

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	
COMPANY FOR APPROVAL OF AN	)	CASE NO. 98-474
ALTERNATIVE METHOD OF REGULATION	)	
OF ITS RATES AND SERVICE	)	

O R D E R

On February 9, 2000, the Commission issued an Order granting rehearing on a limited number of issues raised by Kentucky Utilities Company ("KU") and Kentucky Industrial Utility Customers, Inc. ("KIUC"). The Commission established a procedural schedule providing for discovery, the filing of prepared testimony, and a hearing on March 31, 2000. Briefs have been filed and this case stands submitted for a decision.

REVENUE REQUIREMENTS ISSUES

Based on the Commission's findings on the rehearing issues, KU's overall revenue sufficiency, as set out in the January 7, 2000 Order, should be reduced by \$6,031,298, from \$36,450,394, to \$30,419,096. This amount includes the \$2,577,051 reduction in KU's revenue sufficiency reflected in the Commission's February 9, 2000 Order. The discussion of this reduction is contained in the following sections of this Order.

## Environmental Surcharge

In its February 9, 2000 Order, the Commission granted rehearing on three issues raised by KU: the amount of environmental surcharge to be excluded from KU's capitalization, whether KU's cost of debt should be adjusted to reflect the exclusion of the environmental surcharge, and whether environmental surcharge expenses should be allocated to off-system sales. Based on its position on each issue, KU proposed that the overall revenue sufficiency should be reduced from \$36,450,394 to \$28,743,629, a difference of \$7,706,765.<sup>1</sup> This \$7,706,765 includes \$2,577,051 that has already been reflected in rates by the Commission's February 9, 2000 Order revising the jurisdictional allocation of environmental surcharge revenues.<sup>2</sup>

KU argues that the Commission's adjustment to KU's capitalization is in error because the adjustment did not recognize Pollution Control Deferred Income Taxes ("PC DIT"). By not recognizing the PC DIT, KU claims that the adjustment to its capitalization was excessive and resulted in an overstatement of its revenue sufficiency.<sup>3</sup> KU contends that when determining the revenue sufficiency, the exclusion

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<sup>1</sup> Willhite Rehearing Testimony at 12. In LG&E's and KU's Post Rehearing Data Response, Exhibit KU-9, filed with the Commission on April 10, 2000, KU indicated that the overall revenue sufficiency would be \$28,646,536, or a correction of \$7,803,858, if the alternative approach discussed in that filing is adopted. The \$7,803,858 reflects the February 9, 2000 Order amount of \$2,577,051 and the \$5,226,807 shown on Exhibit KU-9.

<sup>2</sup> In the February 9, 2000 Order, the Commission agreed with KU and KIUC that the allocation of environmental surcharge revenues should have been at 100 percent Kentucky jurisdictional, since these revenues were collected solely from Kentucky jurisdictional ratepayers. The revised calculations, including the recognition of income tax effects and gross up, resulted in the overall revenue sufficiency being lowered from \$36,450,394 to \$33,873,343, or a reduction of \$2,577,051.

<sup>3</sup> Willhite Rehearing Testimony at 3-4.

of the environmental surcharge components in base rate calculations should be neutral.<sup>4</sup> To achieve this neutrality, KU states that the environmental surcharge amounts removed from its capitalization must be the same as the amounts removed from its rate base.<sup>5</sup> Finally, KU takes the position that the July 19, 1994 Order establishing its environmental surcharge equated its environmental surcharge rate base with its environmental surcharge capitalization.<sup>6</sup>

One of the basic theories of rate-making is the concept that a utility's net original cost rate base should be equal to its capitalization. While accepting this theoretical concept, the Commission has long recognized that a utility's rate base is rarely equal to its capitalization. Because rate base and capitalization are rarely equal, the Commission promulgated 807 KAR 5:001, Section 10(6)(i), which requires a utility to file a reconciliation of its rate base and capitalization used for determining revenue requirements in a historic test year rate application. In determining a utility's revenue requirements, the Commission does not adjust the rate base or capitalization to be equal. Rather, the Commission's Orders state two different rates of return; one on rate base and one on capital. But when the rate base and capital are multiplied by their respective rates of return, they produce the same net operating income found reasonable by the Commission. The rate base and capitalization utilized by KU in this proceeding were not equal.<sup>7</sup> In response to a KU data request, KIUC stated that for

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<sup>4</sup> KU and LG&E Post Rehearing Brief at 2.

<sup>5</sup> Response to the Commission's March 9, 2000 Order, Item 6.

<sup>6</sup> Id., Item 7(b).

<sup>7</sup> Response to the Commission's March 9, 2000 Order, Item 7(b).

base rate-making purposes, the Commission has not required that capitalization be set equal to rate base, nor did KU advocate such a position.<sup>8</sup>

The Commission is not persuaded by the evidence or arguments presented by KU. The purpose of the Commission's exclusion of the environmental surcharge items was to remove the effects of a stand-alone cost recovery mechanism from the determination of KU's base rate revenue requirements. This is the fundamental goal when determining the revenue sufficiency as it relates to the environmental surcharge items. KU has acknowledged that the PC DIT are not funded by its capitalization, but are the result of differences between book and tax accounting practices and requirements prescribed by the applicable tax code.<sup>9</sup> At the public hearing, KU agreed that its argument that the July 19, 1994 Order establishing KU's environmental surcharge equated the surcharge rate base with the surcharge capitalization was based on its interpretation of the Order rather than on any explicit statement to that effect in the Order.<sup>10</sup> Therefore, the adjustments to KU's rate base and capitalization to remove the impacts of its environmental surcharge will remain as originally calculated in the January 7, 2000 Order.

The second issue raised by KU was whether its cost of debt should be adjusted to reflect the exclusion of the environmental surcharge. KU contends that to be consistent with the decision to remove the impacts of the environmental surcharge items from the determination of the revenue sufficiency, the blended cost of long-term

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<sup>8</sup> KIUC's Response to KU's and LG&E's Request for Information, Item 8.

<sup>9</sup> Transcript of Evidence ("T.E."), March 31, 2000, at 27-28.

<sup>10</sup> Id. at 29-33.

debt should have been adjusted. KU states that the calculation should be based on applying the rate of return allowed in the environmental surcharge mechanism to the amount of debt excluded from KU's long-term debt component of its capitalization.<sup>11</sup>

The Commission has considered the arguments made by KU and agrees that the blended interest rate calculations should have recognized the assignment of the environmental surcharge adjustment to long-term debt, at an interest rate equal to the rate of return provided in the environmental surcharge mechanism. The Commission has made this calculation, recognizing an adjustment to long-term debt of \$126,445,340 at an interest rate of 5.85 percent, which results in a blended interest rate of 7.07 percent.<sup>12</sup>

The final issue raised by KU is whether the environmental surcharge expenses should be allocated to off-system sales. KU contends that the calculations in the January 7, 2000 Order credited all off-system sales revenue to jurisdictional customers, but because incorrect jurisdictional allocation factors were utilized, the environmental costs corresponding to these off-system sales were not assigned.<sup>13</sup> This resulted in overstatement of the margins from off-system sales and a mismatch of the revenues and expenses relating to the off-system sales portion of the allocated environmental

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<sup>11</sup> Willhite Rehearing Testimony at Exhibit KU-5.

<sup>12</sup> In the January 7, 2000 Order and this rehearing Order, the blended interest rate has been stated to two decimal places. However, the blended interest rate used to calculate the interest synchronization adjustment was carried to three decimal places. In the January 7, 2000 Order, that value was 6.788 percent. As a result of recalculating the blended interest rate as described in this Order, the value is now 7.070 percent and is used to recalculate the interest synchronization adjustment included in the revised overall revenue sufficiency found herein for KU.

<sup>13</sup> Willhite Rehearing Testimony at 6.

surcharge monthly revenue requirement.<sup>14</sup> KU proposed to correct this error by adjusting the jurisdictional allocation factors used in the environmental surcharge adjustments.<sup>15</sup> During the public hearing, an alternative method was suggested that would adjust the off-system sales revenues to reflect the environmental surcharge calculations recognized in the determination of off-system sales.<sup>16</sup> KU analyzed this alternative and indicated that it would be an acceptable method to correct the overstated margins set forth in the January 7, 2000 Order. KU requested that the Commission adopt either of these methodologies.<sup>17</sup>

The Commission agrees that the calculations in its January 7, 2000 Order inadvertently resulted in a mismatch of the off-system sales revenues and expenses. After considering both alternatives, the Commission finds that adjusting the off-system sales revenue for the environmental surcharge costs is the most appropriate alternative. Therefore, the Commission will reduce KU's test-year off-system sales revenues by \$2,591,117.<sup>18</sup>

KIUC argued that KU incorrectly computed the income tax effects and interest synchronization in its exhibits that incorporate the impacts of the rehearing issues on its

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<sup>14</sup> KU and LG&E Post Rehearing Brief at 4 and T.E., March 31, 2000, at 36.

<sup>15</sup> Willhite Rehearing Testimony at 6.

<sup>16</sup> T.E., March 31, 2000, at 36-38.

<sup>17</sup> LG&E's and KU's Post Rehearing Data Response, filed with the Commission on April 10, 2000, and KU and LG&E Post Rehearing Brief at 4.

<sup>18</sup> Bellar Rehearing Testimony, Exhibit LEB-4.

base rate revenue sufficiency.<sup>19</sup> As a result of the Commission's decisions on these rehearing issues, it is necessary to recalculate KU's interest synchronization adjustment, the income tax adjustment, and the associated effects on the base rate revenue sufficiency. Consequently, the Commission has not relied upon KU's exhibits for these calculations. Rather, the recalculations have been done independently by the Commission. Based on the decisions discussed in this Order, and the recalculation of the interest synchronization and income tax effects, the Commission finds that KU's revised revenue sufficiency is \$30,419,096, which is a change of \$6,031,298 from the amount determined in the January 7, 2000 Order. The calculation of this revised revenue sufficiency is shown later in this Order.

In its February 17, 2000 Order, the Commission granted rehearing on KIUC's request to investigate and evaluate whether the environmental surcharge revenues removed from the determination of KU's base rates properly reflected the effects of the 1999 Environmental Surcharge Settlement Agreement ("Settlement Agreement") in Case No. 93-465.<sup>20</sup> However, upon further review, KIUC stated that it had reconsidered this issue and agrees that the Commission properly quantified the surcharge revenues removed from base revenues.<sup>21</sup> The Commission finds that this rehearing issue is resolved and that no further consideration is necessary.

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<sup>19</sup> Kollen Direct Rehearing Testimony at 26-27.

<sup>20</sup> Case No. 93-465, The Application of Kentucky Utilities Company to Assess a Surcharge Under KRS 278.183 to Recover Costs of Compliance with Environmental Requirements for Coal Combustion Wastes and By-Products. The Order adopting the unanimous Settlement Agreement was dated August 17, 1999.

<sup>21</sup> Kollen Direct Rehearing Testimony at 26.

## Off-System Sales and Purchased Power

KIUC argues that the Commission's adjustment to decrease KU's test year net margins from off-system sales by \$2,521,656 based on the level of such margins for the 12 months ended August 1999 is not adequately supported by KU's internal accounting documents.<sup>22</sup> KIUC contends that KU's method of accounting for off-system sales does not adequately ensure that native load customers are receiving the full benefit of the margins from those sales. KIUC states that the record on rehearing regarding the level of off-system sales and their margins is contradictory and incomplete and that the adjustment to decrease net margins from off-system sales based on post-test year activity should be reversed.<sup>23</sup>

KIUC also argues that the Commission's adjustment to increase KU's test year purchased power expense by \$4,768,000 based on KU's actual purchased power expense for the 12 months ended August 1999 is not adequately supported by KU's evidence on rehearing.<sup>24</sup> KIUC contends that KU misrepresents the nature of its power purchases to support their recovery through base rates rather than through KU's Fuel Adjustment Clause ("FAC").<sup>25</sup> KIUC states that if the Commission allows the costs of "Reserve Margin Purchases" to be included in the determination of KU's revenue requirement for purposes of establishing base rates, it must put KU on notice that

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<sup>22</sup> Kollen Rehearing Response Testimony at 10-11.

<sup>23</sup> KIUC Post Hearing Brief at 5 and 6.

<sup>24</sup> Kollen Rehearing Response Testimony at 4-5.

<sup>25</sup> Kollen Direct Rehearing Testimony at 17-18.

similar costs, calculated using the same methodology, will not be allowed to be recovered in future FAC proceedings.<sup>26</sup>

KU states that its after-the-fact billing process ensures that the highest fuel costs are assigned to off-system sales, while native load customers benefit from the assignment of the lowest fuel costs.<sup>27</sup> KU contends that KIUC misunderstands the information supporting the off-system sales that it criticizes as being incomplete or erroneous. KU maintains that changes in the wholesale power market due to the price spikes experienced in 1998 caused it to change its strategy for 1999, resulting in its “Reserve Margin Purchases” being structured differently than they were during the test year.<sup>28</sup> KU defines its “Reserve Margin Purchases” as purchases that are similar to physical generating assets installed to meet native load<sup>29</sup> and states that none of these purchases in 1999 were flowed-through the FAC.<sup>30</sup> KU argues that the adjustments are adequately supported by the evidence of record and that they should not be modified.<sup>31</sup>

The Commission is not persuaded by KIUC’s arguments to reverse the adjustments to net margins from off-system sales or purchased power expense contained in the January 7, 2000 Order. Rehearing was granted on these issues for the

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<sup>26</sup> KIUC Post Hearing Brief at 9.

<sup>27</sup> Bellar Direct Rehearing Testimony at 7-8.

<sup>28</sup> T.E., March 31, 2000, at 90-93.

<sup>29</sup> Response 15 to Staff Hearing Data Request, September 16, 1999.

<sup>30</sup> Id. at 49.

<sup>31</sup> KU Post Hearing Brief at 8.

limited purpose of investigating the level of KU's off-system sales and purchased power for the 12-month period ending August 31, 1999. KIUC's attempts to portray the support offered by KU as incomplete and contradictory reflect a misunderstanding of the information provided by KU on rehearing. The Commission's adjustments were made to reflect KU's actual sales and expenses incurred after the wholesale power market experienced significant changes in the summer of 1998. These changes significantly altered prices in that market. Having considered all the evidence on rehearing, the Commission affirms the adjustments in the January 7, 2000 Order.

The Commission finds that what KU has defined as "Reserve Margin Purchases" are needed to adequately serve native load customers and such purchases are properly included in the determination of KU's base rate revenue requirements. Thus, such purchases cannot also be recoverable through the FAC. In future FAC proceedings, KU must separately identify similar purchases according to the same methodology presented in this proceeding to ensure that "Reserve Margin Purchases" are not included for recovery through the FAC.

#### Revenue Requirements Calculation

The revised overall revenue sufficiency for KU has been recomputed to reflect the Commission's findings herein. The revised overall revenue sufficiency, with a comparison to the calculations contained in the January 7, 2000 and February 9, 2000 Orders is as follows:

	<u>Determined in 01/07/00 Order</u>	<u>02/09/00 Decision</u>	<u>Rehearing Decision</u>
Net Operating Income Found Reasonable	\$ 85,872,693	\$ 85,872,693	\$ 86,778,523
Pro Forma Net Operating Income	<u>107,574,558</u>	<u>106,040,231</u>	<u>104,889,469</u>
Net Operating Income Sufficiency	(21,701,865)	(20,167,538)	(18,110,946)
Gross Up Revenue Factor	<u>.595381</u>	<u>.595381</u>	<u>.595381</u>
Overall Revenue Sufficiency	<u>\$(36,450,394)</u>	<u>\$(33,873,343)</u>	<u>\$(30,419,096)</u>
Incremental Change per Decision		<u>\$ 2,577,051</u>	<u>\$ 3,454,247</u>
Total Change from 01/07/00 Order			<u>\$ 6,031,298</u>

The revised reduction of KU's jurisdictional revenues in the amount of \$30,419,096 will provide a rate of return on the jurisdictional rate base of 8.85 percent and an overall return on jurisdictional capitalization of 9.58 percent.<sup>32</sup> The reduction determined in the January 7, 2000 Order for KU of \$36,450,394 provided a rate of return on the jurisdictional rate base of 8.76 percent and an overall return on jurisdictional capitalization of 9.48 percent. The authorized rate of return on common equity is unchanged.

### EARNINGS SHARING MECHANISM ISSUES

Both KU and KIUC raised issues related to the Earnings Sharing Mechanism ("ESM"), which KU adopted pursuant to the Commission's January 7, 2000 Order. Some of those issues relate to the scope of the annual earnings reviews contemplated under the ESM, while others relate to whether specific items should be reflected as

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<sup>32</sup> The rates of return on jurisdictional rate base and jurisdictional capitalization change because the cost rate for long-term debt increased from 6.79 percent to 7.07 percent, as described in this Order.

adjustments within an annual ESM filing. While some ESM-related issues may be more appropriately addressed in an ESM-specific proceeding, all ESM issues that now require clarification are addressed herein.

### Scope of an ESM Proceeding

One rehearing issue is whether KU may propose, in an ESM proceeding or a rate unbundling proceeding, to adjust class rates of return on a revenue neutral basis. KU states that the ability to make such adjustments is critical, given the move within the electric industry toward unbundled rates. KU proposes to conduct a class cost-of-service study and, based on the results of that study, present proposals to adjust class rates of return during an ESM review or an unbundling proceeding.<sup>33</sup>

The AG opposes KU's proposal, stating that while base rate changes based on cost-of-service and class rates of return are firmly entrenched in traditional regulation, KU's proposal runs counter to the intent and purpose of alternative regulation, in the form of the ESM.<sup>34</sup> The AG argues that expanding an ESM review to examine class cost-of-service studies and other evidence to support adjusting class rates of return will require the Commission and all parties to devote significant time and resources to rate-making issues when one purpose of alternative regulation is to eliminate the need to review such issues.<sup>35</sup>

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<sup>33</sup> Willhite Rehearing Testimony at 10.

<sup>34</sup> AG Post Hearing Brief at 1-3.

<sup>35</sup> Id. at 5.

The arguments advanced by KU in support of its proposal are not persuasive. Both the move within the electric industry toward unbundling of rates and any differences among the class rates of return for KU's various customer classes predate the implementation of the ESM.<sup>36</sup> By allocating the revenue decrease in the January 7, 2000 Order on a percentage-of-revenue basis, the Commission maintained the existing relationships among the various customer classes' rates of return. If KU believes it needs to adjust class rates of return, it should do so in a separate proceeding, not within an annual ESM proceeding. Filing a class cost-of-service study, and the potential issues that such a filing would raise, will assuredly result in expanding the ESM review proceeding beyond the type of expedited review that was intended when the ESM was offered as an alternative form of regulation. For these reasons, the Commission finds that a review of class rates of return should not be included as part of an annual ESM review.

The Commission does not oppose KU's filing, for informational purposes only, an analysis of class rates of return as part of an informational unbundling study. Such an analysis would likely be both informative and helpful in identifying issues of interest to the Commission and the parties, particularly in light of today's regulatory environment and the interest in restructuring the electricity industry within the Commonwealth.

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<sup>36</sup> There was no proposal from KU to either review or adjust its class rates of return prior to this proceeding or at anytime during this proceeding prior to the January 7, 2000 Order.

## ESM Review – Specific Adjustments

KU and KIUC raised several questions regarding the nature of the future ESM reviews and the type of adjustments that will be appropriate. The following findings and guidelines should clarify what should be included in an annual ESM review and whether any modifications are necessary to the ESM tariff submitted by KU.

The impacts of the Orders issued in this proceeding should be reflected in the normalization of KU's revenues for purposes of the initial ESM review. That initial review will cover KU's operations for calendar year 2000. Since the Orders in this case were issued during this calendar year, the Commission finds it reasonable to reflect a full 12 months of the impact of these Orders in the initial ESM review. As to reflecting future Orders in ESM reviews, it is now unknown what issues will be addressed and how those issues might affect KU's rates and earnings. Therefore, it is neither necessary nor appropriate to now decide the extent to which future Orders should be reflected in ESM reviews. This issue will be deferred until such time as future cases are docketed and consideration can then be given to whether the decisions in those cases should be reflected in future ESM reviews.

The Commission finds that the calculations performed during the annual review should include adjustments for the shareholders' portion of KU's merger savings, as was recognized in this proceeding, and the removal of advertising expenses consistent with the requirements of 807 KAR 5:016.

KU should use actual revenues rather than estimated revenues in the derivation of its future ESM factors. The January 7, 2000 Order states that when earnings fall outside the deadband, the monthly ESM factor will be a "credit or charge based on a

percentage-of-revenue calculation as utilized in KU's monthly environmental surcharge factors."<sup>37</sup> The percentage-of-revenue calculation utilized in KU's environmental surcharge factor uses actual, not estimated revenues. The same will be required for the ESM factor.

### SUMMARY OF FINDINGS AND ORDERS

The Commission, based on the evidence of record and being otherwise sufficiently advised, finds that:

1. Based on the adjustments found reasonable herein related to KU's environmental surcharge, KU's annual revenue sufficiency is determined to be \$30,419,096, or \$3,454,247 less than that found in the February 9, 2000 Order.
2. All other rehearing issues affecting revenue requirements are denied.
3. KU's rates for electric service should be increased to recover this increase of \$3,454,247 in its annual revenue requirement, with the revenue increase allocated to customer classes and within customer classes according to the same instructions set out in the January 7, 2000 Order.
4. The increased rates authorized herein should be effective for service rendered on and after the date of this Order.
5. KU's request for authority to adjust class rates of return as part of an annual ESM proceeding goes beyond the scope of the limited earnings review appropriate for an ESM proceeding and should, therefore, be denied. However, KU can

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<sup>37</sup> January 7, 2000 Order at 49.

present for informational purposes an analysis of its class rates of return as part of its informational rate unbundling filing.

6. KU's annual ESM filings should include adjustments to reflect the shareholders' portion of KU's merger savings and the elimination of advertising expenses pursuant to 807 KAR 5:016.

7. KU's ESM filing for calendar year 2000 should include adjustments to normalize its revenues to reflect the impact of the Commission's Orders in this proceeding.

8. KU's ESM tariff should be amended to reflect that actual revenues, not estimated revenues, are to be included in the derivation of its ESM factor.

IT IS THEREFORE ORDERED that:

1. KU shall file, within 15 days of the date of this Order, revised tariff sheets that reflect new rates based on the \$3,454,247 reduction to its revenue sufficiency found reasonable herein. The rates, to be effective for service rendered on and after the date of this Order, shall be determined in the same manner as was originally prescribed in the January 7, 2000 Order in this proceeding.

2. KU shall file, within 15 days of the date of this Order, an amended ESM tariff that includes actual revenues, not estimated revenues, in the calculation of its ESM factor.

3. KU's ESM filing for calendar year 2000 shall reflect the impacts of the Commission's Orders issued in this proceeding in the normalization of its electric revenues for the period under review.

4. All of KU's annual ESM filings shall include adjustments for the shareholders' portion of KU's merger savings and the elimination of advertising expenses pursuant to 807 KAR 5:016.

5. KU's request to include with its annual ESM filings proposals to adjust class rates of return is denied. KU is authorized to file for informational purposes only an analysis of its class rates of return as part of an informational rate unbundling filing.

Done at Frankfort, Kentucky, this 1<sup>st</sup> day of June, 2000.

By the Commission

ATTEST:

  
Executive Director