COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

O R D E R

On January 28, 2000, the Kentucky Industrial Utility Customers, Inc. ("KIUC") filed a petition for rehearing on certain issues arising from the Commission's January 7, 2000 Order requiring Kentucky Utilities Company ("KU") to reduce its electric rates. KU and the Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties ("CAC") filed petitions for rehearing on January 31, 2000. The Kentucky Association for Community Action, Inc. ("KACA") filed a petition for rehearing on February 1, 2000.[1]

Based on the petitions, the responses, and the replies thereto, the Commission makes the following findings.

Fuel Adjustment Clause Adjustment

KU seeks rehearing on the Commission's rate-making treatment of the decisions in KU's recent Fuel Adjustment Clause ("FAC") proceedings. In those proceedings, the Commission required KU to (1) discontinue restating total system losses using its retail line loss factor, (2) use its overall system losses to calculate its retail line loss factor,

[1] While KACA's petition was filed after the deadline established by KRS 278.400, the issues raised by KACA are essentially the same as those raised by CAC, which are addressed in this Order.

and (3) reduce recovery of its actual fuel expenses to reflect these decisions of the Commission. KU argues that those decisions resulted in less "collectible revenue," and, therefore, that reduction should be reflected in an adjustment to reduce its test year revenues. In its response to this request, KIUC states that KU is attempting to recover through base rates those fuel expenses the Commission determined were not recoverable from Kentucky jurisdictional customers through the FAC but were determined to be properly recovered from other jurisdictions.

The Commission is not persuaded by KU's arguments. The decisions in KU's FAC cases did find that $1,273,976 in fuel costs were improperly recovered from Kentucky jurisdictional ratepayers and that those monies should be refunded to ratepayers via reductions in future FAC filings. However, the adjustment proposed by KU to reduce test year revenues by this amount is not appropriate unless there is a corresponding adjustment to eliminate the related fuel expense. Since there was no attempt by KU to eliminate both the revenues and expenses impacted by the Commission's decisions in these FAC cases, to make the adjustment solely to reduce revenues as KU proposes would be improper. Such an adjustment would eliminate the revenues that should not have been collected, but would allow the related cost to be reflected in the determination of KU's revenue requirements. This is clearly an instance where either a "two-part" adjustment must be made to both revenues and expenses or no adjustment be made. KU's proposal would result in a "one-part" adjustment to revenues but not expenses. Such an adjustment would clearly understate KU's jurisdictional revenue requirements and understate the revenue sufficiency found reasonable in our January 7, 2000 Order. Rehearing on this issue is denied.

Clarification of ESM Calculations

KU requested that the optional earnings sharing mechanism ("ESM") set forth in the January 7, 2000 Order be clarified to provide that any required calculations will reflect Commission decisions that have a current or future impact on revenues or expenses. KU cited three examples of decisions that should be reflected in the ESM. One is the March 1, 2000 electric rate reduction that KU states needs to be annualized to avoid overstating revenues for January and February 2000. Another is the sharing of merger savings with shareholders, which KU states needs to be reflected in the ESM by an adjustment to operating expenses. The last is the need to adjust the ESM to reflect over- or under-earnings to avoid double counting those earnings when determining the ESM.

In response, KIUC stated that it agreed in principle that the financial impact of Commission decisions should be reflected in the ESM calculations. However, KIUC expressed no opinion on the three specific examples cited by KU.

Based on a review of the arguments presented, the Commission finds good cause to grant rehearing on this issue to further investigate which decisions need to be reflected in the ESM calculation and how they should be reflected in that calculation.

CAC also requested rehearing on the ESM, arguing that it should be mandatory, not optional, and that the Commission erred in allocating over- or under-earnings outside the deadband on a 60 percent shareholder, 40 percent ratepayer basis, rather than on a symmetrical 50/50 basis. CAC claims that a 50/50 sharing should provide sufficient incentive to KU to operate efficiently. In response, KU stated that it had accepted the optional ESM, thereby rendering moot the claim that the Commission should have made it mandatory. On the sharing ratio, KU asserts that it is within the Commission's sole discretion to determine what appropriately balances the ratepayer and shareholder interests.

The Commission finds that CAC has neither demonstrated that the initial decision on the sharing ratio was in error or that there is any new evidence to justify a rehearing. As the Commission found in its January 7, 2000 Order, it was not appropriate under the circumstances of this case to mandate an ESM for KU. Consequently, in fashioning the optional ESM, the Commission had to consider the appropriate sharing ratio that would create an incentive for KU to operate efficiently, provide ratepayers with a meaningful share of any over-earnings while limiting their risk for under-earnings, and induce KU to adopt an ESM that it maintained it did not want.

Balancing all these factors, the Commission determined that a 60/40 shareholder to ratepayer ratio was reasonable and appropriate. As KU noted, its adoption of the ESM renders moot the claim that it should have been mandatory, rather than optional. Therefore, rehearing on this issue is denied.

Revenue Allocations

KU requests that the January 7, 2000 Order be modified to allow it to present future proposals, either in conjunction with an annual review of its ESM or as part of a rate unbundling study, as to differences in class rates of return that would permit adjustments to class revenue allocations but be neutral as to total jurisdictional revenues. KIUC argues that what KU proposes is unclear and that a ruling now on the role that class costs of service might play in a future rate unbundling proceeding would be premature.

The Commission finds that KU has not clearly stated its proposal and, thus, the request to now modify the January 7, 2000 Order is premature. However, since this issue was precipitated by our decisions to offer KU an ESM and to require a report on rate unbundling, we find it appropriate to grant rehearing for the purpose of clarifying the proposal and determining what, if any, ruling is necessary at this time. Therefore, for these purposes, rehearing will be granted on the issue of revenue allocation in future proceedings resulting from the January 7, 2000 Order.

Unbundling Report

The January 7, 2000 Order in this case requires KU to file a detailed report by May 1, 2000 discussing the issue of rate unbundling for informational purposes and a suggested methodology to accurately determine the generation, transmission, and distribution components of its rates. KU states that it is willing to file the report, but requests that it be permitted to make that filing no later than January 1, 2001, so that it may prepare the report in conjunction with the rate unbundling plan that must be filed by its affiliate in Virginia. KU notes that this extension will allow it to prepare and file its unbundling studies in a comprehensive, efficient, and cost-effective manner. KIUC states that it has no objection to delaying the filing of the unbundling plan.

The Commission finds that KU's request is reasonable and should be granted. We agree with KU that it would be more efficient to time the filing of the report on unbundling for informational purposes with the unbundling filing to be made in Virginia.

Off-System Sales and Purchased Power

CAC and KIUC request rehearing on the adjustments made for off-system sales revenues and purchased power expense. CAC argues that the adjustments, based on the 12 months ended August 1999, are improper because they reflect the unusually hot weather of the summer of 1999 and because the two items in question are volatile in nature and cannot be readily predicted. KIUC argues that the adjustments, which go out 8 months beyond the end of the test period, violate the matching principle, and, by relying on post-hearing information responses, violate its due process rights. KIUC also claims the adjustments, if let stand, should also reflect the results of KU's brokered sales.

We deny CAC's request on all counts. Having rejected KU's proposed weather normalization adjustment, the Commission would create an unacceptable inconsistency if it chose to reject an adjustment to off-system sales and purchased power expense because of weather impacts on those adjustments. The evidence of record clearly indicates that the wholesale power markets experienced a significant change during the summer of 1998, a change which makes both off-system sales and purchased power expense more volatile and less easily predicted than in the past. However, the fact that these items are not easily predicted is not sufficient reason to reject adjustments to these items. If ease of prediction were the criteria for adjusting test year revenues and expenses, there would be a dearth of adjustments in most rate cases before this Commission. CAC's request on this issue is denied.

We find some merit in KIUC's arguments on these issues, as discussed below. The rate-making standard to which the Commission is held is the reasonableness of the results achieved, not strict adherence to a specific method or formula. Recognizing events or circumstances within a test year that make it unrepresentative of ongoing conditions, or recognizing changes occurring during the test year that will impact ongoing operations when the new rates will be in effect are two of several situations that justify a degree of flexibility in the rate-making process. Given the changes that occurred during 1998 in the wholesale power markets resulting from the tight capacity and related price spikes, it was entirely appropriate to recognize those changes. These were the two items for which adjustments were proposed to recognize these changes. If other adjustments had been proposed for the other items of revenue and expense KIUC includes in its argument, we would have been required to consider those as well. While we did not accept KU's adjustment based on projections for calendar year 2000, we did find it reasonable and appropriate to recognize, to some extent, the impact of the dramatic changes in 1998 in the wholesale power markets. That recognition was afforded in the adjustments approved in the January 7, 2000 Order.

KU's proposed adjustments to its test year off-system sales and purchased power expense were at issue throughout this proceeding and KIUC was well aware of that as evidenced by its consistent opposition thereto. KIUC cannot reasonably claim that the Commission was limited to either accepting KU's proposed adjustment based on year 2000 projections or making no adjustment, which was KIUC's recommendation. The Commission has both the latitude and the expertise to fashion rate-making adjustments of its own if the record supports a determination that such adjustments are reasonable and appropriate. However, since some of the data underlying these two adjustments had not been subject to investigation in this proceeding, or in a formal review of KU's fuel adjustment clause, we will grant rehearing for the limited purpose of conducting an investigation of KU's off-system sales and purchased power expense for the 12 months ending August 1999. Since the details of the underlying data are within

KU's records, the rehearing phase will be expedited by requiring KU to address this issue in its testimony to be filed on March 2, 2000.

KIUC previously raised the issue of brokered sales in its post-hearing brief and it was considered and addressed in our January 7, 2000 Order. It has been further addressed and described in detail in KU's response to KIUC's request for rehearing. Nothing contained in KIUC's rehearing petition raises any new issue or presents any new evidence that was not already considered. Therefore, we find no basis to grant rehearing or to modify our original adjustment to reflect the impact of KU's brokered sales.

Environmental Surcharge Revenues

In its application for rehearing, KIUC alleges that KU's rate reduction should be increased by $1.612 million due to two errors in the calculation of the level of environmental surcharge revenues. First, KIUC states that the effects of the 1999 Environmental Surcharge Settlement Agreement ("Settlement Agreement") in Case No. 93-465[2] were properly recognized by the Commission in adjusting environmental capitalization and operating expenses, but not properly recognized in adjusting revenues. KIUC argues that this error results in a mismatch between the environmental

[2] 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. On August 17, 1999, the Commission approved a unanimous Settlement Agreement which resolved all outstanding issues and pending litigation relating to KU's environmental surcharge. The Settlement Agreement was in response to the December 17, 1998 Opinion of the Supreme Court of Kentucky in Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Co., Ky., 983 S.W.2d 493 (1998). As a result of the Settlement Agreement, certain expenses and investments were no longer recovered through the surcharge mechanism.

revenues, operating expenses, and capitalization. Second, KIUC claims that the Commission incorrectly applied a jurisdictional allocation factor to the environmental surcharge revenues, which are 100 percent Kentucky jurisdictional. The net impact of these two errors is $1.612 million.[3]

KIUC had previously raised these same alleged errors in its response to KU's motion for correction and KU previously filed a reply to KIUC's response. In that reply, KU addressed KIUC's first alleged error by characterizing KIUC's position as arbitrary and unreasonable. KU claims that KIUC's argument is based on the false premise that the amount of environmental compliance cost removed from the environmental surcharge pursuant to the Settlement Agreement cannot be recovered through base rates. KU contends that nothing in the Kentucky Supreme Court Opinion, the Settlement Agreement, or the Commission's August 17, 1999 Order approving the Settlement Agreement prohibits KU from recovering through base rates its current costs of environmental projects built prior to or under construction on January 1, 1993, a right that has been acknowledged by KIUC. KU states that the Commission correctly intended to exclude all per book revenues and expenses associated with environmental surcharge recovery in the test period, including the Settlement Agreement expenses and rate base items.

As the Commission stated in its February 9, 2000 Order in this case, this was the first base rate case that included an environmental surcharge, and many of the issues

[3] KIUC calculates that the first error identified had a revenue requirement effect of $4.185 million, which would increase the overall reduction for KU. The second error identified had a revenue requirement effect of $2.573 million, which would decrease the overall reduction for KU. The net of these errors results in the $1.612 million proposed by KIUC.

decided were ones of first impression. Consequently, rehearing should be granted to afford all parties a further opportunity to investigate and evaluate whether the environmental surcharge revenues removed from the determination of KU's base rates properly reflected the effects of the Settlement Agreement. As the Commission addressed the jurisdictional allocation of environmental surcharge revenues in its February 9, 2000 Order, no additional ruling is required.

Low-Income Funding Proposal

CAC and KACA request reconsideration of the Commission's decision to deny their proposal to require KU to impose a line charge for all customer billings in order to create a universal energy assistance fund for low-income customers. Contrary to the findings in our January 7, 2000 Order, CAC and KACA argue that the Commission has the statutory authority to establish a low-income assistance program and to require KU ratepayers to provide the funds for such a program.

KU replied to the CAC and KACA petitions, arguing that the Commission's January 7, 2000 decision on this issue was correct. KU acknowledges that federal assistance programs for low-income customers are being reduced, but states that the creation and continuation of such programs is a matter to be dealt with by legislation, not regulation. KU further states that the Commission is not authorized to compel utility companies and their customers to participate in such programs absent specific legislative authority or utility consent.

The Commission finds that CAC and KACA have not presented any argument in support of their proposal that was not previously presented and considered by the Commission. Absent specific state or federal legislation, the Commission is prohibited under KRS 278.030 and 278.170 from imposing the type of program and funding mechanism CAC and KACA have proposed. While funding for low-income programs has been included, on occasion, in settlement agreements that have been approved by the Commission, in only one instance did the program permit participants to pay less than the utility's authorized rates or require ratepayers to fund the program.[4] That program, agreed to as a pilot by the utility and all customer representatives, requires shareholders to bear 50 percent of the program's costs. Even so, at the time of its approval, the Commission expressed reservations that the program did not fully comport with KRS Chapter 278.[5] As noted in the January 7, 2000 Order, in its initial phase that pilot program has failed to produce the type of benefits that CAC and KACA attribute to such programs.

CAC and KACA have offered no persuasive evidence in support of the argument that the Commission has the authority to mandate their proposed program absent consent of all participants. As the Commission has previously stated, this is a legislative issue that will need to be addressed by the Kentucky General Assembly. We note that CAC and KACA are currently supporting such legislation, Senate Bill 211, which would authorize the Commission to mandate energy assistance programs for low-income customers. Finding no basis to grant rehearing, we deny CAC and KACA's requests on this issue.

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[4] Case No. 94-179, An Adjustment of Rates of Columbia Gas of Kentucky, Inc. On and After July 1, 1994, Order dated November 1, 1994 at 6.

[5] Id. at 5.

Other Issues

Based on a review of the myriad of pleadings filed since issuing the January 7, 2000 Order, the Commission notes two issues raised by KIUC that were not included in a timely request for rehearing but do warrant some discussion.

In its response to KU's motion for corrections, KIUC claims that the illustrative tariffs attached to that motion as Appendix B are flawed in that the Bill Reduction component of the performance-based rate-making ("PBR") tariff implemented on July 2, 1999 is not continued until the March 1, 2000 effective date of the base rate reduction. KIUC also claims that, as a result of the provisions of these tariffs, ratepayers lose some portion of the merger dispatch savings that would have continued to flow through the FAC had it not been suspended when the PBR tariffs were implemented. KIUC argues that the ratepayers' loss will be permanent unless remedial action is taken by the Commission.

KU replied to KIUC, citing the tariff language that states that the Bill Reduction component of the PBR tariff remains in effect through February of 2000, consistent with the Commission's Order dated January 7, 2000. KU also replied that ratepayers will not lose any portion of merger dispatch savings under its proposed tariffs. Its PBR adjustment factors for the first quarter of 2000, which were filed with the Commission on December 20, 1999, show the inclusion of the merger dispatch savings for the third calendar quarter of 1999, which was the first quarter the PBR tariffs were in effect. Furthermore, the PBR tariffs filed in this case on January 20, 2000, state that they are closed effective January 7, 2000, and are thereafter limited to the disposition of the last two billing calendar quarters of 1999. Accordingly, the merger dispatch savings for the last two calendar quarters of 1999 will be received by customers through the PBR tariffs during the first two calendar quarters of 2000. With the reinstatement of the FAC effective March 1, 2000, the merger dispatch savings for January will begin to be reflected in customers bills through the fuel clause factors based on January's fuel costs as reflected in the fuel clause factors billed to customers in March 2000.

Based on a review of the illustrative tariffs, KU intends to continue the Bill Reduction portion of the PBR tariff through February 2000 and the Merger Dispatch Savings will also continue uninterrupted with no savings loss to ratepayers. Absent any loss to ratepayers, no Commission action is needed on these issues.

IT IS THEREFORE ORDERED that:

1. Rehearing is granted to investigate which Commission decisions need to be reflected in the ESM calculation and how those decisions should be reflected in that calculation.

2. Rehearing is granted for the purpose of clarifying KU's proposal concerning the issue of revenue allocation in future proceedings resulting from the January 7, 2000 Order.

3. Rehearing is granted on delaying the filing date of KU's unbundling report, which shall be filed with the Commission no later than January 1, 2001.

4. Rehearing is granted to investigate KU's level of off-system sales and purchased power expense for the 12-month period ending August 31, 1999. KU shall address this issue in its testimony to be filed on March 2, 2000.

5. Rehearing is granted to investigate and evaluate whether the environmental surcharge revenues removed from the determination of KU's base rates properly reflected the effects of the Settlement Agreement.

6. Ordering paragraphs Nos. 2 and 3 of the Commission's February 9, 2000 Order shall apply to the issues granted rehearing herein as if separately so ordered.

7. Rehearing on all other issues is denied.

Done at Frankfort, Kentucky, this 17th day of February, 2000.

By the Commission

ATTEST:

Executive Director