Kentucky Utilities Company
Case No. 2018-00294

United Department of Defense and All Other Federal Executive Agencies'
Responses to Commission Staff's Initial Request For Information

Data Request No. 1:

Refer to the Direct Testimony of Glenn A. Watkins on behalf of the Kentucky Office of the Attorney General, pages 20-21. Mr. Watkins concludes that Kentucky Utilities Company's (KU) cost-of-service study (COSS) should be rejected and proposes that any revenue increase be distributed on an equal percentage basis to the individual classes.

a. State DOD/FEA's opinion regarding Mr. Watkins' conclusion that KU's COSS should be rejected in its entirety.

b. State whether DOD/FEA agrees that an equal percentage or pro rata revenue allocation, in the absence of an approved COSS, is an appropriate method of revenue allocation.

Response:

a. DoD/FEA does not concur with Mr. Watkins' conclusion that KU's COSS should be rejected in its entirety.

b. DoD/FEA does not agree that an equal percentage or pro rate revenue allocation is appropriate method for revenue allocation in the absence of approved COSS.

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Data Request No. 2:

Refer to the Direct Testimony of James T. Selecky (Selecky Testimony), page 12, line 18.

a. Provide support for the proposed two percent point increase in proposed revenues for the residential rate.

b. Also, refer to page 9, lines 20-21, in which Mr. Selecky notes that Rate Class Time of Day Primary (TODP) is providing a rate of return below the system average. Explain why an additional increase for Rate Class TODP is not suggested.

Response:

a. The support for the proposed 2% increase in the proposed revenues for the residential rate is based in part on the results of KU's cost of service study at present and proposed rates. Exhibit JTS-1 shows that the residential rate class is receiving a rate subsidy of $65.3 million at present rates and $68.5 million at proposed rates. Because there is no reduction in the residential rate class subsidy, Mr. Selecky is recommending a 2% point increase so that the subsidy can be reduced. In addition, the DoD/FEA cost of service study shown on Exhibit JTS-6 shows that the residential rate subsidy is $84.9 million. The level of this rate subsidy is substantial and steps should be made to reduce it.

b. Mr. Selecky supports the KU's approach for allocating the revenue increase based on the tiers. The rate class TODP is included in Tier 3. Mr. Selecky supports KU's recommendation that economic development should be considered when formulating the allocation of the proposed revenue deficiency.

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Data Request No. 3:

Refer to the Selecky Testimony, page 14, lines 7-15. Explain if the fact that no other regulatory jurisdiction has adopted the Loss of Load Probability cost-of service method should be the only reason to reject KU's proposed COSS.

Response:

The fact that no other regulatory jurisdiction has adopted the Loss of Load Probability cost of service method should not be the only reason the Commission should use DoD/FEA proposed COSS as a guide to allocate any revenue increase. Mr. Selecky provides additional reasons regarding his concern about using the LOLP method in cost of service studies in his testimony on page 15, lines 9-22.

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Data Request No. 4:

Refer to the Selecky Testimony, page 19, lines 13-21. Mr. Selecky accepts the proposed methodology for cost recovery of demand charges for rate TODP, but not the proposed rates. Provide the proposed rates Mr. Selecky would recommend, with an analysis supporting the rates.

Response:

Mr. Selecky's did not develop proposed rates for TODP. Any rates would have to rely on a specific rate allocation and revenue deficiency. Because of these unknowns, Mr. Selecky did not design specific rates for TODP. For the level of increase that KU is seeking in this case, the proposed TODP rates conform to the methodology.

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Data Request No. 5:

Refer to the Selecky Testimony, page 20, lines 19-24. Provide the estimated revenue impact from Fort Knox changing from Rate TODP to the Retail Transmission Service Rate.

Response:

The estimated revenue impact for Fort Knox changing from Rate TODP to the Retail Transmission Service rate is approximately $550 thousand per year.

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Data Request No. 6:

Refer to the Selecky Testimony, Exhibits JTS-8. Provide all supporting workpapers for the proposed COSS in Excel spreadsheet format with all rows and columns accessible and formulas unprotected.

Response:

The supporting workpapers for the proposed COSS in Excel spreadsheet format with all rows and columns accessible and formulas unprotected is attached as Staff DR1 DOD-FEA Q6 Attach 6.

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Data Request No. 7:

Refer to the Direct Testimony of Christopher C. Walters (Walters Testimony), page 5. Provide all supporting source documents used to compile Table 1.

Response:

Please see Confidential Staff DR1 DOD-FEA Q7 Attach 7.

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Data Request No. 8:

Refer to the Walters Testimony, page 7, line 23. Define what is considered to be a robust valuation for regulated utilities.

Response:

Robust is synonymous with strong. In this context, Mr. Walters is observing the fact that utility stocks have been trading near the top end of their multi-year range which is indicative of utility access to equity capital at lower investor-required returns. Should investors require a higher return, the valuation metrics would be reflective of those requirements and would be trading at the lower-end of their multi-year range. Please refer to Exhibit CCW-1, pages 1-7 for specific valuation metrics.

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Data Request No. 9:

Refer to the Walters Testimony, page 17, lines 11-13.

a. Explain why the short-term debt is excluded from the Value Line calculation of the average common equity ratio.

b. Provide the average Value Line common equity ratio including short-term debt.

Response:

a. In its individual company reports, Value Line only provides the Long-Term Debt and Common Equity ratios for book value capital.

b. Please see response to (a) above. Further, Mr. Walters has not attempted to calculate the common equity ratio, including short-term debt, based on the information provided in the individual Value Line reports.

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Data Request No. 10:

Refer to the Walters Testimony, page 20, lines 13-17. Explain why earnings growth estimates from Value Line were not used.

Response:

Mr. Walters has always relied on the same three sources of growth rates for electric and gas utility DCF studies: SNL/Market Intelligence, Reuters, and Zack's. These sources tend to provide growth rate estimates from multiple sell-side analysts, and are often referred to as the consensus of analyst growth projections. Consensus estimates are less susceptible to bias or error than are estimates from single analysts. As such, consensus estimates are more likely to be reflective of investor outlooks for earnings growth.

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Data Request No. 11:

Refer to the Walters Testimony, page 26, lines 7-12. Provide academic support for the assumptions applied to the transition growth rates adjustments.

Response:

As a matter of principle, no company's earnings and/or dividends can grow faster than the economy in which it sells goods and services into perpetuity. In the long-run, earnings growth will be limited by several factors, including, but not limited to, competition and market saturation.

As the CFA Institute has stated (see Confidential Staff DR1 DOD-FEA Q11 Attach 11A):

> For earnings growth to exceed GDP growth, the ratio of corporate profits to GDP must trend upward over time. It should be clear that the share of profits in GDP cannot rise forever. At some point, stagnant labor income would make workers unwilling to work and would also undermine demand, making further profit growth unsustainable. Thus, in the long run, real earnings growth cannot exceed the growth rate of potential GDP.

Also, Dr. Morin states the following in his book, "New Regulatory Finance" (see Confidential Staff DR1 DOD-FEA Q11 Attach 11B):

> "It is useful to remember that eventually all company growth rates, especially utility services growth rates, converge to a level consistent with the growth rate of the aggregate economy."

Further, Dr. Morin continues to state (see Confidential Staff DR1 DOD-FEA Q11 Attach 11B):

> "[…] it is quite possible that a company's dividends can grow faster than the general economy for five years, but it is quite implausible for such growth to continue into perpetuity."

Additionally, please refer to the discussion of the multi-stage DCF in Mr. Walters' testimony.

Additionally, the consensus earnings growth estimates Mr. Walters relied on for years 1-5 are compound annual growth estimates for 3-5 years. The consensus long-term GDP growth rate used in years 11 through perpetuity is based on 5 and 10 year projections,

so, Mr. Walters assumed a linear progression or regression towards the long-term GDP growth. This is further explained on page 32 of his testimony.

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Data Request No. 12:

Refer to the Walters Testimony, Exhibit CCW-8. The graph illustrates how electricity use and total energy use has not increased as fast as Real GDP growth. Explain whether the flattening of electricity use and total energy use is due to efficiency measures.

Response:

Mr. Walters is not certain of the set of factors have contributed to, or completely explains, the divergence between real GDP growth and electric/total energy usage, and therefore will not speculate on it cause. However, the graph clearly shows that growth in electric usage trails growth in real GDP.

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Data Request No. 13:

Refer to the Walters Testimony, page 40, line 7 and Exhibit CCW-14. Explain why the three-month average of the Treasury bond yield is used as opposed to the most recent Treasury bond yield.

Response:

Please see lines 8-10 on page 40 of Mr. Walters' direct testimony. Using the projected long-term Treasury yield coincides more so with the rate effective period resulting from this rate case and are reflective of the macro-economic expectations of independent economists during that time. Additionally, spot yields can be impacted by sudden and/or unexplained market aberrations. Such aberrations may skew or bias the indicated market cost of capital.

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Data Request No. 14:

Refer to the Walters Testimony, page 46, line 9. The recommended return on equity (ROE) of 9.35 percent is 35 basis points below the awarded ROE in KU's last rate case, Case No. 2016-00370.[1] In addition, the recommended ROE is 37.5 basis points less the most recent Commission-awarded ROE for an electric utility in Case No. 2017-00321.[2] Lastly, since the final order in Case No. 2016-00370, the federal funds rate has increased four times, the economy has reached full employment, and inflation has increased to almost the target rate of two percent. Explain how a relatively lower ROE is supported by the macroeconomic data and federal funds interest rate increases.

Response:

The recommended return of 9.35% is the unbiased midpoint estimate of Mr. Walters' recommended range of 9.0% to 9.7%. Mr. Walters' recommended range of 9.0% to 9.7% is based on the results of several financial models which took into consideration historical, current, and expected financial and economic data. It should be noted that Mr. Walters' recommended range of 9.0% to 9.7% and recommended ROE of 9.35% in this case, is identical to his recommendations in Case No. 2016-00371, which ran concurrently with KU's previous rate case, Case No. 2016-00370.

Limiting the cost of equity to a review of only macroeconomic data would be an incomplete analysis. Furthermore, please refer to pages 9-12, generally, and Figure 2 on page 11 specifically, of Mr. Walters' Direct testimony. As shown on Figure 2, the yields on 30-year Treasury bonds, as well as A and Baa rated utility bond yields are practically unchanged since the Federal Reserve started raising the Federal Funds rate in December 2015. While current inflation has approached the Fed's target rate of 2.0%, the consensus of economic projections for inflation are virtually unchanged from KU's previous rate case in the area 2.0% to 2.1%. (See Mr. Walters' Direct testimony filed in Case No. 2016-00371, which ran concurrently with KU's previous rate case, Case No. 2016-00370).

Mr. Walters is unfamiliar with the record evidence contemplated by the Commission in Case No. 2017-00321. Also, it is unclear what Staff means by "the economy has reached full employment."

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[1] Case No. 2016-00370, *Electronic Application of Kentucky Utilities Company for an Adjustment of Its Electric Rates and for Certificates of Public Convenience and Necessity* (Ky. PSC June 22, 2017).

[2] Case No. 2017-00321 , *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* (Ky. PSC Apr. 13, 201 8).

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Data Request No. 15:

Refer to the Walters Testimony, page 14-15. Explain how Value Line adjusts its published beta estimates.

Response:

Value Line's published beta is adjusted by what is commonly referred to as the Blume method. The Blume adjustment is an attempt to account for the raw beta's long-term tendency to converge on the market's beta of 1.0. In other words, the raw beta understates the expected return for companies with betas of less than 1.0, and overstates the expected return for companies with betas greater than 1.0. The effect of Value Line's Blume adjustment to the raw beta has the effect of raising the intercept and flattening the slope of the security market line. This effect is shown on page 60 Figure 3 of Mr. Walters' direct testimony. CAPM expected return with a raw beta is shown with the red line and square markers. The CAPM expected return with the adjusted Value Line beta is shown in the green line with triangle markers.

Value Line's adjusted beta is calculated as follows:

$\beta_{adjusted} = \beta_{raw}(.67) + .35(\beta_{market})$

Where:
β_{raw} is the raw regression beta for a company's stock
β_{market} is the market beta of 1.0.

For example, suppose Company A has a raw regression beta of 0.50 and Company B has a raw regression beta of 1.70.

The adjusted beta for Company A would be:
$\beta_{adjusted} = 0.50(.67) + .35(1) = 0.685$

The adjusted beta for Company B would be:
$\beta_{adjusted} = 1.70(.67) + .35(1) = 1.489$

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Data Request No. 16:

Refer to pages 13-14 of the Direct Testimony of Stephen J. Baron on behalf of Kentucky Industrial Utility Customers, Inc. (KIUC). Mr. Baron presents an alternative COSS based on the 12 coincident peak (CP) method.

a. State the opinion of the DOD/FEA regarding the 12 CP methodology.

b. State whether the DOD/FEA believes the 12 CP methodology would produce a COSS that could be used to allocate the revenue increase.

c. State whether the DOD/FEA supports KIUC's proposed COSS.

Response:

a. The DoD/FEA supports the CP methodology. DoD/FEA supports a 6 CP methodology as opposed to a 12 CP methodology.

b. Yes.

c. DoD/FEA's position is that the 6 CP methodology is more appropriate than the 12 CP methodology.

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Data Request No. 17:

Provide all exhibits in Excel spreadsheet format with all rows and columns accessible and formulas unprotected.

Response:

All the exhibits in Excel Spreadsheet formats with all rows and columns accessible and formulas unprotected are provided in Staff DR1 DOD-FEA Q17 Attach 17 for DoD-FEA witness Chris Walters and Staff DR1 DOD-FEA Q6 Attach 6 for DoD-FEA witness James Selecky.

VERIFICATION

STATE OF MISSOURI)
) **SS:**
COUNTY OF ST. LOUIS)

The undersigned, **James T. Selecky**, being duly sworn, deposes and says that he is a Principal of Brubaker & Associates, Inc., and that he has personal knowledge of the matters set forth in the responses for which he is identified as the witness, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

James Selecky
James T. Selecky

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 7th day of February 2019.

Maria E. Decker
Notary Public

My commission expires: May 5, 2021

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2021
Commission # 13706793

VERIFICATION

STATE OF MISSOURI)
) **SS:**
COUNTY OF ST. LOUIS)

The undersigned, **Christopher C. Walters**, being duly sworn, deposes and says that he is a Senior Consultant of Brubaker & Associates, Inc., and that he has personal knowledge of the matters set forth in the responses for which he is identified as the witness, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

Christopher C. Walters

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 7th day of February 2019.

Notary Public

My commission expires: May 5, 2021

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2021
Commission # 13706793