COMMONWEALTH OF KENTUCKY

BEFORE THE ENERGY REGULATORY COMMISSION

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In the Matter of:

GENERAL ADJUSTMENT IN ELECTRIC RATES OF KENTUCKY UTILITIES COMPANY	)))	CASE NO. 7804

ORDER DENYING REHEARING

On October 1, 1980, the Commission issued its Order in this matter approving an increase in the rates of Kentucky Utilities Company (hereinafter K.U. or the Company) for service rendered on and after the date of said Order. Thereafter, on October 17, 1980, the Division of Consumer Intervention in the Department of Law (hereinafter Attorney General) filed a motion for rehearing. Likewise, on October 20, 1980, Black River Mining Company (hereinafter Black River) and K.U. filed similar motions for reconsideration of certain issues in this matter.

On October 31, 1980, the Lexington-Fayette Urban County Government (Fayette County) filed a motion for leave to intervene in this matter and a motion for rehearing on the Commission's treatment of the franchise fee for rate purposes. In support of this motion, Fayette County asserts that it had no notice that the treatment of the franchise fee would be a part of this rate case since K.U. had not requested any change in its treatment as a part of its application to this Commission.

Fayette County's argument on this point overlooks the fact that a franchise fee is just as much a matter for consideration in a rate case as any other cost to a utility for providing service to the public. Accordingly, the fact that an applicant before this Commission did not specifically request any change in the treatment of franchise fees in a rate case

does not preclude the Commission from considering this matter on its own initiative. When K.U. filed its rate case with the Commission, it placed all of its customers (including Fayette County) on notice that all aspects of its rates would be under scrutiny by the Energy Regulatory Commission, and any customer desiring to protect its perceived interest was required to intervene prior to the conclusion of the proceedings. Accordingly, Fayette County's motion to intervene after the case has been closed should be, and hereby is, denied. Since only a party to a proceeding may seek rehearing under the provisions of KRS 278.410, Fayette County's motion for rehearing must likewise be denied.

The Application for rehearing filed by Black River Mining Company stated that the Commission failed to make findings of fact and conclusions of law concerning the issues of rate design and revenue allocation and requested that the Order of October 1, 1980, be modified to include findings of fact and conclusion of law regarding these issues.

During the hearing on June 23, 1980, Black River cross examined K.U. concerning the allocation of the revenue increase and the impact of the proposed rate design on the consumers. The testimony and exhibits of K.U. reflected that the proposed revenue allocation was on a percentage basis to the various customer classes with a kilowatt hour adder to the rates within each class. This method of allocation resulted in a "flattening" of the rates within each class with a larger percentage of increase applied to the larger volume usage blocks.

Black River argued in its brief that the revenue increase should be allocated on the basis of the non-fuel revenue within each customer class and that in order to maintain the existing rate structure, each block within a rate class should be increased a uniform percent. No testimony was submitted by Black

River on these issues during the evidentiary proceedings in this matter.

Within its rate classifications K.U. has a declining block rate structure. This rate structure reflects the rate design concept which assumes that the large users of electricity within a certain class are entitled to a volume or quantity discount on energy consumption beyond a specific point.

The Commission is of the opinion and finds that the distribution of the increase allowed in its Order of October 1, 1980, should be made on a percentage basis to the various classes of consumers of K.U. The Commission is further of the opinion that as energy costs the same per unit for the last unit produced as the first that the increase should be applied on a per unit, i.e., kilowatt hour, basis rather than the percentage basis advocated by the intervenor, Black River Mining Company.

The rates contained in the Appendix to the Order dated October 1, 1980, were designed in the aforesaid manner. It was and it remains the Commission's opinion that this design is proper. Therefore, the petition for rehearing in this matter is hereby denied.

In its petition for rehearing, K.U. urges the Commission to reconsider its decision to reduce by $29,893,777 the fuel inventory included in rate base. K.U. contends that the Commission's decision has unlawfully deprived the company of $2,211,788 in return on its Kentucky jurisdictional rate base.

In support of this position, K.U. alleges that no factual or legal basis exists for the Commission's finding that the fuel inventory was so excessive as to deprive the company of any return on the amount the Commission found to be excessive. It claims that uncontradicted proof shows that the inventory contained 116 days' burn and that such level is not unreasonably in excess of an optimum 90 days' burn and in any event, such an inventory is less than the average of the 31 utilities

in the nine state ECAR region which includes Kentucky. It further alleges that the coal build-up resulted from the unavoidable consequence of soft coal market conditions and EPA mandated environmental restrictions.

The Commission is not persuaded by the allegations in the company's petition on this point. At the hearing in this matter, the Attorney General's witness, Mr. Skirpan, testified that the industry norm ranged from 60 to 90 days' burn. It was this level that the Commission allowed. Also the Commission is not persuaded from the record that a soft coal market or EPA requirements had or will have anything to do with the number of days' burn a company should keep in inventory. If anything, depending on the relationship between the portion of the total coal supply secured in the spot market, a soft market should result in the company being able to maintain an inventory at or below its normal requirements. Finally, the only reference to the coal supply utilities should maintain consists of assertions made to the Attorney General's witness during cross by company counsel. The witness did agree with these assertions but this can hardly be considered persuasive in light of the company's own position that 75 days' burn was a desirable or normal level. The Commission, accordingly, concludes that the company's petition for rehearing on this point should be denied.

The Attorney General also requested rehearing on the treatment of the coal inventory. The Attorney General alleges that the dollar amount of the inventory adjustment should be deducted from capital structure in the same manner as the subsidiary earnings and other investments were deducted. The Commission is not persuaded by the Attorney General's argument on this point. First of all, the Attorney General argues in its petition that the Commission's adjustment results in a $2.2 million lower rate request. Such an argument is not, of course, evidence but does tend to demonstrate that a difference

of opinion exists as to the effect of the Commission's reduction in rate base. In its deliberations in this matter, the Commission determined that since fuel inventory is used as a component of rate base this excess inventory should be removed from the rate base used to evaluate the fair return on capital. The Commission points out that it considered not only rate base, but total capital, the level of operating expenses, and the fair return required for attraction of capital in assessing the company's overall revenue needs. While it is true that subsidiary earnings and other investments are deducted directly from total capitalization, the reason in that instance is obvious: This capital is not currently and is not expected in the future to be employed in providing service to customers. To the extent the company has suffered a reduction in revenue requirements due to our treatment of the excess fuel inventory, the Commission believes such a reduction is justified and believes such action will motivate the Company to better manage this inventory in the future. As to the Attorney General's contention that the revenue reduction should have been even greater, the Commission emphasizes that this is a matter for the informed discretion of this Commission as decreed by the legislature. In sum, this Commission believes that its treatment of the fuel inventory in the instant case is both reasonable and serves to put the company on notice that this Commission will not tolerate excessive fuel inventory levels. The Commission, accordingly, concludes the Attorney General's petition for rehearing on this point should be denied.

In its petition for rehearing, K.U. states that the Commission's "adjustment of $454,739 for new depreciation rates is contrary to the proof and unreasonable and unlawfully deprives it of lawful test year revenue of $454,739." In denying the $454,739 adjustment to operating expenses because of K.U.'s method for determining depreciation, the Commission's principal

concern was the long term effect these new depreciation rates would have on the company's requirements and the customers' rates. K.U. admitted on cross examination that by using these new rates, more expense for depreciation would occur in the earlier years and less in the later years. This would, in this Commission's opinion, have the effect of the present ratepayer subsidizing the future ratepayer, and we find this to be unjust and unfair.

K.U.'s contention that the Commission has radically changed its past policy on depreciation rates is equally misplaced. In the past, a utility desiring to change its depreciation rates simply submitted the new depreciation rates to the Commission without requesting that they be approved in a formal proceeding. In such cases, the Commission would review the new depreciation rates in connection with the next general rate hearing for the particular utility. Prior to the time of the utility's next rate case, the proposed depreciation rates would be allowed to go into effect without formal approval or disapproval. This same policy has been followed in this proceeding. K.U. had full notice that the Commission would review the new depreciation rates in this proceeding. The rates were entered as part of the record and K.U's principal witness was cross-examined on them at the hearing.

K.U.'s new depreciation rates were based on the straight line equal life group method (SLELG) which is a major deviation from the straight line vintage group (SLVG) method that has been in use ever since K.U. started incurring depreciation expenses. The equal life group depreciation method is not a universally accepted method for determining service lives and annual depreciation rates; no federal agency has accepted this method of determining depreciation rates. In fact, the Federal Communications Commission has been studying for seven years a

proposal by the Bell Systems to institute this method in determining depreciation rates. These are a number of reasons that regulatory agencies are reluctant to adopt this ELG method of depreciation, but, their major concern is the immediate impact that it has on the revenue requirements of utilities. In K.U.'s case, this could amount to hundreds of thousands of dollars annually which would have to be achieved through higher rates from K.U.'s customers. Moreover, K.U. has made no argument against a deficiency in its depreciation accruals, and has provided no valid proof that the present method of determining depreciation won't provide sufficient depreciation accruals. Finally, K.U. alleges that this Commission has previously permitted the use of the equal life group method for determining depreciation rates for production plant. This position is stretching the argument beyond the point of reasonableness. We consider what K.U. has done as being nothing more than "life-spanning" these production facilities, and only in a very broad connotation could this be considered the same as the equal life group method proposed for all other properties. The Federal Energy Regulatory Commission and many state Commissions have permitted this method for determining depreciation rates for production facilities; however, they have not permitted utilities to adopt the equal life group depreciation for transmission and distribution properties.

For all of the above-stated reasons, the Commission hereby reaffirms its position on depreciation as set forth in its order of October 1, 1980.

K.U. further argues that the Commission's reduction of the test year cost of short term debt from 13% to 11.5% is contrary to the proof and unreasonably reduces test year revenue requirements by $321,257. K.U. argues that the short term interest costs have currently returned to test year levels.

The record reflects that the composite interest cost on short term debt outstanding at the end of the test period was 13.24%.[1/] The Company adjusted the cost rate to 13.0% on Newton Exhibit 6-A to reflect its anticipated cost of short-term debt based on the adjusted capitalization. No factual evidence was entered by the Company in support of the 13% cost rate on short-term debt. The record did reflect that the short-term debt outstanding at the end of the test year consisted of commercial paper maturing within 60 days or less.

In its original decision, the Commission chose not to include the cost of short term debt at the end of the test year because, in its judgement, this figure reflected an abnormally inflated cost of money at the time. Instead the Commission established the cost of short term debt at a level which it considered to be reasonable based on historical trends in the short term money market. K.U., however, argues that the decline in short term interest rates was only temporary and that the cost of short term debt has now returned to test year levels. This point further supports the position of the Commission that the short term interest rates are not stable in the short run, and that the revenue requirements of K.U. should not be determined on the basis of current short term interest rates. Therefore, the Commission is of the opinion that the petition for rehearing on this issue should be denied.

K.U. also argues that the 13.9% rate of return on equity allowed in this case is unfair, unjust and unreasonable, and that the proof supports a rate of return of at least 15%. The Attorney General, however, argues that the 13.9% return granted to K.U. is excessive. The Attorney General further argues that increasing K.U.'s return on common equity because of its failure

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1/ Newton Exhibit 6.

to earn the return previously-authorized, results in an "attrition allowance" which was neither requested nor supported by any evidence. The Attorney General's last point is that the Commission failed to make a necessary finding of fact by not stating what constitutes a reasonable return on common equity for K.U.

The Commission's Order of October 1, 1980, does, in fact, establish a rate of return of 13.9% on common equity as fair, just and reasonable. The Commission has simply pointed out that while it finds this return to be fair, it is unlikely that K.U. will actually achieve this return.

As is virtually always the case in a controversial issue such as the proper return on common equity, the evidence was conflicting and the conclusions of the expert witnesses were quite divergent, although each of them had impressive qualifications. The Attorney General's witness, Mr. Parcell, testified that a range of return on common equity of 12% to 13.5% is fair for K.U. Likewise, K.U.'s witness (Mr. Mount) testified that a rate of return of 16% is fair for the company. The underlying bases of their conclusions, their choices of data, and the manner of its application are not totally free from challenge and contradiction. We do not believe, however, that any of this expert testimony is so lacking in factual support and probative value that it should be disregarded; neither do we believe that any of it is so persuasive or well founded that it should be considered conclusive. Accordingly, it was and it remains this Commission's opinion that the most reasonable conclusion which may be drawn from the evidence offered is that the appropriate decision lies somewhere between the extreme limits of the expert testimony.

The determination of a fair rate of return for a public utility requires the exercise of a fair and informed judgement having regard for all relevant facts. The range of returns must not only allow the utility to attract capital at reasonable

costs to insure continued services and provide for necessary expansion to meet future requirements, but it must also provide for the lowest possible cost to the consumer. The Commission has determined that a range of returns on equity of 13% to 15% would meet these criteria. This finding of a "zone of reasonableness" for K.U.'s return on equity is fully consistent with the precepts established by the United States Supreme Court in FPC v. Natural Gas Pipeline Company, 315 U.S. 574, 586 (1942).

After careful consideration of K.U.'s original cost, its cost of reproduction, its entire capital structure, its historical debt cost and equity requirements along with its inability to earn a fair, just and reasonable return on equity, the Commission found that a rate of return on common equity of 13.9% is both necessary and adequate to provide a fair return on the operations of the utility. In addition, the rate of return allowed on equity will produce rates of return on net original cost and capital structure of 10.83% and 10.28%, respectively, which are the returns found fair, just and reasonable in its Order of October 1, 1980. The Commission, after additional consideration, hereby affirms its decision with regard to a fair, just and reasonable return.

For all of the reasons set forth above, the Commission FINDS that the petitioners herein have not presented any facts or issues which were not a part of the Commission's original consideration in this matter, and that the petitions for rehearing should be, and hereby are, denied.

Done at Frankfort, Kentucky, this 6th day of November, 1980.

ENERGY REGULATORY COMMISSION

Vice Chairman

Commissioner

I dissent to the extent of and for the reasons previously stated in my original dissent.

Chairman

ATTEST:

Secretary