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October 1, 2012

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PUBLIC SERVICE
COMMISSION

Mr. Jeff Derouen, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: Case No. 2011-00036

Dear Mr. Derouen:

Please find enclosed the original and ten (10) copies of the BRIEF ON REHEARING OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC. for filing in the above-referenced matter.

By copy of this letter, all parties listed on the Certificate of Service have been served. Please place these documents of file.

Very Truly Yours,

Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment
cc: Certificate of Service
Richard Raff, Esq.
David C. Brown, Esq.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by electronic mail (when available) or by mailing a true and correct copy by overnight mail, unless other noted, this 1st day of October, 2012 to the following

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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

APPLICATION OF BIG RIVERS ELECTRIC CORPORATION FOR A GENERAL ADJUSTMENT IN RATES	)))	**CASE NO. 2011-00036**

BRIEF ON REHEARING OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

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October 1, 2012

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COMMONWEALTH OF KENTUCKY
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GENERAL ADJUSTMENT IN RATES	)	

BRIEF ON REHEARING OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

Comes now, Kentucky Industrial Utility Customers, Inc. ("KIUC") representing the interests of Alcan Primary Products Corporation ("Alcan"), Century Aluminum of Kentucky, General Partnership ("Century", and together with Alcan, the "Smelters"), Domtar Paper Co., LLC, Kimberly-Clark Corporation and Aleris International, Inc., and submits its Brief on Rehearing as follows:

I. INTRODUCTION

On matters of cost allocation, as opposed to revenue requirement, it is often appropriate for the Commission to give certain deference to the recommendations of utility management on grounds that they are neutral arbitrators on the question of who pays. But that is not the case here. The corporate structure of Big Rivers creates an inherent bias for its management to set Rural rates artificially low. That is why it is even more important in this case than in the standard rate case for the Commission to diligently exercise its jurisdiction to ensure that rates for all consumers are fair, just and reasonable.

Big Rivers is owned by three Member distribution cooperatives: Kenergy, Jackson Purchase and Meade County. Each of the three Members elects two Directors to the Big Rivers Board. The Big Rivers Board has direct responsibility for hiring and firing its General Manager, Mr. Bailey. Where the ultimate ratepayers are relatively homogeneous (which is the case for most electric cooperatives), this corporate structure works well. But for the Big Rivers system it does not. There are approximately 110,000 Rural customers. Rural encompasses all residential, commercial and small industrial ratepayers. There are 18 Large Industrial customers who take service directly from the transmission lines. And then there are the two Smelters, both of which are on the Kenergy system. Even though the two Smelters comprise almost 70% of native load sales they each have only one vote for the Kenergy Board of Directors. This means that on the critical question of who is on the Kenergy Board and ultimately the Big Rivers Board, Century Aluminum and Alcan Aluminum each have the same voting rights as John Doe. Since the General Manager of Big Rivers ultimately owes his job to the voters there is a natural inclination to be overly preferential to the Rural rate class and their 110,000 votes. This is natural and unavoidable despite the best intentions of Mr. Bailey to be as objective as possible. But that is why it is all the more important in this case for the Commission not to be deferential to the recommendations of utility management on the question of who pays. The three Commissioners are the only ones in a position to step back and take a big picture view and craft an order that is in the best interests of all ratepayers and the economy in general.

The record in this case clearly defined the grave financial impact that would be thrust on the people of Western Kentucky if the Smelters are no longer able to continue operations due to high power rates. The issues in this Rehearing are but a piece of the puzzle facing Big Rivers and the Smelters, but an important piece. In its Order entered November 17, 2011, the Commission continued the Rural (residential, commercial and small industrial customers) subsidy by the Smelters and Large Industrial customers to the extent of $11.1 million, inadvertently imposed on the Smelters and Large Industrials a portion of the new $1 million DSM expense, and increased Big Rivers' depreciation rates. In this Rehearing the KIUC recommends that:

- The $11.1 million annual Rural subsidy to the residential, commercial and small industrial customers be eliminated immediately rather than gradually because of the particular facts of this case;
- The misallocation of Rural DSM costs to Smelter and Large Industrial customers be corrected consistent with the intent of the Order;
- The KIUC depreciation rates, which the Commission has already found to be supported by credible evidence, be adopted which will lower rates by $5.8 million without affecting the utility's earnings;

- The Commission reject Big Rivers' proposed recovery of depreciation expense on projects listed on the utility's accounting records as still under construction as of the end of the test year, but which are now claimed to have actually been in service;
- The Commission reject Big Rivers' proposed recovery of depreciation expense on projects completed after the end of the test year as being contrary to the November 17, 2011 Order which rejected all other post-test year adjustments; and
- The Commission allow recovery of rate case expense only up to the original budget of $898,930 (which is already extremely high) and deny recovery of the over budget amount of $1,077,099 which is primarily related to the utility's $740/hour Washington lawyers being 500% over budget.

II. STANDARD OF REVIEW

As the Commission is aware, the Smelters take electric service from Big Rivers under agreements approved by the Commission in Case No. 2007-00455 ("the Smelter Agreements"). The fact that the Smelters operate under Commission-approved special contracts in no way diminishes the Commission's broad and unqualified responsibility to set rates that are fair, just and reasonable. In *Kentucky Public Service Com'n v. Com. ex rel. Conway*, the Supreme Court of Kentucky stated in:

> *"The broad role of the PSC in regulating and investigating utilities to ensure that utilities comply with state law is set forth in KRS 278.040... Because utilities are allowed to charge consumers only 'fair, just, and reasonable rates' under KRS 278.030(1), the PSC must ensure that utility rates are fair, just, and reasonable to discharge its duty under KRS 278.040 to ensure that utilities comply with state law.*
>
> ***
>
> *In sum, we agree with the view that the PSC had the plenary authority to regulate and investigate utilities and to ensure that rates charged are fair, just, and reasonable under KRS 278.030 and KRS 278.040.*
>
> ***
>
> *We conclude that. because the statutes generally recognize a duty to establish 'fair, just, and reasonable' rates without necessarily requiring a particular procedure to deal with isolated ratemaking issues, the Hope doctrine that '[it is] the result reached rather than the method employed which is controlling'* [footnote omitted] *is applicable."* *Kentucky Public Service Com'n v. Com. ex rel. Conway*, Supreme Court of Ky., 324 S.W. 3d 373 (2010).

The Commission acknowledged its plenary authority over the rates charged by Big Rivers in its April 12 2012 Order in this Rehearing:

"It is clear from the Court's March 8, 2012 Order that both KIUC and Big Rivers have disputes over the Rate Order, and that the Commission is the agency with jurisdiction over all of the rate matters in dispute. Pursuant to KRS 278.040(2) and KRS 279.210(1), the Commission has exclusive jurisdiction over the rates of Big Rivers. In addition, KRS 278.260(1) empowers the Commission with original jurisdiction over complaints as to the rates of Big Rivers, and the Commission can make such investigation of those rates as it deems necessary or convenient, either upon a complaint in writing or on its own motion. Further, pursuant to KRS 278.390, the Rate Order continues in force until revoked or modified by the Commission, unless the Order is suspended or vacated in whole or in part by order or decree of a court of competent jurisdiction, while, under KRS 278.270, the Commission is authorized to prescribe a just and reasonable rate to be charged prospectively after conducting an investigation under KRS 278.260(1).

These statutes grant the Commission plenary authority to expand the scope of our investigation in this rehearing to include the disputed issues raised at the Franklin Case No. 2011-00036 Circuit Court by KIUC, now that all of the Court actions have been remanded to the Commission. We find that, on our own motion, a full and thorough investigation should be conducted of all the disputed rate issues in one forum at the same time, and that this will result in administrative efficiencies, conserve the scarce resources of all the parties and the Commission, and lead to an expedited resolution of the disputed issues and the correction of actual errors, if any." In Application of Big Rivers Electric Corporation for a General Adjustment in Rates, Case No. 2011-00036, April 12, 2012 Order at 3.

The Smelter contracts are "rates" under KRS 278.010(12). Therefore, the Commission has an affirmative duty to ensure that the Smelter rates are and continue to be fair, just and reasonable.

The Commission has consistently held that special rate contracts will be treated no differently than tariffs of general applicability. In Kentucky Utilities Company Revised Special Contract with North American Stainless, LP., Case No. 2003-00137 the Commission stated:

"The Commission is not persuaded by NAS' legal arguments that the issue of rate retroactivity should be decided on the basis of contract law, rather than under the provisions of KRS Chapter 278. Neither the statutes nor legal precedent cited by NAS supports a finding that special contracts can be treated differently from generally available rate tariffs. KRS Chapter 278 sets forth a comprehensive scheme for the regulation of utilities. More specifically, KRS 278.040(1) provides that, 'The Public Service Commission shall regulate utilities and enforce the provisions of this chapter,' and KRS 278.040(2) provides that, 'The commission shall have exclusive jurisdiction over the regulation of rates and service of utilities....' In Board of Education of Jefferson County, Kentucky v. Dohrman, 620 S.W.2d 328 (Ky. App. 1981), a utility customer receiving service under a special contract claimed that its rates could only be changed in accordance with the terms of its special contract. The Court, citing the Commission's exclusive jurisdiction to regulate rates under KRS 278.040(2), rejected the customer's claim, declaring that, 'Strictly speaking, the Commission had the right and duty to regulate rates and services, no matter what a contract provided.'" (Order at 7).

Finally, in a 1990 Court of Appeals case involving approval of the electric rate for National Southwire Aluminum (the predecessor owner of the Century facility) that fluctuated with the world-wide price of aluminum, the Court ruled: "*Kentucky law generally holds utility contracts are subject to rate changes ordered by the PSC, no matter what the contracts provide.*" National-Southwire v. Big Rivers Elec., Ky. App., 785 S.W. 3d 503, 517.

The Smelter contracts/rates provide, among other things, that the Smelters are to pay a base rate equal to the Large Industrial rate (adjusted for a 98% load factor), plus three additional charges:[1]

- $0.25/MWh;
- an incremental TIER Adjustment Charge equal to the amount necessary for Big Rivers to achieve a Times Interest Earned Ratio ("TIER") of 1.24 for each calendar year, subject to a cap of $2.95/MWh for the years 2012-2014; and
- various surcharges benefitting the Rural and Large Industrial customers (not Big Rivers) pursuant to Section 4.11 of the Retail Agreements which will amount to approximately $1.90/MWh in 2012.

The precedents cited above establish the legal principle that if the Commission concludes based upon sufficient record evidence that the current Smelter rates are no longer fair, just and reasonable and that different rates are necessary in order to keep the Smelters viable and therefore protect the Kentucky economy and the interests of other ratepayers, it has an affirmative obligation to order those new rates.

While the Commission has jurisdiction to make such rate changes, the KIUC revenue allocation proposal to remove the $11.1 million subsidy to the residential, commercial and small industrial customers immediately rather than gradually is specifically permitted by the Smelter contracts. Section 3.8(b) of the Coordination Agreements between Big Rivers and each of the Smelters states:

> "[The Smelters] *shall have the right to intervene and participate in any proceeding that may affect rates at the KPSC or FERC or before any other Governmental Authority. . . . For the avoidance of doubt,* [the Smelters'] *intervention and participation in a regulatory proceeding involving cost-of-service issues relating to the rates of the Non-Smelter Ratepayers shall not be considered a challenge to the rate formula*." (Emphasis added).

Likewise, Section 13.1.1(b) of the Retail Electric Service Agreements between Kenergy Corp. and each Smelter provides:

> "*For the avoidance of doubt,* [The Smelters'] *intervention and participation in a regulatory proceeding involving cost of service issues relating to the rates of Non-Smelter Ratepayers shall not be considered a challenge to the rate formula.*"

[1] Fayne Direct Testimony at 13-14.

KIUC's proposal is consistent with the Smelter rates and does not propose any changes to either the Retail or Wholesale Agreements. It simply addresses the reasonableness of the allocation of the Commission approved rate increase based on traditional cost of service principles, as applied to the unique circumstances of this case which make gradualism inappropriate.

III. ARGUMENT

1. <u>The Commission Should Eliminate The Subsidy Paid By The Smelters And Large Industrial Customers To Big Rivers' Rural (Residential, Commercial And Small Industrial) Customers.</u>

The Commission's November 17, 2011 Order adopted a 12 CP cost study[2] and reflected "*the exclusion of Big Rivers' proposed Smelter TIER adjustment*"[3] and the inclusion of an adjustment allocating $1 million of DSM expense directly to the Rural customer class.[4] Using this cost of service methodology, the Commission found that the amount of subsidy to the Rural class was $13.5 million.[5]

The Commission agreed with KIUC that the subsidy paid by the Smelters and large Industrials to the Rural Class (residential, commercial and small industrial) should be eliminated, but determined that the subsidy should be eliminated gradually.[6] The Commission reduced the subsidy by $2.4 million. As a result the Smelters and large Industrials continue to pay a $11.1 million subsidy to the Rural class.[7] While the Commission's decision reduced the rate gap between the Rural class and the Large Industrial and Smelter classes, Rural customers continue to pay rates significantly below their cost of service. Consequently, the Smelters and Large industrials continue to pay rates in excess of cost of service in order to fund this continuing subsidy.

There are a number of unique and special circumstances that distinguish Big Rivers from other Kentucky electric utilities and make immediate elimination of the Rural subsidy necessary and in the best interest of not only the Smelters, but also the Rural customers and Big Rivers. The uniqueness of the Smelter-Big Rivers relationship

[2] Order at 28.
[3] Order at 28.
[4] Order at 22.
[5] Order at 29.
[6] Order at 29-30.
[7] As noted below, the Smelters pay a total subsidy of $11.7 million of which, $11.1 million goes to the Rural class.

justifies such a policy in this case without diminishing the Commission's revenue allocation flexibility in rate cases involving other utilities.

a. The High Concentration of Smelter Revenue Creates A Tremendous Risk For Big Rivers, Its Ratepayers And its Creditors That Is Exacerbated By Continuing The Rural Subsidy.

The first unique attribute of the Big Rivers system is the most important – the exceptionally large load concentration associated with serving two Smelters taking 68% of Big Rivers' sales and producing approximately 65% of its revenues. This unique circumstance does not exist in any other Kentucky electric utility system, and creates a high risk for Big Rivers' relatively small system. Smelter sustainability is tied directly to the price of aluminum and the cost of electric energy. These are facts which, if disregarded, can quickly change what we now call risk into reality.

As discussed in the original direct testimony of KIUC witness Henry Fayne, the economic viability of the Smelters on Big Rivers' system is highly sensitive to the price of aluminum and is dependent on a competitive power rate.[8] When the London Metal Exchange (LME) aluminum price drops or the price of electricity increases, a smelter's ability to maintain its economic viability decreases. When both events occur at once, the result can be catastrophic. While the Commission cannot control the LME aluminum price, it has complete control over Big Rivers' electric rates and the imposition of cross subsidies between rate classes. The $11.1 million subsidy to the residential, commercial and small industrial customers raises the cost of electricity to the Smelters and therefore decreases the viability of the Smelters for any given level of LME price. Consequently, continuing the subsidy increases the risk of losing the high-margin Smelter revenue, a loss that would necessarily be borne by Big Rivers' other customers or by Big Rivers' creditors. While elimination of the Rural subsidy may not be politically popular with the Big Rivers Board or its management, it is the correct decision for the Commission.

[8] Direct Testimony of Henry Fayne p. 8.

b. The Loss Of Either Smelter Would Cause Great Harm To Big Rivers And Its Rural And Industrial Ratepayers.

KIUC provided evidence through its witnesses Dr. Mathew J. Morey and Henry Fayne that if the Smelters were to terminate their contracts the rate impact on the remaining customers would be staggering. According to Dr. Morey, the net margin contribution from the Smelters averages $162 million per year.[9] If the Smelters were to leave Big Rivers' system, Big Rivers' near term financial health would be determined by a single question: could Big Rivers, as a merchant generator, achieve a level of margin contribution from off-system sales in the wholesale energy market equivalent to the margins it receives from the Smelters?

Dr. Morey's analysis shows that due to high operating costs at some Big Rivers' plants and the frequently low locational marginal price ("LMP") for energy in MISO, Big Rivers would only manage to sell into the wholesale market an average of about 4.2 million MWh per year of the 7.3 million MWh per year of lost Smelter sales. Dr. Morey concluded that Big Rivers' margins would deteriorate by approximately $83 million per year if the Smelters shut down and Big Rivers were forced to sell the excess energy in the wholesale market.[10] If the Commission allowed the shortfall to be borne by the remaining, primarily Rural, customers then their rates would increase by more than 55%.[11] If only one smelter were to terminate its contract but the remaining smelter were forced to make up an allocable share of the shortfall, it would likely hasten the remaining smelter's demise. If the Commission denied such massive rate increases, then Big Rivers and its creditors would be at risk.

The subsidy paid to the Rural class by the Smelters is penny-wise and pound-foolish from the perspective of Rural customers. It may save the Rural class a small amount on current bills, but it puts the Smelters at greater risk of shutting down. Upon Smelter closure, the Rural customers would suffer tremendous financial harm depending on the level of Commission authorized rate increases that could far exceed any benefit they currently receive from the Smelter subsidy.

[9] Morey Direct Testimony at 16.

[10] Morey Direct Testimony at 4-5.

[11] Fayne Direct Testimony at 12.

c. A Subsidy Is Not Necessary To Prevent Big Rivers' Rural Customers From Paying Electric Rates That Are Comparable To Customers Served By The Other Kentucky Electric Utilities.

The residential rates of Big Rivers' three distribution Member cooperatives are relatively low compared to other Kentucky electric utilities. Based on data provided in this case,[12] the Members' proposed residential rates were among the lowest in Kentucky and significantly lower than the national average residential rate.

Based on recent U.S. Energy Information Administration ("EIA") data, Kentucky residential rates in 2011 ranked 7th lowest in the nation at 9.09 cents/kWh.[13] Following the Commission authorized increase in this case, residential customers of Kenergy Corp. (the Member serving the greatest number of residential customers) paid average rates of 7.9 cents/kWh. The fact that the Members' residential rates are among the lowest in Kentucky and Kentucky residential rates are among the lowest in the nation provides additional support to KIUC's recommendation to fully eliminate Rural subsidy in this case.

Low electric rates are not the only advantage benefitting Big Rivers' Rural customers. They are also in a unique and favorable position given the existence of the reserves established in the Unwind Order. The $63 million Rural Economic Reserve Fund ("RER"), for example, provides a future cushion for residential, commercial and small industrial customers from the impacts of higher electric rates. The Commission required E.ON to fund the RER as a condition to approving the Unwind. Thus, the Rural customers did not negotiate for the RER, but were granted it by the Commission. This was a wise decision by the Commission because it now provides a needed safety net. The $63 million RER is equivalent to about 7 months of free electric service from Big Rivers to the Rural class. The RER's rate mitigation benefit to Rural customers provides a unique cushion against the impact of future rate increases for these smaller customers that do not exist on other Kentucky electric utility systems.

Because the Rural subsidy puts pressure on Smelter rates and therefore increases the load concentration risk associated with the Smelters, the subsidy may only temporarily lower rates to the Rural customer class. If the subsidy is ultimately a contributor to the loss of either or both of the Smelters, the impact on the Rural customers will be far greater than elimination of the subsidy. This is a unique circumstance in Kentucky that characterizes only Big Rivers and would not establish a precedent that would be applicable to other utilities regulated by the Commission. No other

[12] KIUC Cross Exhibit 10, based on December 2010 data.

[13] *See* Baron Exhibit__(SJB-2)

Kentucky utility risks the loss of 68% of its load by maintaining the philosophy of gradualism. In this unique case, the Commission should set Smelter and Large industrial rates containing no cross subsidy to Big Rivers' Rural customers and avoid aggravating Big Rivers' load concentration risk. This may be tough politically, but it is correct economically.

d. KIUC Recommends That The Subsidy Paid By Industrial And Smelter Customers Be Fully Eliminated In This Proceeding.

KIUC recommends that the remaining Rural rate class subsidy be eliminated in this proceeding. The Table below shows the return earned on sales to the Rural, Large Industrial and Smelter classes before this rate case, after the November 17, 2011 Order and the further adjustments needed to fully set rates at cost of service. Before this rate case, Big Rivers lost money on its sales to its approximate 110,000 residential, commercial and small industrial customers as the return on Rural sales was a negative 1.06%. Selling electricity at a loss helps explain why Big Rivers' Rural rates are among the lowest in the Country. Even after the November 17, 2011 Order and the gradual elimination of $2.4 million of the Rural subsidy, sales to the Smelters were 3.5 times more profitable than sales to the 110,000 Rural customers. To fully align the Rural rates with cost of service an $11.1 million increase to them is required.[14]

Big Rivers Electric Corporation
KIUC Recommended Revenue Allocation to Remove Rural Subsidies

	Total System	Rurals	Large Industrials	Smelters
Rate Base - Commission Adjusted 12 CP	1,175,239,849	360,953,693	99,688,642	714,597,513
Net Utility Operating Margin	31,612,553	(3,825,556)	2,453,136	32,984,973
Return on Rate Base	2.69%	-1.06%	2.46%	4.62%
Subsidy at Present Rates	-	(13,534,781)	(228,370)	13,763,150
Total Increase Approved	26,744,776	10,597,930	1,969,615	14,177,231
Income at Proposed Rates	58,357,329	6,772,374	4,422,751	47,162,204
Return on Rate Base - Proposed Rates	4.97%	1.88%	4.44%	6.60%
Subsidy at Proposed Rates	-	(11,151,026)	(527,355)	11,678,381
Revenue Increase to Eliminate Rural Subsidies	-	11,151,026	(1,360,218)	(9,790,808)
KIUC Recommended Revenue Allocation	**26,744,776**	**21,748,955**	**609,397**	**4,386,423**
Income at KIUC Recommended Rates	58,357,329	17,923,400	3,062,533	37,371,396
Return on Rate Base - KIUC Recommended Rates	4.97%	4.97%	3.07%	5.23%
Subsidy at KIUC Recommended Rates	-	-	(1,887,573)	1,887,573

[14] Direct Rehearing Testimony of Stephen Baron p. 13.

Because of the contractual linkage between the Smelter rates and the Large Industrial rates, pursuant to the Smelter Agreements,[15] the Smelters will continue paying a relatively small subsidy to the Large Industrial class. However, as shown in the above Table, the total subsidy paid by the Smelters would be reduced from $13.8 million to $1.9 million.

The above Table is based upon the rate increase approved on November 17, 2011. If the Commission approves a total rate increase in this Rehearing proceeding that is higher or lower than approved in the November 17 Order, the Commission should apply the same allocation methodology to the new revenue requirement consistent with the above Table so that the Smelter subsidy to Rural customers is eliminated.

e. There Is No Legal Prohibition Against Using Reserve Funds To Mitigate Elimination of the Rural Subsidy If That Is The Commission's Determination.

The Economic Reserve Fund ("ER"), which currently stands at approximately $94 million, was carved out of cash received by Big Rivers from the E.ON Entities at the closing of the Unwind Transaction. The Unwind Order does not contain an ordering paragraph relating to the ER, only a commitment in the Appendix to the Order requiring Big Rivers to fund the ER at no less than $157 million. The Member Rate Stability Mechanism ("MRSM") is the tariff vehicle that distributes the ER to the non-Smelter customers to mitigate increased rates due to fuel, environmental and other cost increases.

By contrast to the ER, the RER (as discussed above) was not negotiated by Big Rivers as part of the Unwind Transaction. Instead, it was ordered by the Commission to be paid by the E.ON Entities as a condition of approving the Unwind Transaction.[16] In this sense it was an unsolicited benefit afforded by the Commission to the residential, commercial and small industrial customers of Big Rivers. As set forth in the Unwind Order, the RER was originally to be used over a 24 month period upon the expiration of the ER. However, in this base rate case, Big Rivers proposed, and the Commission approved, a change as to how the RER is to be used: RER funds would be distributed under the MRSM on the same basis as ER except only to Rural Customers.[17] Currently, the

[15] The Smelter Agreements provide that the Smelters pay base rates that are equal to the rates charged to the direct-service Industrial customers, plus three additional charges.

[16] Case No. 2007-00455 at 25.

[17] Case No. 2011-00036, November 17, 2011 Order at 35.

RER remains at the full $63 million level and has not been accessed.

It is clear from this history, and consistent with the Commission's plenary authority over rates and tariffs, that the use of these reserves is subject to the Commission's discretion and can be used to help facilitate a short term solution that avoids Smelter contract terminations. This is not to suggest that the reserves be provided to the Smelters. Instead, adjustments resulting in a Smelter rate reduction as a result of this Rehearing could be funded by a rate increase to the Rural Class, with the impact off-set by the reserves in such amounts and at such times as the Commission may determine in the exercise of its regulatory discretion.

f. Elimination Of The Rural Subsidy Might Be Viewed Favorably By The Credit Agencies And Could Improve Big Rivers' Financing Flexibility.

Two of the three credit rating agencies (S&P[18] and Fitch) assign Big Rivers a credit rating at the lowest level in the investment grade category. In their July 2011 ratings reports, both S&P and Moody's listed the Smelter loads as the number one credit risk to Big Rivers.[19] Loss of one or both of its Smelters from its customer portfolio could result in the loss of Big Rivers' investment grade credit rating and could trigger many negative implications for Big Rivers, including the almost certain need for further increases in base rates. Without access to long term debt capital on terms and conditions, including interest rates, that are typically available to investment grade utilities, the ability of Big Rivers to provide adequate service under KRS 278.030 may come into question.

For these reasons, an improvement in the financial condition of the Smelters through a lower Smelter rate by eliminating the Rural subsidy should improve Big Rivers' access to capital on reasonable terms for the benefit of all consumers. Conversely, continuing the Rural subsidy could exacerbate Big Rivers' credit problems. These considerations can be taken into account by the Commission in setting fair, just and reasonable rates.

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[18] KIUC Cross Ex. 13.

[19] KIUC Cross Ex. 12 &13.

2. <u>The Commission May Set Rates Based On Factors Other Than Cost-Of-Service.</u>

Although KIUC recommends that the Commission set rates as close as possible to cost of service in this proceeding, Kentucky law does not require that the Commission set electric rates at cost of service. Although KRS §278.170(1) states that "[n]*o utility shall, as to rates or service, give any unreasonable preference or advantage to any person or subject any person to any unreasonable prejudice or disadvantage, or establish or maintain any unreasonable difference between localities or between classes of service for doing a like and contemporaneous service under the same or substantially the same conditions,*" the Commission and Kentucky Courts have recognized that the KPSC can consider factors other than cost-of-service when setting rates.

As the Commission noted in <u>Re Union, Light, Heat & Power Co.</u>, Case No. 2005-00042, "[a] *Cost of Service Study serves as a guide in setting rates by allocating the costs incurred by a utility to its different customer classes. By doing this, a COSS also shows the return contributed by each customer class. Historically, the Commission has used a COSS as a first step in determining how a revenue increase, or decrease, will be allocated to the different classes of customers.*" (Order of December 22, 2005 at 60) After that "first step" the Commission will often look at a variety of other factors, such as gradualism[20] and economic development and retention principles,[21] in determining fair, just and reasonable rates. Furthermore, cost of service, like beauty, is often times in the eyes of the beholder. There are many different types of cost of service studies which can yield many different results. Even the same cost of service methodology can yield differing results depending on test year billing determinants.

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[20] See <u>Re Louisville Gas and Electric Company</u>, Case No. 2000-080, Order of September 27, 2000 at p. 27. "*The Commission generally recognizes that fees such as these allocate costs to cost causers and are a fair and reasonable component of a gas utility's rate design. However, we also recognize that any increase in utility rates or charges has the potential to create a financial hardship for low-income customers. In this instance, the Commission will approve a fee of $18.50 for disconnecting and reconnecting service and a returned check charge of $7.50 to partially compensate LG&E for its increased costs. This results in an additional $20,892 of revenues. By increasing these charges by one-half of the amount proposed by LG&E the Commission is adhering to the rate-making concepts of continuity and gradualism in order to lessen the impact of these increases on the customers that incur these charges.*"

[21] See <u>National Southwire Aluminum Co. v. Big Rivers Elec. Corp.</u>, 785 S.W.2d 503, 508 (Ky. Ct. App. 1990) "*The PSC specifically "found" that the inclusion of variable aluminum smelter power rates are an important new feature which will make it more likely that the smelters will stay in business when aluminum prices are low. There was testimony in the record that a variable rate would greatly assist the smelters in weathering the down turns in the aluminum market which are an inevitable part of a highly-cyclical industry.*"

But on this record it is clear that the 110,000 Rural customers are being subsidized by the two Smelters and 18 Large Industrial customers. This policy is no longer economically rational. It cannot continue. It is now time for the residential, commercial and small industrial customers to pay their fair share.

3. <u>The Commission's Order Unintentionally Assigns A Portion Of Rural DSM Costs To The Smelters.</u>

The Commission's Order clearly states its intent to assign 100% of the test year DSM expense ($1,000,000) allowed in this case to the Rural customer class because only that class will receive the benefits of such programs.[22] KIUC agrees with this intent, however, the Commission's Order does not accomplish this objective.

Specifically, while the Commission has adjusted Big Rivers' class cost of service study to directly assign 100% of the $1 million in DSM expense to the Rural customer class, this specific assignment is effective only in the event that the Rural customer class pays its full cost of service without subsidy. As discussed previously, the Commission Order does not eliminate the $11.1 million subsidy received by the Rural class (see Table on page 10), which means that the Rural class is not paying 100% of the DSM expenses assigned by the Commission because the $11.1 million subsidy is proportionately distributed among all categories of cost, including the DSM expense. As a result, by virtue of the Rural class not paying all of its allocated costs, the Commission Order results in a portion of DSM expense being paid by the Smelters and Large Industrials.

This inconsistency is easily cured. First, if the Commission eliminates the Rural subsidy per KIUC's request, the issue regarding the allocation of DSM expenses will fix itself because it is the subsidy that is causing the misallocation of DSM expense. If the subsidy is eliminated the misallocation of the DSM expense will also be eliminated. Second, DSM charges can be recovered from the Rurals through a surcharge mechanism as authorized by KRS 278.285. This would directly assign the responsibility of these costs to the class of customers identified in the Commission's Order. A surcharge also has the virtue of precisely matching DSM revenue with DSM expense. Right now Big Rivers is collecting $1 million in DSM revenue in base rates, but is not necessarily spending that same amount as its programs gear up. In fact, during tight economic times when Big Rivers is struggling to meet the 1.10

[22] Commission Order of November 17, 2011 at 22; "*For that reason, in allocating the revenue increase granted herein, we will incorporate an adjustment to ensure that none of the $1 million will be recovered from the Smelters. Also at page 29; "the Commission will make an adjustment to reflect the assignment of the full $1 million cost for Big Rivers' energy efficiency programs to the Rural rate class.*"

MFIR required in its credit agreements it has a double incentive not to spend the full $1 million. The first incentive is that the difference between what it receives and what it actually spends translates into margins. The second incentive not to spend the full $1 million is that DSM programs by design reduce retail sales which also reduce margins. A DSM surcharge under KRS 278.285 avoids these adverse incentives.

4. **The Commission Should Adopt The Depreciation Service Lives Recommended By KIUC Witness Charlie King.**

In its November 17, 2011 Order, the Commission found that the depreciation studies presented by both KIUC and Big Rivers constituted "credible evidence" in support of their respective proposed depreciation rates. The Commission adopted the shorter service lives (and higher depreciation rates) proposed by Big Rivers due to concerns over "early retirements experienced by Big Rivers since the closing of the Unwind Transaction." The Commission stated:

> *"In this instance, our review of the record indicates that both Big Rivers and KIUC have presented credible evidence in support of their respective positions on the remaining service lives and proposed depreciation rates. However, due to the problem of early retirements experienced by Big Rivers since the closing of the Unwind Transaction, there is a clear need to utilize shorter service lives."*[23]

However, in its April 12, 2012 Order in this rehearing proceeding, the Commission directed the parties to address this issue further. KIUC recommends that the Commission accept the depreciation rates proposed by KIUC through the Direct Testimony of Charles King, its depreciation witness in the original proceeding.[24]

The record shows that the depreciation rates developed and sponsored by Mr. King correctly reflect the service lives for the Company's generating units determined by Big Rivers' management and reported to the Rural Utilities Service ("RUS").[25] In contrast, the depreciation rates developed for the Company by Burns & McDonnell ("B&M") witness Ted Kelly reflect shorter service lives that are not supported by the evidence in the record. Furthermore, Mr. King's analysis is consistent as he used the accumulated depreciation balance and remaining service lives both as of April 30, 2010. Mr. Kelly used the accumulation depreciation balance as of

[23] Order at 20.

[24] *See* Revised Schedule 1 of Exhibit___CWK-1 in column (2) attached to Mr. King's Direct Testimony.

[25] King Direct Testimony at 11.

April 30, 2010, but remaining service lives from December 31, 2011. Having added an additional 20 months from April 30, 2010 the power plants obviously have shorter remaining lives. But there has also been 20 months of additional depreciation expense which was ignored by Mr. Kelly. This fundamental mismatch renders his study not credible. Additionally, any early retirements of Big Rivers' facilities since the Unwind transaction are not a proper basis for determining appropriate depreciation service lives.

The proposed KIUC depreciation rates would reduce depreciation expense and the revenue requirement by \$5.851 million. This quantification is based on the difference in the KIUC depreciation rates compared to the present depreciation rates applied to the gross plant in service at October 31, 2010, the end of the historic test year. It does not include the effects of the depreciation rates applied to any amount of CWIP at October 31, 2010, (discussed later in this Brief) consistent with the Commission's determination that all CWIP should be excluded from the computation of depreciation expense.[26]

KIUC's recommendation would have no effect on the Company's Net Margins because the reduction in depreciation expense will be matched with a reduction in revenues.

a. The Issue Of "Early Retirements Experienced By Big Rivers Since The Closing Of The Unwind Transaction" Was Not Developed In The Record And Should Not Be The Basis For The Commission's Decision Concerning Service Lives.

As noted above, the Commission stated on page 20 of its November 17, 2011 Order:

"In this instance, our review of the record indicates that both Big Rivers and KIUC have presented credible evidence in support of their respective positions on the remaining service lives and proposed depreciation rates. However, due to the problem of early retirements experienced by Big Rivers since the closing of the Unwind Transaction, there is a clear need to utilize shorter service lives."[27] (Emphasis added).

The relevance of early retirements of Big Rivers' facilities since the close of the Unwind Transaction is unclear and does not appear to be an issue that was developed in the record. In any event, the effects of all early retirements in the past already have been captured in the depreciation study through the remaining net plant (gross plant less accumulated depreciation) at April 30, 2010. This is true and will continue to be true in each future depreciation study whenever the remaining net plant is updated and used, along with the remaining lives, to

[26] These computations are detailed in the Supplemental Rehearing Testimony of Lane Kollen, Exhibit(LK-2).

[27] Order at 20.

compute the depreciation rates going forward. There is no evidence in the record quantifying early retirements in the past, demonstrating that any such early retirements will be repeated, and even if they were to be repeated, demonstrating what the pattern and amount of any such retirements might be or would be in the future.

The Commission should not justify the use of the Company's flawed depreciation rates on the basis of generalized statements regarding early retirements that the Company has not quantified or explicitly addressed going forward, and that have already been incorporated in the remaining net plant as of the depreciation study date. The Commission does not need to speculate on this issue because each time a depreciation study is performed there is a true-up of all early retirements that occurred in the past through the calculation of remaining net plant. The Commission does not need to adopt the Company's demonstrably flawed depreciation rates to resolve a problem that does not exist.

b. <u>Big Rivers Did Not Present Credible Evidence In Support Of Its Position On The Remaining Service Lives And Proposed Depreciation Rates.</u>

The record shows that there were numerous inconsistencies and inaccuracies in the B&M depreciation study that formed the basis for the Company's depreciation rates. Mr. Kelly generally used shorter remaining service lives than he was provided by Big Rivers' management. In the narrative section of the B&M study, Mr. Kelly reported the probable retirement dates provided by Big Rivers' management. Instead of simply using these probable retirement dates to determine the service lives, Mr. Kelly developed a range of remaining service lives for each of Big Rivers' generating units based on various other assumptions, including remaining operating hours and the probability of plant life extensions.

Mr. Kelly then subjectively combined and translated this information for each generating unit into the remaining lives for each production plant account in the B&M depreciation study. Mr. Kelly chose remaining lives at the low end of the ranges for each account, relying in part on the simple averages and mW weighted averages of the remaining lives for each generating unit to determine the remaining lives for depreciation of the gross plant investment.

By contrast, the ordinary and usual practice is to determine the average lives for each production plant account by weighting the service lives by the balance of gross plant in service for each generating unit. The results of Mr. Kelly's non-standard methodologies were to understate the remaining lives for the plant accounts and thus overstate the depreciation expense and rates.

According to Mr. Kelly, B&M used six separate assumptions regarding useful lives to develop a dispersion of results and to inform his judgment. The total service life assumptions appear to have been selected in order to support shorter remaining lives than management expects, that Big Rivers reported to the RUS, and that B&M itself expects based on the probable retirement dates of each generating unit. For example, in a February 28, 2011 letter to RUS[28] and in a January 2011 Report, B&M projected that the Wilson unit would remain in service through the year 2051, which equates to a 65 year total life. In the January 2011 Report, B&M states that the Wilson unit "*is in excellent condition for its age and service requirements. Provided that operation and maintenance continue as is, this unit is estimated to be suitable for ongoing service through the year 2051.*"[29]

Despite Big Rivers' management's intent to operate the generating units until their probable retirement dates and Big Rivers' representations to the RUS, which were repeated in the B&M study, Mr. Kelly did not use a 65 year service life for the Wilson unit. Instead, he assumed a wide variety of service lives for the Wilson unit, ranging from 57 to 65 years, and then used a service life somewhere within this range in the calculation of depreciation rates.[30] Even if correct, this assumption would result in a remaining service life of 33 to 41 years. However, Mr. Kelly assumed that all gross plant investment in accounts 312 and 314 had a remaining life of only 28 years and the amount in account 313 had a remaining life of only 30 years on average when combined with the other production plant amounts in those accounts.

The gross plant in service balances for each of Big Rivers' production plants are recorded in plant accounts. The depreciation rates were developed at the plant account level in the depreciation study, e.g., Structures, Boiler Plants, Turbines, etc. The Wilson unit has the greatest effect on the remaining lives for each production plant account because it is the Company's newest and most expensive generating unit both in absolute dollars and on a per mW basis. Wilson comprises approximately 60% of the capitalized cost included in each

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[28] KIUC Cross Exam Exhibit 15 at 5.

[29] KIUC Cross Exam Exhibit 15 at 11.

[30] Kelly Rebuttal Testimony at 9-12.

production plant account.[31]

Despite Big Rivers' management's estimate of a 65 year life for the Wilson unit, only two of the six studies cited by Mr. Kelly in his Rebuttal Testimony to determine the remaining lives for each account reflected the proper service life of 65 years for Wilson, namely, studies #1 and #4. That is why the remaining service lives computed in studies #1 and #4 were longer than the remaining lives used by Mr. Kelly for his proposed depreciation rates. The Table below compares the assumed remaining useful lives used in the B&M Report (Column 1) to the Kelly rebuttal testimony scenarios #1 and #4 (Columns 2 and 3, respectively), which used the 65 year life for Wilson.[32]

REMAINING SERVICE LIVES (YEARS)[33]

Gross Plant	(1) Table ES-1 Remaining Life Based On B&M Judgment (Actually Used In Depreciation Study)	(2) B&M Actual Operating Hours (Annual) Remaining Life Analysis #1 (Using A 65 Year Total Life For Wilson)	(3) B&M Actual Operating Hours (Annual) Remaining Life Analysis #4, (Using A 65 Year Total Life For Wilson)
Account 311 - $124,375.974	30	33.8	31.6
Account 312 - $667,206,536	28	34.2	32.3
Account 312 A-K - $574,184,346	28	34.2	32.3
Account 314 - $225,272,354	28	33.6	31.3

B&M's practice of using shorter remaining service lives was not limited to the Wilson Unit. KIUC has focused on the Wilson unit as a point of reference, but Mr. Kelly applied the same flawed methodology in his treatment of the other Big Rivers generating units.[34] Mr. King developed a corrected computation of the average remaining lives for each plant account using the Company's life spans based on the Company's probable retirement dates, adjusted for interim retirements based on the same retirement information used by Mr. Kelly, and weighted these life spans based on the balances for each generating unit in each plant account.[35]

[31] KIUC Cross Exam Exhibit 15.

[32] Kelly Rebuttal Testimony at 9-12.

[33] KIUC Cross Exam Exhibit 14 for Column (1); KIUC Cross Exam Exhibit 15 at p. 12 for Columns (2) and (3).

[34] King Direct Testimony at 8-9.

[35] Mr. King presented his results in Schedule 4 of his Exhibit___(CWK-1) attached to his Direct Testimony.

In his Rebuttal Testimony, Mr. Kelly defended his analysis by stating:

> "'[a]*rriving at the remaining lives used in B&M's analysis required the use of judgment...'*[36]... *'Many factors, both quantitative and qualitative, along with the substantial application of judgment went into determining the remaining useful lives of each production facility. The selection of the ultimate remaining lives used to calculate Big Rivers' final depreciation rates required judgment, but...the selection was clearly not arbitrary.*'"[37] (Emphasis added).

While Mr. Kelly is correct that the selection of remaining plant lives requires some judgment, the judgment must be *informed* and objective based on a reasonable assessment of the facts and management's intent, and not biased toward shorter lives and higher depreciation rates. In addition, the basis for the analyst's informed judgment should be fully documented in his testimony and workpapers. Mr. Kelly substituted his own judgment in place of the judgment of the Big Rivers' management regarding the useful life of the generating units and failed to explain, let alone justify, this departure from management's intent. His remaining lives also were substantially shorter than the useful lives that the Company's management submitted to RUS. Again, there was no explanation, let alone justification, for this divergence.

c. Mr. Kelly's Depreciation Rates Rely On A Fundamental Mismatch by Using The Accumulated Depreciation Reserve As Of April 30, 2010 And Remaining Service Lives From 20 Months Later On December 31, 2011

In his Rebuttal Testimony, Mr. Kelly attempted to revise Mr. King's depreciation rates for shorter remaining lives that the Commission did not address in its November 17, 2011 Order. This attempt suffers from several infirmities that render the so-called revisions meritless. Mr. Kelly argued that Mr. King should have computed his remaining lives as of December 31, 2011, which would have reduced the remaining lives and brought them closer to those used by Mr. Kelly. If correct, the revisions would have the effect of increasing depreciation rates because the Big Rivers generating units were twenty months older than they were on April 30, 2010 and thus, the remaining service lives were twenty months less, all else equal.

As noted above, Mr. King used the same study date as did Mr. Kelly, i.e., April 30, 2010. Mr. Kelly's argument rests on the simple premise that if Mr. King had used a December 31, 2011 date to estimate the

[36] Kelly Rebuttal Testimony at 4.

[37] *Id.* at 6.

remaining service lives, then the result would have been closer to the remaining service lives developed by Mr. Kelly, who used the same April 30, 2010 study date. This argument is logically indefensible because it imposes a different and later study date on Mr. King's analysis to derive the remaining service lives than Mr. Kelly used.

Mr. Kelly then compounded this error by failing to update the balance of accumulated depreciation from April 30, 2010 to December 31, 2011, thus creating a mismatch in the calculations of net plant and remaining service lives, the two most important components in the equation used to develop the depreciation rates. If the remaining lives are to be reduced by 20 or more months due to the passage of time through December 31, 2011, then the net plant balances also should by reduced to reflect the additional depreciation expense incurred and recovered during that same period. Mr. Kelly's introduction of and support for this obvious mismatch is another analytical error that should be considered by the Commission in conjunction with all the other errors during the conduct of the B&M depreciation study.

At hearing, Mr. Kelly was not able to justify the fact that he did not revise the balance of accumulated depreciation to December 31, 2011 in his attempt to revise Mr. King's analysis. Mr. Kelly initially was not even sure whether he had updated the accumulated depreciation. During cross-examination at the hearing, the following exchange took place between counsel for KIUC and Mr. Kelly:

> "Q. *You've updated the useful life and made it shorter, because it's a year and half later, but you haven't updated the amount of depreciation consumers will have paid on the plants [through 2011] because it is a year and half later?*
>
> A. *Okay...I'll have to check that, but I assume that would be correct.*"[38]

Subsequently during cross-examination, the following exchange between counsel for KIUC and Mr. Kelly confirmed that indeed there was a mismatch:

> "Q. *You didn't update the accumulated depreciation since your original study date, did you?*
>
> A. *No.*"[39]

The B&M analysis has been plagued with problems from the beginning, including serious computational errors. Prior to filing its Application, Big Rivers invited KIUC to review the B&M analysis. In his review of the

[38] Video Transcript (7-27-11; 13:17:45 through 7-27-11; 13:18:07)

[39] Video Transcript (7-27-11; 13:20:40 through 13:20:55)

B&M analysis on behalf of KIUC, Mr. King discovered that B&M had reversed the positive and negative signs in its net salvage factors and failed to subtract removal costs from the salvage proceeds to derive net salvage.[40] Correction of these two errors reduced the proposed depreciation increase from $12 million to $4.33 million.[41] Additionally, in emails provided by Big Rivers in response to discovery, Big Rivers' managers repeatedly expressed frustration and disappointment with B&M's failure to calculate reliable depreciation rates.[42] These emails show, among other things, that Big Rivers' management had concerns that the total service life used by B&M for the Wilson generating unit was too short because it was less than the 65 years they had determined was most probable.[43] The evidence in this proceeding shows that the B&M analysis is fundamentally flawed and unreliable.

The KIUC depreciation analysis performed by Mr. King is credible and does not suffer from the infirmities reflected in the various iterations of the B&M analysis. Mr. King's depreciation study corrected the remaining service lives and used the estimates developed by Big Rivers' own management rather than substituting his own judgment. Mr. King's study also matched the remaining useful life and balance of accumulated depreciation at April 30, 2010, the standard analytical approach when performing a depreciation study.

KIUC recommends that the Commission approve the depreciation rates sponsored by Mr. King and addressed in his Direct Testimony. These depreciation rates are based on Big River's management's determinations of the remaining plant lives and are properly computed using an April 30, 2010 study date.

5. **The Commission Should Reject Big Rivers' Proposed Recovery Of Depreciation Expense On Projects Listed On The Utility's Accounting Records As Still Under Construction As Of The End Of The Test Year , But Which Are Now Claimed To Have Actually Been In Service**.

In its Petition for Rehearing filed on December 6, 2011, Big Rivers contends that the Commission erred by denying recovery of an additional $359,678 in depreciation expense based on its claim that $18,654,607 of its

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[40] KIUC Cross Exam Exhibit 16 at 6.

[41] *Id*.

[42] KIUC Cross Exam Exhibit 16 at 11-34.

[43] KIUC Cross Exam Exhibit 16 at 15.

construction work-in-progress ("CWIP") balance at October 31, 2010 as shown on its accounting books and financial records was actually no longer under construction but was operational and in-service.[44]

The Commission should reject the Company's request to include $18,654,607 of CWIP as in-service. The Commission is entitled to rely on the Company's accounting records, which are maintained in accordance with generally accepted accounting practices.[45] The Company's request is based upon an after-the-fact determination that the CWIP reflected in its accounting records and reported previously to the Commission, the RUS, and its creditors, was not actually CWIP, but plant-in-service. Such a claim would treat this amount differently for ratemaking purposes than it is treated for all other accounting purposes. The Commission should reject the Company's attempt to use disparate results for accounting and ratemaking purposes.

The Company claims that its accounting records were not in error and that the projects remain in CWIP even after they are in-service in order to collect additional charges to the project work orders.[46] There is no accounting requirement to forego transfers of balances from CWIP to Plant in Service or to hold open work orders beyond in-service dates to collect additional charges. The Commission and KIUC relied on the Company's accounting records, and the Commission should not consider an ex post facto accounting adjustment for ratemaking purposes that the Company did not consider necessary or appropriate for accounting or financial reporting purposes.[47]

6. The Commission Should Reject Big Rivers' Proposed Recovery Of Depreciation Expense On Projects Completed After The End Of The Test Year As Being Contrary To The November 17, 2011 Order Which Rejected All Other Post-Test Year Adjustments.

Big Rivers contends that the Commission erred by not allowing recovery of an additional $1,284,476 in depreciation expense based on its claim that $16,109,062 of its CWIP balance at October 31, 2010 was placed in-service after that date, but prior to September 1, 2011.[48] This argument should fail because the Commission was

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[44] Petition for Rehearing of Big Rivers at 7.

[45] *See* Big Rivers' response to KIUC Rehearing 1(a), (c), (d), and (f).

[46] *See* Big Rivers' response to KIUC Rehearing 2.

[47] Kollen Rehearing Testimony at 12.

[48] Petition for Rehearing of Big Rivers at 8.

unequivocal that the "four corners" of the historic test year should be adhered to and rejected attempts to incorporate post-test year adjustments.[49]

In its November 17, 2011 Order, the Commission adopted the historic test year as the conceptual framework for the revenue requirement and rejected the post-test year adjustments proposed by the Company and KIUC. More specifically, on the depreciation expense proforma adjustment proposed by the Company, the Commission stated:

> "[W]*e will approve and authorize Big Rivers' use, on a going-forward basis, of the depreciation rates proposed in its application. However, we will not authorize a level of depreciation expense that reflects the accrual of depreciation on Big Rivers' test-year-end CWIP balance. Going beyond the end of test year plant-in-service balances is inconsistent with the concept of a historical test year and a violation of the broad "matching principle" described previously in this Order. For this reason, we will limit the adjustment to the amount derived by applying Big Rivers' proposed depreciation rates to its test-year-end plant in service balances.*" (Order at 20)

Even if the Commission had adopted selective post-test year adjustments in its Order, the Company's proposed increase in depreciation expense on projects placed in-service after the test year, but prior to September 1, 2011, was not and could not have been known and measurable at the time of the Company's filing.

The Commission should be careful not to upend the conceptual framework of its Order in which it rejected selective post-test year adjustments, and even more careful if it does consider this proposed adjustment that it does not accept the Company's adjustment as "known and measurable" today when it could not have accepted it on that basis, at least in its entirety, when the issue was originally decided.

The Commission should not selectively choose post-test year adjustments without setting forth some standard for such adjustments and then applying that standard on a consistent basis. Although the Company has not articulated a standard for adopting its proposed post test year adjustments to increase depreciation expense, the Commission stated in its Order that adjustments to a historical test year must be "known and measurable," and that consequently, "*adjustments based on events occurring beyond the end of the test year are rarely accepted due to their inability to meet the requisite evidentiary standard.*"[50]

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[49] Order at 20.

[50] Order at 13.

7. **<u>The Commission Should Allow Recovery Of Rate Case Expense Only Up To The Original Budget Of $898,930 (Which Is Already Extremely High) And Deny Recovery Of The Over Budget Amount Of $1,077,099.</u>**

In its initial request, the Company estimated its rate case expenses at $898,390, which it proposed to defer and then amortize over three years. Based on this estimate, the Company included $299,643 for rate case expense in the revenue requirement ($17,924 already in historic test year plus $281,719 proforma adjustment). No party disputed this amount and the Commission should allow recovery of this amount.

However, the Company's actual rate case expenses through August 18, 2011 was $1,976,030, an increase of $1,077,100, or more than double the estimate included in its original rate increase request. A table summarizing Big River's August 18, 2011 submittal of rate case expense versus Big Rivers' original estimate is provided below:[51]

Big Rivers Electric Corporation
Case No. 2011-00036 Reconciliation of Rate Case Expense through August 2011
versus Amounts Requested in Big Rivers' Application

Line No.	Vendor	August 18,2011 Submittal	Original Estimate	Difference	Description
1	Burns & McDonnell	$187,151.58	$120,000.00	$67,151.58	Engineering
2	GDS Associates	4,341.66	5,000.00	(658.34)	Engineering
3	The Prime Group	399,971.50	300,000.00	99,971.50	Consulting
4	Sullivan Mountjoy Stainback & Miller	386,316.92	300,000.00	86,316.92	Legal
5	Hogan & Lovells	897,199.84	173,930.00	723,269.84	Legal
6	D.R. Eicher Consulting	1,160.00	0.00	1,160.00	Consulting
7	American Management Consulting	18,281.25	0.00	18,281.25	Consulting
8	Orrick Herrington & Sutcliffe	2,440.92	0.00	2,440.92	Legal
9	Public Financial Management	79,166.04	0.00	79,166.04	Consulting
10	**Total**	**$1,976,029.71**	**$898,930.00**	**$1,077,099.72**	

[51] *See* Big Rivers' Attachment For Response to KIUC Rehearing Item 7a. Note this attachment contained a miscalculation of the Total Difference between the August 18, 2011 Submittal and the Original Estimate. That Calculation is corrected ($1,077,099.72) in the above Table.

The Company now seeks $640,753 in annual rate case amortization expense, or an additional $359,034 annual rate increase to recover the actual expenses it incurred through August 18, 2011 in excess of the amount included in its initial request.[52] If the additional amount is approved, the Company will recover an additional $359,034 each year until rates are reset.

In its testimony and during discovery, Big Rivers refused to provide evidence that its rate case expense was reasonable. Because nearly 75% of the increased rate case expense was attributable to legal fees, KIUC sought to review the activities of Big Rivers' law firms to determine the basis for the extraordinary increase in expense, but the Company refused to provide the information requested, citing attorney-client and attorney work product privilege.[53] The Company refused to provide any evidence that it had performed any contemporaneous variance analyses, other than a tally of the amounts actually billed compared to the estimated amounts for each outside advisor.[54] The Company refused to provide documents related to the Company's control over the scope of work and cost of outside services.[55] The Company refused to provide correspondence between Big Rivers' and outside advisors or internal correspondence regarding the Company's evaluation of or satisfaction with each outside firm's performance.[56] The Company refused to provide copies of the unredacted invoices from its law firms for rate case activities,[57] thus precluding KIUC, Staff and all other parties from reviewing the charges from the outside law firms in order to determine if any of the additional charges were appropriate, let alone necessary.

Prior to hearing the Company refused to provide the parties and the Commission with any documentation supporting the tremendous increase in costs that Big Rivers' now seeks from the ratepayers. The Company's claim was based on nothing more than the fact that it had incurred more expense than its estimate, citing the "*amount of work that had to be performed*."[58] The Company blamed this additional work on "*the actions of the intervenors and the Commission, not Big Rivers*,"[59] Even if the additional work is attributable to the actions of

[52] Petition for Rehearing of Big Rivers at 2-3.
[53] *See* Big Rivers' response to KIUC Rehearing 10.
[54] *See* Big Rivers' response to KIUC Rehearing 7(b) and (c).
[55] *See* Big Rivers' response to KIUC 8(c).
[56] *See* Big Rivers' response to KIUC Rehearing 8(f) and (g).
[57] *See* Big Rivers' response to KIUC Rehearing 10.
[58] *See* Response to KIUC Rehearing 8.
[59] *See* Response to KIUC Rehearing 8.

the intervenors and the Commission, Big Rivers had the burden of proving that its rate case expenses were reasonable. Otherwise, the Commission would be sanctioning the ability of Big Rivers (or any other regulated utility) to punish ratepayers for exercising their rights of intervention in rate proceedings.

At rehearing, the Commission requested that Big Rivers provide un-redacted legal invoices. Despite its refusal to provide this information during discovery, Big Rivers provided partially redacted invoices to all parties on September 18, 2012. These invoices generally show that the Hogan & Lovells law firm billed Big Rivers hundreds of hours in legal service at astoundingly high hourly rates. The vast majority of the Hogan & Lovells work was billed at $740/hour and $650/hour (less a 5% -10% discount). These charges from Hogan & Lovells make up 67% of the charges that are in excess of Big Rivers' originally estimated budget. Contrast the Hogan & Lovells bills with Big Rivers' local attorneys which charged $220/hour for Mr. Miller and $170/hour for Mr. Kamuf. The evidence provided after the hearing shows clearly excessive billing rates that Big Rivers' customers should not be responsible for paying. Nevertheless, consistent with KRS 278.400 the Commission should ignore the post-hearing evidence and decide the issue of rate case expense based on the evidence provided prior to hearing. KRS 278.400 states that "[u]*pon the rehearing any party may offer additional evidence that could not with reasonable diligence have been offered on the former hearing*." The evidence presented by Big Rivers after the hearing was in Big Rivers' possession during the original hearing and Big Rivers failed to present it. Big Rivers continued to refuse to provide this evidence until a week after the rehearing. Big Rivers did not meet its burden of proof and this defect cannot be cured by the submission of post-hearing evidence.

The Commission should not simply accept the Company's actual rate case expenses based on its precedent of using actual expenses rather than estimated expenses. The Commission's precedent is not a ratemaking principle or standard and is more akin to a ratemaking tool or approach. There is a practical limit on the use of improperly inflated utility estimates, and the Commission's precedent of approving actual expenses should not now be turned inside out and used as the basis to recover actual expenses that far exceed the estimate. If the Commission allows its precedent to be misused in this manner, then other utilities also may view such a change as the ability to run up an unlimited tab that will be picked up by consumers.

If the Commission limits the rate case expenses to the amount estimated by the Company, the Company will not be required to write-off any deferred amounts. The Company did not defer its rate case expenses. The Company expensed the rate case costs as they were incurred.[60] That means that the Company expensed $1,976,030 through August 18, 2011 and likely expensed additional amounts since then. Thus, the rate case expense reduced the Company's Margins for Interest Ratio ("MFIR") and Debt Service Coverage Ratio ("DSC") in 2010 and in 2011, and the ongoing expenses continue to reduce these ratios in 2012. The amounts expensed in 2010 and 2011 will be reversed this year, at least in part, by the amount of rate case expense that is allowed recovery by the Commission. The accounting entry will be to record a credit to rate case expense and a debit to a regulatory asset for any amount of rate case expense that the Commission authorizes in this proceeding. Instead of a write-off, the Company will record a "write-up" that will increase Net Margins, the MFIR and the DSC this year based on the total amount of recovery the Commission allows. Thus, any self-inflicted damage to the MFIR and DSC from the excessive rate case expenses in 2010 and 2011 now cannot be undone and the effects in those years should not be a factor in the amount of rate case expense that is allowed in this proceeding.

8. Any Modification Of Rates Ordered By The Commission In This Rehearing Proceeding Must Be Billed To Customers On A Prospective Basis.

The KPSC's statutory rate-making authority is derived from an integrated, comprehensive system aimed at providing stability and notice to all entities involved in the rate process.[61] Consistent with this system, KRS 278.160 forbids a utility from charging any rate other than the rate in effect at the time that service was rendered. KRS 278.160(2) provides as follows:

> *"No utility shall charge, demand, collect, or receive from any person a greater or less compensation for any service rendered or to be rendered than that prescribed in its filed schedules, and no person shall receive any service from any utility for a compensation greater or less than that prescribed in such schedules."*

KRS 278.390 provides that rates set by the Commission are the "filed rate" until revoked or modified by Commission order:

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[60] *See* Big Rivers' Response to KIUC Rehearing 7(e).

[61] Cincinnati Bell Telephone Co. v. Kentucky Public Service Com'n, Court of Appeals of Kentucky. 223 S.W.3d 829, 837-838 (February 2, 2007)

"Every order entered by the commission shall continue in force until the expiration of the time, if any, named by the commission in the order, or until revoked or modified by the commission, unless the order is suspended, or vacated in whole or in part, by order of decree of a court of competent jurisdiction." (KRS 278.390)

Finally, KRS 278.270 empowers the Commission to set "just and reasonable" rates on a prospective basis only. 278.270 states:

"Whenever the commission, upon its own motion or upon complaint as provided in KRS 278.260, and after a hearing had upon reasonable notice, finds that any rate is unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any of the provisions of this chapter, the commission shall by order prescribe a just and reasonable rate <u>to be followed in the future.</u>" (Emphasis added)

Conspicuously absent from this Statute is any phrase enabling the Commission to set rates retroactively. The Commission explained in <u>Office of the Atty. Gen. v. Atmos Energy Corp.</u>, KPSC Case No. 2005-00057:

"The rule against retroactive ratemaking is a 'generally accepted principle of public utility law which recognizes the prospective nature of utility ratemaking and prohibits regulatory commissions from rolling back rates which have already been approved and become final.' . . . It further prohibits regulatory commissions when setting utility rates, from adjusting for past losses or gains to either the utility consumers, or particular classes of consumers." (Order of February 9, 2007 at 1)

The Commission concluded that if it later finds that its rates are not just and reasonable it can adjust those rates prospectively, but not retrospectively. The Commission stated that "*it is specifically authorized by KRS 278.270 to make prospective adjustments to rates if it finds that the rates are unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any provisions of KRS Chapter 278.*" (Id. at 1).

Accordingly, the rate that the Commission authorized Big Rivers to charge customers on November 17, 2011 remains in full force and effect until the Commission modifies it by order in this rehearing proceeding. Consequently, if the Commission determines that rates paid to Big Rivers should be increased, as a matter of law, customers that paid the filed rates during the pendency of the rehearing did not underpay during that time and no surcharge is owed to Big Rivers.

This is consistent with the opinion of the Court of Appeals of Kentucky in <u>Cincinnati Bell Telephone Co. v. Kentucky Public Service Com'n</u>, Court of Appeals of Kentucky. 223 S.W.3d 829 (February 2, 2007). In that case, three telecommunications companies appealed an order of the Franklin Circuit Court that had affirmed an order of the KPSC. At issue was the validity of a refund ordered by the KPSC. The telecommunication companies had collected sums of money from independent payphone service providers pursuant to a rate approved by the KPSC. In a complaint case filed by the payphone service providers, the KPSC later determined that the rates imposed by the telecommunications companies did not comply with FCC tariff guidelines. The KPSC adjusted the rates paid by the payphone providers downward and ordered that the telecommunications companies refund the difference between the two rates retroactive to the date of the original order. The telecommunications companies argued, and the Court of Appeals agreed, that the refund of money collected pursuant to a lawfully approved rate violated the Filed Rate Doctrine and the rule against retroactive ratemaking. The Court explained:

> "*BellSouth contends that the rate approved by the PSC in January 1999, was and remained at all relevant times the "filed rate." Thus, based upon the constraints of the filed rate doctrine, that rate could not be altered retroactively by the PSC. We agree.*
>
> *In its 1999 proceedings, the PSC duly adjusted the 1997 interim rates of local exchange carriers for the local exchange carriers. Each of the parties accepted the PSC's new, final rate. In light of the General Assembly's comprehensive rate-making scheme, including only a narrowly defined circumstance under which refunds can be ordered, the filed rate can only be lawfully altered prospectively. KRS 278.270, supra. Under the requirements of the statutes, the rate that the PSC authorized BellSouth to charge payphone service providers remained in full force and effect until the Commission modified it by its order of May 2003. Consequently, as a matter of law, BellSouth was never overpaid; no credits accrued; and no refunds were owed.*" (Id. at 839)

If the Commission determines in this rehearing proceeding that the rates approved on November 17, 2011 should be changed it may set new rates prospectively, but it cannot issue a surcharge or a surcredit in order to collect or refund monies that were billed during the period after the November 17, 2011 Order and the effective date of the new rates. An agency may not impose a surcharge over and above the rates on file at the time of the delivered service for regulated services already rendered; such a surcharge violates the Filed Rate Doctrine. (*See* Associated Gas Distributors v. F.E.R.C., 893 F.2d 349, 354-56 (D.C. Cir. 1989)

IV. CONCLUSION

The $11.1 million subsidy received by the residential, commercial and small industrial customers needlessly increases the risk that one or both of the Smelters will cease operations in Western Kentucky. In exchange for a small break on already very low Rural rates, the subsidy places a burden on the Kentucky Smelters that must compete internationally with smelters that benefit from much lower power rates. If one Smelter closes, the other Smelter may soon follow if the Commission determines that the remaining Smelter must pay its allocable share of the revenue shortfall. If the Smelters are forced to close, 4,700 hundred jobs will be lost along with $176 million in annual payroll and nearly $12 million in state and local taxes.[62] The high wage, high benefit Smelter jobs will likely never be replaced. Reselling the freed-up Smelter power in the volatile wholesale market would raise rates on remaining ratepayers by about 55%.[63]

KIUC recommends that the Commission do what it can to mitigate this danger: 1) the Rural subsidy should be eliminated completely in this rehearing; 2) the misallocation of DSM costs to Smelter and Direct-Serve Industrial customers should be corrected; 3) the KIUC depreciation rates should be adopted; 4) the proposed recovery of depreciation expense on projects which the utility's accounting records show were still under construction at the end of the test year should be rejected; 5) the proposed recovery of depreciation expense on projects completed after the end of the test year should be rejected; and ; and 6) the Commission should deny Big Rivers recovery of rate case expense in excess of its original estimates.

Respectfully submitted,

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[62] Direct Testimony of Paul A. Coomes at p. 6.
[63] Direct Testimony of Mathew J. Morey at p. 4-5; Direct Testimony of Henry Fayne at p. 12.

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October 1, 2012