VTE at 3:57:30.
[121] March 8, 2018 VTE at 3:59:15.
[122] Duke response to AG DR 1-35.
[123] Kollen Direct at 34.
[124] See Kollen Direct at 35.
[125] Kollen Direct at 32 & 35.

depreciation rates are based on ELG. These current depreciation rates came about through a settlement in Duke's last electric base rate case, even though the AG's witness in direct testimony opposed the use of the ELG procedure. Importantly, the Commission went to significant lengths in the final Order of Case No. 2006-00172, to note its status as non-precedential. Specifically, the Commission stated at the outset of the Order, that:

> Based upon a review of each provision in the Settlement Agreement, an examination of the record, and being otherwise sufficiently advised, the Commission finds that the provisions of the Settlement Agreement are in the public interest and should be approved. The Commission's approval of the provisions of the Settlement Agreement is based solely on their reasonableness in toto and does not constitute precedent on any issue.[126]

The fact that Duke currently uses the ELG procedure has no bearing on the reasonableness of its use moving forward, although it does provide at least one explanation as to how Duke has gone 12 years between rate cases. The Attorney General recommends Mr. Kollen's adjustments regarding the denial of ELG and use of ALG, specifically "a reduction in the revenue requirement of $6.698 million, comprised of the reduction in deprecation expense of $6.939 million . . . offset by the return on the increase in capitalization of $0.241 million due to the reduction in accumulated depreciation."[127]

l. Remove Terminal Net Salvage from Depreciation Expense

Duke's inclusion of more than $4.5M in proposed depreciation expense for terminal net salvage is unreasonable. The Company's request is for its customers to pay "forecast costs

[126] Order Case No. 2006-00172 at 2 (Ky. PSC Dec. 21, 2006) [*emphasis added*].
[127] Kollen Direct at 36.

that are not known with reasonable certainty today."[128] The effect of recovering these forecast costs "inherently adopts a default assumption that the production facilities will be dismantled and the site restored even though that often is not the economic alternative when compared to 'retirement in place.'"[129] The Attorney General agrees with Mr. Kollen that the Commission should adopt a default assumption of retirement in place, and when the actual decision is made regarding dismantling or site restoration, the Commission will have the opportunity to review and approve or deny the Company's decision and to determine whether the estimated cost and procedure itself is reasonable. Recovering terminal net salvage in the manner proposed by Duke turns into a self-fulfilling prophecy, setting up a situation where Duke realizes it has already recovered the money for dismantlement, so they decide they might as well follow through. Waiting until actual costs are incurred further ensures that only actual costs are recovered from customers.

Mr. Spanos argues that not including terminal net salvage in deprecation rates violates the FERC Uniform System of Accounts.[130] At the hearing in this matter, Mr. Kollen rebutted that argument, noting:

> the FERC Uniform System of Accounts does not say you have to include terminal net salvage in the depreciation rates and the proof of that I will suggest to you is that KU and LG&E did not have terminal net salvage in their depreciation rates for many, many years. Until approximately 10 years or so ago. And AEP/Kentucky Power just recently agreed to take it out of their depreciation rates. So if it's truly a violation of the FERC Uniform System as Mr. Spanos claims then KU would have been in violation, LG&E would have been in violation in the past and Kentucky Power would be in violation today. And I can tell you that their auditors would then not sign off on their Form 1

[128] Kollen Direct at 39.
[129] Kollen Direct at 39-40, internal citation omitted.
[130] See Spanos Rebuttal.

> filings with the FERC, or on their SEC financial statements. And in fact that has not been the case, they have signed off on those.[131]

The Commission should ignore Mr. Spanos' desperate plea, remove the test-year expense associated with terminal net salvage for production plant, and adopt Mr. Kollen's proposal, resulting in an overall net revenue requirement reduction of $4.362 million.[132] In the alternative, if the Commission approves Duke's proposal regarding terminal net salvage, it should at a minimum, "remove the 2.5% annual escalation rate applied to the terminal net salvage estimate."[133]

m. Reduce Interim Net Salvage In Depreciation Expense

In addition to including terminal net salvage in depreciation expense, Duke also included interim net salvage "based on forecasts of future costs of removal and salvage income.[134] Mr. Kollen raised concerns in his direct testimony as to whether the Company's methodology regarding interim net salvage was appropriate. Mr. Kollen noted that, "[i]t preemptively recovers costs that have not and may not be incurred. It overstates depreciation rates and expense."[135] Instead, Mr. Kollen proposed a methodology that calculates interim net salvage based on actual cost data used by the Company but using the "average annual historic interim net salvage dollars divided by the interim retirement portion of the production plant account and the entirety of the transmission and distribution plant accounts rather than the annual historic retirements. This methodology assumes that interim net salvage will continue at the same dollar amount until the next depreciation study. As such, it provides contemporaneous recovery of the net salvage dollars as I previously described."[136] Mr.

[131] March 8, 2018 VTE at 3:52:00-3:53:35.
[132] Kollen Direct at 42.
[133] Kollen Direct at 41.
[134] Kollen Direct at 43.
[135] Kollen Direct at 44.
[136] Kollen Direct at 44-45.

Kollen's proposal still makes the Company whole, while the effect is an overall reduction to the revenue requirement of $4.469 million, net.[137] The Commission should reject the Company's proposal on interim net salvage and instead adopt Mr. Kollen's.

n. Income Tax Expense

Duke's Application was filed months before the passage of the Tax Cuts and Jobs Act ("TCJA"), and therefore did not reflect the changes in the federal law.[138] Mr. Kollen filed his direct testimony soon after the passage of the TCJA, and thus his testimony reflected an attempt at calculating the reduction in expense that should flow to customers. The primary change to status quo that the TCJA provided was the reduction in the federal corporate income tax rate from 35% to 21% for calendar year 2018.[139] As Mr. Kollen points out, due to the reduction of the corporate tax rates:

> There are three direct effects based on the Company's income tax expense and ADIT. First there is a reduction in current and deferred federal income tax expense included in the test year. Second, there is a reduction in deferred income tax expense to reflect the amortization (through negative deferred income tax expense) of the excess accumulated deferred income taxes ("ADIT"). Third, there is a reduction in the gross revenue conversion factor ["GRCF"].[140]

Mr. Kollen reflected the reduction to test-year expense, evidencing the three direct effects.

Income Tax Expense/Gross Revenue Conversion Factor

Mr. Kollen reduced current and deferred income tax expense by the reduction in the federal income tax rate from 35% to 21%, or "40%, all else equal."[141] Mr. Kollen calculated that this reduction in the federal income tax expense should be a reduction to the revenue

[137] Kollen Direct at 45.
[138] *See* Tax Cuts and Jobs Act.
[139] Kollen Direct at 46.
[140] Kollen Direct at 46.
[141] Kollen Direct at 47.

requirement of approximately $10.255 M.[142] The Company subsequently addressed this issue in its rebuttal testimony, specifically in the testimony of Ms. Lawler and Mr. Wathen. As Mr. Wathen commented, the Company does agree that there should be a reduction to the GRCF.[143] Duke's reduction to the revenue requirement to reflect the lower federal income tax rate is $10,622,916.[144] Although Mr. Kollen and Ms. Lawler's exact amounts are slightly different, Mr. Wathen notes that the *de minimis* difference is caused by "a different recommended level of taxable income" than Mr. Kollen proposed.[145] The Attorney General agrees with Mr. Kollen and the Company that Duke's revenue requirement should reflect the entire reduction of income tax expense. Further, the Attorney General has no reason to believe the Company's calculation is incorrect as it has additional access to the necessary information.[146]

Accumulated Deferred Income Taxes ("ADIT")

The more controversial direct effect of the TCJA is the impact on the company's ADIT. Mr. Kollen describes the effect on ADIT by stating that the reduction in the federal income tax rate from 35% to 21% "results in a reduction of the future net income tax liabilities recorded in the asset and liability ADIT accounts."[147] As the federal income tax rate is permanently lowered to 21%, the future liability these ADITs represent are permanently reduced.[148] The net difference between the old ADIT balance and the new liability balance reflecting the lower federal income tax rate is referred to as "excess ADIT, and is considered

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[142] *Id.* at 48.
[143] Wathen Rebuttal at 21-22.
[144] Lawler Rebuttal at 3.
[145] Wathen Rebuttal at 21-22.
[146] March 7, 2018 VTE at 11:20:30.
[147] Kollen Direct at 47.
[148] *Id.*

a regulatory liability for [GAAP]."[149] Excess ADIT represents a balance of money that customers pre-paid for taxes, but given the reduction in the federal income tax rate, the liability for which will never come due. Pursuant to the TCJA, "protected" excess ADIT are subject to the provisions of the Internal Revenue Code, regulations and the TCJA, and must be amortized pursuant to a prescribed methodology.[150] In this case, Duke proposes to amortize these "protected" excess ADIT using the Average Rate Assumption Method, or ARAM.[151] The Attorney General believes Duke correctly calculated what the amortization under the ARAM is. Although Duke has provided the overall revenue requirement reduction related to the amortization of "protected" and "unprotected" excess ADIT, the Attorney General has calculated the reduction related to "protected" ADIT at approximately $1,567,217.[152]

As to "unprotected" excess ADIT, or those "that did not result from depreciation differences," the Attorney General agrees with Mr. Kollen's proposal to amortize them over a five (5) year period.[153] As opposed to the "protected" excess ADIT, the TCJA has no requirement for the amortization of "unprotected" ADIT and as such, it is up to the Commission to determine the time over which those ADIT are returned to customers. Amortizing the "unprotected" excess ADIT over five (5) years would result in a revenue requirement reduction of $8,859,305, in addition to the $1.5M reduction from the

[149] *Id.* internal citations omitted.
[150] March 8, 2018 VTE at 1:40:00.
[151] Bellucci Rebuttal at 4.
[152] The Attorney General calculated this amount by taking the test-year amortization in Attachment LMB-Rebuttal 1 attached to Ms. Bellucci's rebuttal testimony, and grossing it up by the GRCF of 1.3409866 as provided on page 3 of Ms. Lawler's rebuttal testimony.
[153] Bellucci Rebuttal at 4; March 8, 2018 VTE at 1:40:45.

amortization of "protected" excess ADIT.[154] Amortizing the "unprotected" excess ADIT over a longer period compensates new customers for an amount that they most likely did not participate in paying in the first place.[155] The Commission should explicitly reject Duke's unfair and unreasonably long amortization period for "unprotected" excess ADIT and should instead amortize that balance over a 5-year period.

Miscellaneous Tax Issues

Mr. Kollen noted there are ancillary effects of the TCJA, as these are reflected primarily in charges from DEBS and DEO. The Commission indicated in post-hearing data requests that they were interested to know "whether the expenses allocated to Duke Kentucky by its affiliates contain provisions for federal income tax."[156] Duke did not answer the question Commission Staff asked.[157] Instead, Duke stated that after it receives expenses from its affiliates the Company does not subsequently gross those up for taxes.[158] The Company should have confirmed or denied whether affiliates include their own federal income tax expense in the charges to Duke. If those Duke affiliates do recover their income tax expense through their charges to Duke, given the reduction in federal income tax expense, those charges will now be reduced moving forward, all else equal. The Commission should look further into this issue and determine whether the rates moving forward will include a cost that the Company will no longer incur.

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[154] Calculated by taking the $33,032,786 unprotected excess ADIT balance as presented in Attachment LMB-Rebuttal 1 attached to Ms. Bellucci's rebuttal testimony, dividing by five (5) to represent the five (5) year amortization ($6,606,557), and grossing it up by the GRCF of 1.3409866 as provided on page 3 of Ms. Lawler's rebuttal testimony; March 8, 2018 VTE at 1:40:45.
[155] March 8, 2018 VTE at 3:49:30.
[156] Duke response to Commission Staff PHDR 1-11.
[157] *Id.*
[158] *Id.*

Duke proposes to increase the Company's revenue requirement by $209,019 due to the changes in ADIT and the increase in the "Company's rate base and resulting rate base calculation which then changes capitalization."[159] The Attorney General agrees generally that a consequence of the TCJA is that rate base and/or capitalization will increase, all else equal. Mr. Wathen discusses this in further detail on pgs. 22-25 of his rebuttal testimony. The AG has no reason to believe that the Company's modest increase of approximately $200,000 is unreasonable, and thus does not object to the amount being included in a revenue requirement determination.

Duke also proposes a *de minimis* reduction to the revenue requirement to reflect the savings to customers in the first three (3) months of 2018 that will not be reflected in the test-year starting April 1, 2018. The Company proposes a $110,726 reduction to the revenue requirement, reflecting a 5-year amortization of the first three (3) months' savings in 2018, as calculated by Duke.[160] The Attorney General agrees with the 5-year amortization and also agrees that for 2018 customers should see a savings for the reduction of federal income tax expense for the first three (3) months, but disagrees with Duke's calculation for the 2018 "savings." Mr. Wathen calculates his reduction using a historic and forecast capitalization.[161] Mr. Wathen's historic capitalization is from Duke's 2006 electric rate case, while his forecasted capitalization seems to be the future test-year in this case.[162] This is improper.

Although Mr. Wathen likes to refer to his calculations as the "LG&E/KU model", he admitted that as of the time of the hearing in this case, the LG&E/KU case he referenced had

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[159] Lawler Rebuttal at 4.
[160] Wathen Rebuttal at 29-31.
[161] Attachment WDW Rebuttal -5.
[162] *Id.*

not been ruled on.[163] In fact, on March 20, 2018 the Commission entered an Order in Case No. 2018-00034 (the LG&E/KU case Mr. Wathen referred to) explicitly finding that in regard to capitalization, "it is not reasonable to utilize forecasted test years," and that using forecasted test years for the companies "would require the adoption of forecasted adjustments to the capitalizations of KU/LG&E that have not been subjected to the Commission's investigation and review."[164] The Commission should follow its precedent on this issue here in this case. Not only did Duke use a forecasted test year, which has the effect of allowing it to earn a return on capitalization for a period in which the Commission hasn't investigated or reviewed, but it also uses a capitalization beyond the time period for which it is attempting to calculate savings.[165] At a minimum, the Commission should take the new "Pre-Tax Return" of 9.26%, apply it to the historic capitalization from Case No. 2006-00172, and net that amount from the $67.5M number on column 1, row 3 in Mr. Wathen's Attachment WDW Rebuttal – 5. This would result in a $795,759 test-year reduction to the revenue requirement.[166]

Finally, the Commission should ensure that the reduction in the federal income tax rate is also reflected in all riders where there is an equity return and an income expense, including but not limited to Duke's proposed environmental surcharge rider.[167]

o. <u>Income Tax Expense for Research Tax Credits</u>

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[163] *See* Case No. 2018-00034; March 7, 2018 VTE at 3:15:15.
[164] Case No. 2018-00034, Order (Ky. PSC March 20, 2018) at 7.
[165] Attachment WDW Rebuttal -5. The savings are to be calculated for January 1, 2018- March 31, 2018, while the forecast capitalization begins April 1, 2018.
[166] Calculated by multiplying the 9.26% "Pre-Tax Return" on column 2, row 2, by the electric capitalization from Case No.2006-00172 of $557,080,702, equaling $51,585,673. Subtracting $51,585,673 from the $67,500,855 amount in Column 1, row 3 equals $15,915,182. Dividing $15,915,182 by 4 to determine the annual savings allocable to the first three months (Jan. 1- Mar. 31), and then amortizing that amount over 5 years equals an annual reduction to the revenue requirement of $795,759.
[167] Kollen Direct at 48-49.

The Company has historically claimed a research tax credit as a reduction to its current income tax expense.[168] The Company failed to include its forecast research tax credit as a reduction to the revenue requirement in this case and stated that the credit "was erroneously excluded from the calculation of tax expense in the test year revenue requirement."[169] Using the information provided to him and reflecting the reduction of the federal income tax rate, Mr. Kollen recommended a reduction to the revenue requirement to reflect this error of approximately $102,000.[170] In her rebuttal testimony, Ms. Lawler noted that even though Ms. Bellucci agreed that the tax credit should be a reduction to forecasted test year income tax expense, the Company had previously supplied incorrect data in AG-DR-02-005, and thus the actual reduction should be $119,514.[171] The Attorney General agrees with including the research tax credit as a reduction to the revenue requirement and has no reason to question the veracity of the Company's $119,514 amount.

2. Capitalization Issues

a. Reduce Capitalization for Loans Made to Affiliates

Although Duke can be both a borrower and lender in the Duke Energy Money Pool, when it is a borrower "it reflects the borrowings as short-term debt, which it includes in capitalization for ratemaking purposes."[172] Being a lender to the Money Pool, Duke reflects the receivables, but does so in a way where it "does not reflect as a reduction to capitalization for ratemaking purposes."[173] Duke acknowledges that it will be a lender in the Money Pool

[168] Kollen Direct at 49.
[169] Duke response to AG DR 2-9; Kollen Direct at 49-50.
[170] Kollen Direct at 50.
[171] Lawler Rebuttal at 4.
[172] Kollen Direct at 50-51; Duke response to AG DR 2-9.
[173] Kollen Direct at 51.

starting in September 2018, and the debt used to do so "is included in the Company's proposed capitalization."[174] The 13-month average of this short-term investment is $5.126M, which represents the amount that capitalization is overstated.[175] Removing this overstatement reduces the revenue requirement by $451,351.[176] The Attorney General agrees with Mr. Kollen's recommendation and moves the Commission to reduce the capitalization accordingly.

b. Remove East Bend O&M Reg. Asset from Capitalization

As previously mentioned in this brief, Duke's Application improperly provides for two returns on the same amount of money, specifically, the East Bend O&M expense regulatory asset. Mr. Kollen explains the Company's errors as:

> The Company included a debt only rate of return in the levelized amortization expense for the East Bend O&M expense regulatory asset and in the revenue requirement. The Company also included the regulatory asset in capitalization and included the grossed-up return at the weighted cost of capital in the revenue requirement. The Company is entitled to only one return on the regulatory asset, not two.[177]

Mr. Kollen is absolutely correct, and interestingly, the Company agreed that it made a mistake, with Mr. Wathen stating, "[t]he Company agrees that it should not earn a return twice on the regulatory asset."[178] Shamelessly, although Duke is only authorized to carry the regulatory asset at the weighted average cost of debt,[179] upon becoming aware of its mistake Duke now wants to earn the full weighted average cost of capital.[180] Mr. Kollen's proposal is to remove the regulatory asset from capitalization so that Duke can only earn the long-term

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[174] Kollen Direct at 52, *citing* Sch_J3, provided in Duke's response to Staff DR 1-73.
[175] Kollen Direct at 52.
[176] *Id.*
[177] Kollen Direct at 53.
[178] Wathen Rebuttal at 19.
[179] Order in Case No. 2014-00201; Kollen Direct at 53.
[180] Wathen Rebuttal at 19-21.

debt rate.[181] Mr. Wathen argues that removing the entire amount of the regulatory asset from capitalization somehow affects the weighted average cost of capital.[182] He is incorrect. Mr. Wathen agrees that the Commission has only approved Duke a return at the long-term debt rate.[183] It is clear from Mr. Wathen's rebuttal testimony and his cross-examination that the Company is seeking a return in excess of what the Commission has approved. Mr. Wathen's "fix" to Duke's mistake is to credit back the long-term date rate, which in effect provides Duke a weighted average cost of capital return on the entire amount.[184] Mr. Wathen's alternative argument is even more brazen, wherein he asks that if the Commission agrees with Mr. Kollen in removing the regulatory asset from capitalization, then it should approve a weighted-average cost of capital return on the regulatory asset, rather than the debt rate it currently earns.[185] The Company is attempting to extract a bigger benefit than the Commission previously provided, to the detriment of its customers. Duke is only authorized to earn a return <u>at the long-term debt rate</u> and as such, the Commission should adopt Mr. Kollen's proposal to fix the Company's mistake.[186] The revenue requirement effect of removing the regulatory asset from overall capitalization is a reduction of $3.449 million.[187]

c. <u>Remove DSM Reg. Asset from Capitalization</u>

Mr. Kollen's testimony provides for the removal of a DSM regulatory asset from capitalization that was a "result of the Company's under recovery of its DSM costs through rider DSM."[188] Mr. Kollen goes on to note that, "The Company recovers its DSM costs

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[181] Kollen Direct at 53.
[182] March 7, 2018 VTE at 3:04:00; at March 7 VTE 3:06:45 Mr. Wathen admits that the regulatory asset "is not considered long-term debt," and that "[Duke's] capitalization is really independent of this."
[183] March 7, 2018 VTE at 3:05:00.
[184] Wathen Rebuttal at 20; March 7, 2018 VTE at 3:07:30.
[185] Wathen Rebuttal at 21.
[186] Order Case No. 2014-00201.
[187] Kollen Direct at 54.
[188] *Id.*

through the DSM rider, including any over or under recovery. All DSM costs should be removed from the base revenue requirement."[189] The Company agrees with Mr. Kollen that, "DSM costs are recovered through the Company's DSM rider, not through the base revenue requirement."[190] The Attorney General agrees with Duke and Mr. Kollen that any under or over recovery of amounts from rider DSM should be dealt with there, not in the base revenue requirement, and as such recommends Mr. Kollen's adjustment to the revenue requirement of $130,035.[191]

d. Remove East Bend Coal Ash Reg. Asset from Capitalization

Duke's Application mistakenly neglected to remove the East Bend Coal Ash Regulatory Asset in capitalization. In discovery the Company agreed that the regulatory asset should have been removed from capitalization, stating, "The Company has made no adjustment to capitalization for this regulatory asset but would be willing to make an adjustment given the balance is accruing carrying costs."[192] Mr. Kollen's testimony provided for the removal of the ARO from capitalization and in Ms. Lawler's rebuttal testimony, Duke agreed.[193] Both Mr. Kollen and Duke agree on the effect this removal will have on the revenue requirement, which is a reduction of $1,629,904.[194] Additionally, although both Attorney General witness Mr. Kollen and Duke both made proposed adjustments to capitalization throughout this proceeding, Mr. Wathen deemed it necessary to find fault with Mr. Kollen not reconciling his adjustments to rate base.[195] Simply, there is no requirement for Mr. Kollen to do so. The

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[189] *Id.*
[190] *Id.* citing Duke's response to AG DR 2-4(a).
[191] Kollen Direct at 55.
[192] Kollen Direct at 56, citing Duke's response to AG DR 2-4(e).
[193] Lawler Rebuttal at 6; Kollen Direct at 56.
[194] *Id.*
[195] Wathen Rebuttal at 32.

Company made adjustments to capitalization in its rebuttal testimony, but did not reconcile those adjustments to rate base.[196] If there is some requirement that an intervening witness must reconcile adjustments to capitalization to rate base, the Attorney General is unaware of it. Although Mr. Wathen points to KRS 278.290, the record is devoid of evidence that he is an attorney, nor does he provide any explanation as to how that statute has anything to do with Mr. Kollen's adjustments.[197] Although, as Mr. Wathen points out the Commission's regulation does necessitate a reconciliation or explanation of same in the minimum filing requirements of an application, there is no requirement for intervenor testimony.[198] Had there been a requirement for Mr. Kollen to propose adjustments to capitalization and rate base, he would have done so, and it would not have changed his proposals. Duke is the master of its own petition in this matter, and Mr. Kollen simply made adjustments to capitalization as Duke presented it.

C. ***Environmental Surcharge Mechanism***

In his direct testimony Mr. Kollen notes that the Company's Application "proposes recovery of the East Bend Coal Ash ARO through a straight-line amortization over ten years."[199] Mr. Kollen further points out that the Company's proposal seeks authorization to recover expenses that it forecasts it will incur.[200] Notably, recovery of costs in this manner unnecessarily increases costs to customers, "because it requires the prepayment of income taxes."[201] The Attorney General believes this treatment is improper. As a general proposition,

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[196] March 7, 2018 VTE at 11:06:30-11:06:45.
[197] Wathen Rebuttal at 32; Mr. Wathen does note that, "as a general rule, rate base and capitalization should be approximately equal." The Commission's actions are not dictated by general rules.
[198] *Id.*
[199] Kollen Direct at 59.
[200] *Id.*
[201] *Id.* at 60.

the Attorney General has no objection to the implementation and use of an environmental surcharge mechanism. The ESM is authorized by statute,[202] and it is the AG's understanding that Duke is the last utility in the state with generation assets but without an ESM. Although the AG has no objection to the implementation of an ESM, he does recommend that the Commission initially include only the actual costs incurred through March 31, 2018 in the ESM rate base and the related amortization expense,[203] and include costs after that date in the same way it does for the other utilities with an ESM. This treatment will ensure that Duke's costs are fully recovered, with return where necessary, and that customers pay only what they must and with no additional carrying costs.

D. ***Rider FTR***

Duke proposes the initiation of a new rider to track FERC-jurisdictional transmission services that are incremental to the amount included in base rates.[204] The new rider, the FERC Transmission Costs Reconciliation Mechanism, or Rider FTR, will include 22 PJM Billing Line Items ("BLI").[205] Along with deferral accounting for planned outage O&M, preferential treatment regarding tax changes, an increased customer charge, and an Environmental Surcharge Mechanism, Rider FTR is the just the latest in a line of proposals in this matter which Duke has requested, with its primary support being that since another jurisdictional utility has it, Duke wants it too. In fact, an entire page of Duke witness Mr. Wathen's rebuttal testimony is dedicated to mentioning that Kentucky Power Co. requested and received (albeit

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[202] KRS 278.183.
[203] *See* Rebuttal Testimony of Cynthia S. Lee (Ky. PSC Feb, 14, 2018) at 3, wherein Ms. Lee explains that the Company estimated its ARO actual costs through April 2018 will be $17M.
[204] Direct Testimony of John D. Swez ("Swez Direct") (Ky. PSC Feb. 14, 2018) at 26.
[205] Swez Direct at 28.

within the context of a settlement) a similar rider, and noting Mr. Kollen's participation in the Kentucky Power Co. Case.[206] Duke is not Kentucky Power. For instance in the last Kentucky Power rate case, the Commission noted:

> Kentucky Power stated that the proposed tracking mechanism for PJM OATT LSE Charges is necessary due to the volatility of these PJM charges and credits, which Kentucky Power claimed are largely out of its control. Kentucky Power estimated that its PJM OATT LSE expenses will increase in 2018 by approximately $14 million, or 19 percent over the test year amount . . . Kentucky Power stated that tracking the PJM LSE charges and credits via Tariff P.P.A could preclude it from seeking more frequent rate cases.[207]

What Mr. Wathen glosses over, or ignores completely, in his rebuttal testimony is that although a settlement in Kentucky Power did include a FERC transmission rider, Kentucky Power agreed to: 1) recover and collect only 80 percent of the incremental PJM OATT LSE charges; 2) recover a lower ROE for its FERC approved PJM OATT charges; and, 3) commit to a 3 year rate case stay-out.[208] In the case of Kentucky Power, the Commission was faced with an instance where a similar rider would ensure less frequent rate cases, while with Duke, that is not a problem.[209]

In addition to the negative effects Rider DCI and Rider PSM will have on customers between rate cases, Rider FTR "will significantly and negatively transform the retail ratemaking for these costs and drive up customer rates more quickly than under the present ratemaking paradigm."[210] Furthermore, Rider FTR would "shift recovery from the base revenue requirement to the proposed rider" and "change recovery from a fixed amount based

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[206] Wathen Rebuttal at 36; See also, Order, Case No. 2017-00179 (Ky. PSC Jan. 18, 2018).
[207] Order, Case No. 2017-00179 (Ky. PSC Jan. 18, 2018) at 52.
[208] *Id.* at 6 & 53.
[209] Kollen Direct at 62, citing Case No. 2014-00396; Order, Case No. 2017-00179 (Ky. PSC Jan. 18, 2018) at 52.
[210] Kollen Direct at 62.

on the test year expense . . . to an unending series of automatic . . . rate increases."[211] Duke has not shown any evidence that the costs they are requesting to recover through the proposed Rider FTR are so volatile as to force the Company to come directly back to the Commission for additional rate relief. Accordingly, the Commission must reject Rider FTR for the same reason it must reject Rider DCI and the changes to Rider PSM: customers cannot afford constant and never-ending rate increases. If the FERC transmission costs deny Duke an opportunity to earn a reasonable rate of return, then the Company should take the occasion to return for rate relief so the Commission and any intervenors can determine whether the costs, both current and future, are prudently incurred.

E. ***Residential Customer Charge***

Duke proposes an increase of the monthly charge applicable to residential customers from the current $4.50 to $11.22.[212] Duke witness Sailers states that the reason for the proposed increase is to "better reflect the customer related fixed cost to serve. . . [and to] better align[] price signals with cost causation."[213]

In Case No. 2008-00408,[214] the Commission stated that it "has consistently applied the principle of 'gradualism' in its deliberations relating to proposed increases to the utilities' customer charges. . . . As a result, in most rate cases filed with the Commission since late 1982, the electric utilities have requested gradual increases in their customer charges even when a cost-of-service study supported significantly higher customer charges than

[211] *Id.*
[212] Direct Testimony of Bruce L. Sailers ("Sailers Direct") (Ky. PSC Sept. 1, 2017) at 10.
[213] Filing Sch. L.
[214] In re: In the Matter of: Consideration Of The New Federal Standards Of The Energy Independence And Security Act Of 2007, 2011 WL 4732021, Order dated Oct. 6, 2011.

requested."[215] On its face, the proposed 149% increase in the residential customer charge would not comport with the Commission's well-settled principle of gradual increases in customer charges.

Fixed Costs Do Not Require Fixed Charges

Duke maintains that costs classified as customer-related for *revenue allocation* purposes must also be classified as customer-related for purposes of *rate design*.[216] Accordingly, Duke proposes to collect a substantial portion of any potential increased revenue requirement through the fixed monthly charge. However, this proposal is not aligned with the economic theory of efficient competitive pricing. Since regulated utilities in a vertically integrated state such as Kentucky are afforded monopoly status, regulation should serve as surrogate for competition to the furthest extent possible.[217] Thus, pricing policy for a regulated public utility should mirror that of competitive firms to the greatest extent practical.[218] Since all costs are variable in the long run,[219] in competitive, efficient, pricing structures high levels of up front, or sunk, fixed costs are recovered volumetrically based on usage.[220] Upfront expenses for customer-related distribution costs are most commonly associated with the creation of the distribution system, such as transformers and poles.[221] These costs are incurred regardless of the number of customers that join the system, thus they can be characterized as short-run fixed costs to be included in a zero-intercept study in the creation of a fully embedded cost of

[215] *Id*. at 26.
[216] *See* Direct Testimony of Bruce L. Sailers, at 8, wherein he states that his proposed rate design is based on the cost of service study performed by Duke witness James E. Ziolkowski; *see also* Sailers, at 9, "Duke Energy Kentucky supports the general concept that rates . . . should approximate the cost of providing these customers with service."
[217] Direct Testimony of Glenn A. Watkins ("Watkins Direct") at 28 (*citing* James C. Bonbright, Albert L. Danielson & David R. Kamerschen, Principles of Public Utility Rates, p. 141 (2nd Edition, 1988)).
[218] Watkins Direct at 28.
[219] *Id.*
[220] *Id.*
[221] *See infra,* note 217.

service study for the purposes of allocating revenues.[222] However, these costs should not necessarily be reflected in the customer charge, especially under the incorrect argument that fixed costs must be collected through fixed charges. Efficient competitive prices are established based on long-run costs, which are entirely *variable* in nature.[223] There is general consensus in our economic system that those who receive more benefits should pay more in total than those who receive fewer benefits. Regarding electricity usage, i.e., the level of kWh (electric) consumption is the best and most direct indicator of benefits received. Thus, volumetric pricing promotes the fairest pricing mechanism to customers and to the utility.

The process of recovering largely fixed costs in the short-run with a pricing structure that recovers those costs on a volumetric basis is not unique. For instance, "[m]ost manufacturing and transportation industries are comprised of cost structures predominated with 'fixed' costs."[224] Invariably, the Companies' contention that fixed costs need to be recovered through fixed charges is incorrect, especially since all costs are variable in the long-run. When costs that vary in the long term are reflected in volumetric charges, their recovery correlates more with conservation measures than if the costs had been recovered through a fixed charge.[225] Rather, the Company's position regarding fixed cost recovery seems to be nothing more than attempt to reduce its volumetric risk between rate cases.

Of course, by recovering more revenue through the customer charge, Duke is less concerned about the volume of the product it is in the business of providing: electricity.

[222] Watkins Direct at 34-35.
[223] *Id.* at 30-31.
[224] *Id* at 30.
[225] *See* Bonbright, *supra*, p. 491 (noting that the use of a zero-intercept method in determining certain customer-related costs to be included in the customer charge overlooks weak correlation between cost causation of factors and certain customer-related costs). Bonbright further notes that costs associated with the system envisioned by either the zero-intercept or other minimum-sized methods are unallocable and probably best reflected as long-run marginal costs, and thus best recovered volumetrically.

Increased customer charges reduce the Company's risk, which has already been greatly mitigated through recovery of lost sales volumes from the DSM tariff (plus a return to shareholders), surcharges for fuel and environmental compliance costs, and the use of a fully-forecasted test year. As Mr. Watkins notes:

> A pricing structure that is largely fixed, such that customers' effective prices do not properly vary with consumption, promotes the inefficient utilization of resources. Pricing structures that are weighted heavily on fixed charges are much more inferior from a conservation and efficiency standpoint than pricing structure that require consumers to incur more cost with additional consumption.[226]

Rather than promoting rates that reduce Duke's risk, it is more appropriate to recover short-run fixed costs through variable rates, which has the effect of sending proper pricing signals to customers to conserve and utilize resources efficiently.[227] Leaving the customer charge unchanged would strike a reasonable balance between risk reduction for the Companies, and proper long-term price signals for customers, as discussed below.

Commission Policy Dictates Rates Should Promote Conservation

For thirty years, this Commission has recognized that energy conservation as a ratemaking standard "is intended to minimize the 'wasteful' consumption of electricity and to prevent consumption of scarce resources."[228] In Case No. 2012-00222,[229] LG&E requested an increase in the customer charge based solely on its cost of service.[230] In the final order of that case, the Commission noted that in reviewing that increase, it:

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[226] Watkins Direct at 32.
[227] *Id.* at 27-32.
[228] Administrative Case 203, The Determinations with Respect to the Ratemaking Standards Identified in Section III (d)(1)-(6) of the Public Utility Regulatory Policies Act of 1978, (Ky. PSC Feb.28, 1982) at 7.
[229] In Re Application of Louisville Gas and Electric Company for an Adjustment of Its Electric and Gas Rates, A Certificate of Public Convenience and Necessity, Approval of Ownership of Gas Service Lines and Risers, and a Gas Line Surcharge.
[230] *Id.*, Final Order dated Dec. 20, 2012, at 12.

> . . . is faced with a different argument, one raised by consumers whose e-mails, letters, and public hearing comments contend that a higher customer charge will disincentivize them to make energy efficiency expenditures. They argue that their bills will rise even though they reduce their energy usage.[231]

The Commission then analyzed the impact of the proposed increase in the residential customer charge for electric service from the then-existing $8.50 to the rate recommended in the stipulation to that case of $10.75. In finding that the proposed increase would not disincentivize customers from using energy efficiency measures to reduce their bills, the Commission stated:

> Determining the proper balance between cost of service, energy efficiency incentives for the utility, and energy efficiency incentives for the customer is challenging and requires a close examination of the facts and circumstances of each case. . . [W]ith the potential for huge increases in the costs of generation and transmission as a result of aging infrastructure, low natural gas prices and stricter environmental requirements, we will strive to avoid taking actions that might disincent energy efficiency.[232]

The higher customer charge Duke proposes would clearly dampen price signals and discourage economically efficient conservation and investments in distributed generation by residential customers. Likewise, Mr. Watkins' testimony observes that "a rate structure that is heavily based on a fixed monthly customer charge sends an even stronger price signal to consumers to use more energy."[233] Mr. Watkins further noted:

> [O]ne of the most important and effective tools that this, or any, regulatory Commission has to promote conservation is by developing rates that send proper pricing signals to conserve and utilize resources efficiently. A pricing structure that is largely fixed, such that customers' effective prices do not properly vary with consumption, promotes the inefficient utilization of resources.[234]

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[231] *Id.* at 13.
[232] *Id.* at 14-15.
[233] Watkins Direct at 32.
[234] *Id.* at 32.

Additionally, a very large increase in the customer charge such as that Duke proposes would undermine future incentives for efficiency and distributed solar, and would also prove unfair to customers who have already invested in those resources, but who would now see a diminished return on their investment.

As such, the record demonstrates that Mr. Watkins' proposal of leaving the customer charge unchanged is consistent with this Commission's longstanding policy to "avoid taking actions that might disincent energy efficiency."[235] Quite significantly, that proposal would also preserve a greater degree of customer control over electric bills, in contrast to a bill that is largely comprised of a fixed charge that customers cannot avoid no matter what investments or behavioral changes they may make to reduce their usage. The reduced ability to control and therefore lower one's utility bill is especially harmful for low-income customers who have limited financial resources to meet their basic needs.

F. Revenue Allocation

The Attorney General agrees with its witness, Mr. Watkins, that Duke's proposed class revenue distribution is reasonable as it relates to the Residential class.[236] Further, the Attorney General agrees with Mr. Watkins regarding the criteria to be used in evaluating class or rate schedule revenue responsibility.[237] For instance, "[c]lass cost allocation results should be considered," but they "are not surgically precise."[238] In addition to using class allocation results as a guide, the Commission should consider gradualism, rate stability, affordability,

[235] *In Re Application of Louisville Gas and Electric Company for an Adjustment of Its Electric and Gas Rates, A Certificate of Public Convenience and Necessity, Approval of Ownership of Gas Service Lines and Risers, and a Gas Line Surcharge, supra* at 14-15.
[236] Watkins Direct at 25.
[237] Watkins Direct at 23.
[238] Watkins Direct at 4.

and public policy concerning current economic conditions.[239] The Attorney General believes Duke's proposed class revenue distribution strikes a balance between these criteria.

It should be noted that the Attorney General disagrees with Kroger witness, Justin D. Bieber's proposal, wherein he recommends using the "opportunity" the reduction in the federal income tax rate provides to "allocate half" of the "savings" to certain classes pursuant to the class cost of service studies.[240] This would be improper. Foremost, even Mr. Bieber agrees that the reduction in federal taxes is not a savings; it is reduction in income tax expense.[241] Using a forecasted test year provides the Commission an opportunity to look forward to what the Company's level of expense will be for each item in the test year. Since the Company filed its Application, it became aware of the fact that a major expense included in its forecasted test year has decreased— income tax expense. As such, the Commission should treat the reduction in income tax expense the same way it would any reduction, which would be a lowering of the overall revenue requirement, and an allocation in agreement with the ordinary criteria. Although it is understandable that Kroger would like to use the reduction in income tax expense to benefit from a larger bargain, the Commission should see it for what it is— a cash grab— and summarily reject the proposal.

G. Rider DCI

Duke's proposed Distribution Capital Investment reconciliation mechanism ("DCI") is an extraordinary request. Duke's DCI would be the first electric incremental capital recovery mechanism in the Commonwealth,[242] and its purpose is to allow "the Company to more

[239] *Id.* at 23.
[240] March 8, 2018 VTE at 9:23:30.
[241] March 8, 2018 VTE at 9:24:20.
[242] Duke Response to Staff DR 2-55.

timely recover its capital invested . . . thereby reducing regulatory lag."[243] With the DCI, Duke would likely recover amounts for expenses it has yet to incur, all within the context of annual filings establishing rates.[244] Although the purpose of the DCI is "timely" recovery of investments, the effect is a steady increase in customer rates, with little to no corresponding benefit, including no guaranteed increase in system reliability or reductions in O&M expense. There is no need for Rider DCI. Customers do not want the increased costs, and the Company has not proven that it has issues with "timely" recovery of its investment.

Duke Has No Need for Rider DCI

Attorney General Witness Baudino testified that automatic adjustment clauses, such as DCI, enable utilities like Duke to pass through significant new costs without thorough regulatory scrutiny.[245] The effect of the DCI would be increased cash flow to Duke, and more frequent rate increases to customers, effectively shifting "the risk of investment from the utility and its management and shareholder to ratepayers."[246] Aside from the poor mechanics of Duke's DCI (it "lacks any mechanism for Commission review to determine if costs passes through [it] have been prudently incurred"),[247] the DCI is simply not necessary for the Company to have a reasonable opportunity to earn its authorized rate of return. Since Duke's last electric rate case, Case No. 2006-00172, "Duke Energy Kentucky's electric delivery system has grown substantially."[248] Between December 31, 2007 and December 31, 2016, Duke's original cost electric delivery system plant in service increased from $302,307,606 to

[243] Wathen Direct at 26.
[244] Baudino Direct at 45-46.
[245] Baudino Direct at 46.
[246] *Id.*
[247] Baudino Direct at 46-47.
[248] Direct Testimony of Anthony J. Platz ("Platz Direct") (Ky. PSC Sept. 1, 2017) at 5.

$426,635,808, an increase of more than 40%.[249] Despite this substantial investment in plant, Duke's return on equity has not suffered. For instance, for calendar year 2016, the ninth and last year from the data set above, Duke's earned electric ROE was 10.13%.[250] The previous year, Duke earned an 11.3% ROE.[251] These robust ROEs show that the Company *already* has an opportunity to earn a reasonable rate of return *without* rider DCI, even though Duke is making significant investment without such a "timely" recovery mechanism. The record is lacking of any evidence that Duke has had trouble raising capital in order to invest in its system since its last rate case. In the words of Mr. Baudino, "Quite frankly, Duke Kentucky failed to make the case that it needs a DCI to continue to make these distribution system investments for its customers."[252]

<u>Duke's DCI Proposal Is Flawed</u>

In his direct testimony, Mr. Baudino notes that the current DCI rider does not have a mechanism to "include offsets that reflect the build-up of accumulated depreciation and accumulated deferred income taxes."[253] Mr. Baudino goes on to note that this would assure that these investments are treated in the DCI the same way they are in rate base during a rate case.[254] Further, Mr. Baudino notes that the proposed mechanism does not include an "incremental offset for increase in accumulated depreciation and ADIT on total distribution plant," which would reflect "the fact that total distribution plant will continue to depreciate between rate cases."[255]

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[249] *Id.*
[250] Base Period Update Schedule K (Ky. PSC January 12, 2018) page 4 of 5.
[251] *Id.*
[252] Baudino Direct at 50.
[253] Baudino Direct at 53.
[254] I*d*.
[255] *Id.*

Duke Witness Mr. Platz agreed that there is an expectation that as the Company increases capital investment in its distribution system, O&M expense is likely to decrease.[256] Nevertheless, there is no mechanism in the DCI to return that reduction in O&M expense to customers.[257] Effectively, Duke has proposed Rider DCI to be a one-way street: <u>costs flow to customers, but the Company keeps any and all savings</u>. In fact, Mr. Platz testified at the hearing that the expectation of Duke's Targeted Underground Program, or "TUG", is that it will fix some of the Company's worst circuits, which "allows us to provide a solution that we can essentially walk away from . . . and eliminate future recurring maintenance."[258] By spending capital dollars, the Company can save O&M expense.[259] This is the essence of Duke's DCI. Duke requests incremental, and automatic, recovery of certain capital investment between rate cases, while the Company pockets the *expected* O&M savings.

<u>Duke's TUG is Evidence Rider DCI is Poor Ratemaking</u>

Duke's first and flagship program for Rider DCI is its TUG, whereby the Company "proposes to identify specific areas of its distribution system that experience higher than acceptable frequency of outage and replace overhead wires with underground cables."[260] The Attorney General wonders why the Company needs an additional program or capital recovery rider in order to ensure safe, reliable service to its customers. If TUG is approved, Duke anticipates undergrounding 140 line miles over the next 10 years, which includes approximately 5,600 customers.[261] The costs of undergrounding those 5,600 customers over

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[256] March 7, 2018 VTE at 9:44:30-9:46:007 & 10:21:30.
[257] *Id.*
[258] March 7, 2018 VTE at 10:01:45-10:02:50.
[259] March 7, 2018 VTE at 10:20:45.
[260] Platz Direct at 25.
[261] Duke response to AG DR 2-41.

10 years is an expected $66,000,000, or approximately $11,750 per customer affected.[262] Importantly, of the total estimated 10-year cost, 99% is expected to be capital expenses, meaning the company will further recover from customers the weighted-average cost of capital, plus a gross-up for income tax expense.[263] If the cost alone is not shocking enough, Duke admitted that it did not conduct an economic cost-benefit analysis to test the effectiveness of TUG.[264] It is apparent from the record that Duke did not adequately consider reasonable options other than the TUG, including but not limited to purchasing whole-house generators for the 5,600 affected customers at issue.[265]

Duke's Rider DCI and Targeted Underground Program are both "pie in the sky" wish list items for the Company. The record is devoid of evidence that either program is needed or that the Company cannot ensure that customers have safe, reliable service without them. Over the past 10 years, Duke has invested heavily in its distribution network, while maintaining or exceeding the rate of return investors expect and require.[266] DCI ensures that customers keep paying while the Company continues to profit, with capital costs continuing to be charged to customers, but with the expected O&M savings staying with Duke. Rider DCI and TUG are two wishes the Commission should not grant.

H. Proposed Fixed Bill Program

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[262] *Id.*
[263] Duke response to AG DR 1-89(a)(1).
[264] March 7, 2018 VTE at 9:30:00.
[265] *See* AG hearing exhibit 7, *see also* March 7, 2018 VTE at 9:30:00-9:35:00.
[266] See Baudino Direct wherein he recommends an 8.8% ROE for Duke, and Duke Schedule K, filed Jan. 12. 2018.

Duke's proposed Fixed Bill Program would provide for a constant "flat" bill to participating residential customers, regardless of how much energy they consume or, just as importantly, when they consume it. During peak times, Duke's incremental costs of electricity production are higher than they are during milder weather conditions. Such higher costs, of course, are passed on to customers who become incentivized to turn down air conditioning and other load sources. The higher costs in turn increase all customers' fuel rates, yet Fixed Bill customers would face no direct, immediate, monetary consequences if they choose to increase their load during peak pricing. As such, the Fixed Bill Program would incentivize peak load or total consumption, which would be contrary to the objective of efficient pricing and conservation.

Duke's application provides no substantive details regarding the proposed Fixed Bill Program. For example, although the Company stated in response to AG 2-33 that its Fixed Bill Program would essentially mirror one provided by Duke Energy Indiana, the response provided advertising materials from Duke Energy Indiana which indicated that program charges a program fee in an amount not to exceed 7.5% greater than the applicable normal residential tariff.[267] However, Duke never provided a definitive proposal setting forth the specifics, in particular the precise rate and any applicable premium that might apply.

Duke's rebuttal testimony did set forth that in the event Fixed Bill Program participants' usage exceeds weather normal usage for a customer, the Company's shareholders will bear the costs.[268] Additionally, if a Fixed Bill Program participant's usage is more than 15% higher than expected normal weather usage, the customer will either be

[267] Response to AG 2-33, Attach. 2, p. 2 of 4.
[268] Rebuttal Testimony of Alexander "Sasha" J. Weintraub (Weintraub Rebuttal) (Ky. PSC Feb. 14, 2018) at 5.

warned, have their bill repriced, or could be terminated from the program.[269] However, Duke failed to provide a detailed explanation of how it would propose to prevent additional fuel costs from being passed on to all other Duke customers who would pay for the Fixed Bill participants' increased usage. Company witness Weintraub testified that Duke would have to engage in "quite an extensive calculation" in order to determine how much additional fuel was consumed by Fixed Bill participants,[270] yet the company did not provide proof or other documentation of these calculations in the filing or proposed tariff. During the evidentiary hearing, witness Weintraub reiterated that shareholders would, in essence, hold ratepayers harmless from having to incur any additional fuel charges resulting from Fixed Bill Program participants' excess usage, but no details were provided in the record. The proposed Fixed Bill Program does have some assumptions based in part on results in other jurisdictions.[271] Nowhere in the record is there a definitive proposal setting forth the specifics of the Fixed Bill rate, and the level of premium that participants would have to pay.[272]

Perhaps even more troubling is the fact that if approved, the Fixed Bill Program would incentivize energy consumption during peak periods. If, as a result of increased peak consumption Duke is forced to either obtain an additional generation resource or market power, it is ratepayers who will be stuck with that bill, notwithstanding the fact that shareholders would ostensibly cover the incremental fuel costs of individual participants who exceed a weather-averaged consumption level. That is the unseen risk of the Fixed Bill

[269] *Id.* at 6.
[270] March 6, 2018 VTE at 10:59:00 – 10:59:35.
[271] March 6, 2018 VTE at 11:02:20 – 11:02:56; 11:03:35 – 11:04:00.
[272] March 6 VTE 11:10:00 – 11:10:26; 11:14:13 – 11:14:38.

Program, one too significant for ratepayers to bear, which mandates that the Commission reject the program.

I. Rider PSM

Duke's Rider PSM, or Profit Sharing Mechanism, was initially approved in Case No. 2003-00252, where the Commission approved the Company's acquisition of generation.[273] The first construct approved by the Commission provided customers the first $1M in net off-system sales, and shares the remaining amount 50/50, except that customers received 100 percent of net margins from emission allowance sales.[274] Although the Company shared off-system sales in this manner starting in Case No. 2003-00252, the actual Rider PSM "went into effect for customers beginning in January 2007, as approved in Case No. 2006-00172."[275] In Case No. 2014-00201, the Commission approved the most recent changes to Rider PSM, including "sharing 75% of the net margins on capacity transactions with its customers."[276] Although the Company believes it important to note that Mr. Kollen's proposals regarding PSM would be a "significant departure from the formula for Rider PSM that the Commission has approved on multiple occasions since 2007," it ignores the fact that this is the Company's first base rate case since 2007.[277] In addition to Mr. Kollen's aforementioned proposal regarding the off-system sales portion of Rider PSM, the Attorney General has other concerns that were not addressed in testimony.

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[273] Lawler Rebuttal at 9.
[274] *Id.*
[275] *Id.*
[276] *Id*. at 10.*; See also,* Case No. 2010-00203 where the Commission approved the profit sharing percentages from 50/50 to 75% for customers.
[277] Lawler Rebuttal at 7.

As mentioned before, the Company is dismayed that Mr. Kollen proposed changes to the structure of Rider PSM.[278] Nevertheless, it is Duke that is "propos[ing] to restructure Rider PSM."[279] The Company considers its changes to Rider PSM as a "proposal to update and streamline" it.[280] In reality, just like its other rider proposals, Duke is planning to turn Rider PSM into a way to pass costs on to customers, rather than a way to share in profits. Although Mr. Wathen provides a detailed explanation of Rider PSM in his direct testimony, Duke witness Mr. Verderame provides a helpful summary and overview of the proposal. Mr. Verderame notes:

> In summary, the Company is proposing to <u>expand</u> the mechanism to include all eligible net revenues (<u>costs</u> and credits) available through the wholesale electricity markets, as well as, all net revenues for renewable energy credits (RECs) sales that are attributed to the Company's ownership and dedication of generating resources towards its Kentucky customers. The Company is also proposing to simplify the sharing calculation process for ease of administration and adjust the sharing allocations between customers and the Company. Finally, the Company is proposing to include short-term capacity <u>purchases</u> necessary to meet its FRR plan obligations as well as any tariffed capacity co-generation <u>purchases</u> including from qualified facilities ["QF"] as is required under the Public Utilities Regulatory Policy Act (PURPA).[281]

In addition to the above-changes, Duke also plans to include costs or incentives received through the PJM Capacity Performance market.[282] Further, the Company proposes to change the sharing mechanism itself by eliminating "the initial $1 million threshold, and adjust the sharing percentages to provide customers with 90 percent of all net revenues/costs and the Company retaining 10 percent."[283] In short, Duke is setting up Rider PSM to include additional categories that will almost overwhelmingly be net costs, not profits (i.e. capacity

[278] *Id.*
[279] Sailers Direct at 16.
[280] Direct Testimony of John A. Verderame ("Verderame Direct") (Ky. PSC Sept. 1, 2017) at 3.
[281] Verderame Direct at 26, emphasis added.
[282] Verderame Direct at 30.
[283] Verderame Direct at 33.

purchases, PURPA QF purchases), and is doing so where customers are on the hook for 90% of said costs.

Take for instance the inclusion of assessments/bonus in the PJM Capacity Performance market.[284] Duke customers are already going to pay for an ultra-low sulfur diesel upgrade at Woodsdale, and the Company has already invested capital at its East Bend station to improve reliability.[285] The purpose of these investments is to ensure that Duke does not incur PJM Capacity Performance assessments.[286] Although the Company manages its generation fleet, customers ultimately pay for the investments, with a return, that ensure assessments in the PJM Capacity performance market do not occur.[287] The only action customers can take to ensure they do not get charged a Capacity Performance assessment is to pay his or her bill. It is ultimately up to the Company to perform in the event of an assessment hour.[288] Nevertheless, although the Duke's customers have already paid, and are expected to pay more, for investments to "harden" generation assets, there are "severe consequences for non-performance" in an assessment hour.[289] Capacity Performance underlines the major issue with Rider PSM: although it is up to Duke to guarantee its generation performs during an assessment hour, any penalty for not doing so is split 90% to customers and 10% to the Company. That is unfair. By removing the $1 million sharing threshold and including so many additional categories of *costs* to a <u>profit</u> sharing mechanism, the Company is telegraphing that Rider PSM will stop benefiting customers, and start benefitting Duke.

[284] See March 6, 2018 VTE at 2:29:00-2:32:15.
[285] *Id.*
[286] *Id.*
[287] March 6, 2018 VTE at 2:32:30.
[288] Verderame Direct at 31.
[289] Verderame Direct at 23, 32-22; March 6, 2018 VTE at 2:29:15-2:32:15.

Duke has not met its burden as to the necessity of the changes to Rider PSM. Although the Company requests the inclusion of tariffed co-gen purchases from QFs under PURPA, there are no QFs in Duke's territory.[290] There is no over-riding need to include so many new categories of costs in Rider PSM as the Company has not shown that the exclusion of those costs has harmed the Company in any way, particularly in Duke's ability or inability to earn a reasonable rate of return.[291] As such, the Commission should deny the Company's proposals to modify rider PSM and should adopt Mr. Kollen's recommendation to include the test-year amount of off-system sales in base rates.

III. CONCLUSION

WHEREFORE, the Attorney General respectfully requests that the Public Service Commission deny any base rate increase, and instead reduce the Company's current rates by at least approximately $15M. The Attorney General further requests that the Commission deny the Company's proposed Rider DCI, Targeted Underground Program, changes to Rider PSM, deferral accounting for planned outage O&M expense, Rider FTR, fixed bill tariff, and the increase in the residential customer charge.

[290] March 6, 2018 VTE at 3:08:56.
[291] Base Period Update Schedule K, page 4 of 5. (Ky. PSC January 12, 2018).