COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIRONMENTAL SURCHARGE MECHANISM OF KENTUCKY UTILITIES COMPANY FOR THE SIX-MONTH BILLING PERIODS ENDING JANUARY 31, 2001, JULY 31, 2001, JANUARY 31, 2002, AND JANUARY 31, 2002 AND FOR THE TWO-YEAR BILLING PERIODS ENDING JULY 31, 2000 AND JULY 31, 2002	)	**CASE NO. 2003-00068**

SETTLEMENT AGREEMENT

This Settlement Agreement is entered into this 30th day of September 2003, by and between Kentucky Utilities Company ("KU"); Commonwealth of Kentucky, ex. rel. A.B. Chandler, III, Attorney General, by and through the Office of Rate Intervention ("AG"); and Kentucky Industrial Utility Customers, Inc. ("KIUC") and the interests of its participating members as represented by and through the KIUC in the proceeding involving KU that is the subject of this Settlement Agreement.

WITNESSETH:

WHEREAS, on March 17, 2003, the Kentucky Public Service Commission ("Commission") initiated the six-month reviews of the operation of KU's environmental surcharge mechanism as billed from August 1, 2000 to January 31, 2001, from February 1, 2001 to July 31, 2001, from August 1, 2001 to January 31, 2002, and from August 1, 2002 to January 31, 2003, and the two-year reviews of the surcharge as billed from August 1, 1998 to July 31, 2000 and from August 1, 2000 to July 31, 2002; and

surcharge mechanism as billed from August 1, 2000 to January 31, 2001, from February 1, 2001 to July 31, 2001, from August 1, 2001 to January 31, 2002, and from August 1, 2002 to January 31, 2003, and the two-year reviews of the surcharge as billed from August 1, 1998 to July 31, 2000 and from August 1, 2000 to July 31, 2002; and

surcharge mechanism as billed from August 1, 2000 to January 31, 2001, from February 1, 2001

WHEREAS, KU experienced a cumulative over-recovery of $6,922,047 for the periods under review in this proceeding due to timing differences and adjustments to the retail jurisdictional revenue requirement; and

WHEREAS, the Attorney General, by and through the Office of Rate Intervention ("AG") and the Kentucky Industrial Utility Customers, Inc. ("KIUC") have been granted intervention by the Commission in Case No. 2003-00068; and

WHEREAS, the Commission approved KU's 1994 Environmental Surcharge Plan and the recovery of the costs associated therewith by environmental surcharge in *In the Matter of: 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*, Case No. 93-465; and

WHEREAS, the Commission's Order in Case No. 93-465 directed KU to calculate the environmental surcharge by reducing the amount of twelve month operation and maintenance ("O&M") expenses by the Kentucky jurisdictional portion of $1,640,575 to reflect the environmental O&M expenses already included in KU's then existing base rates; and

WHEREAS, the Kentucky jurisdictional portion of $1,640,575 reflects the O&M expenses for the twelve month period ending May 1994 and was a reasonable proxy for O&M expenses associated with KU's 1994 Environmental Surcharge Plan then already included in KU's existing base rates;

WHEREAS, beginning with billing of August 1994 monthly surcharge, KU's monthly environmental surcharge filings have included the reduction to O&M expenses equal to 1/12th of the Kentucky jurisdictional portion of $1,640,575; and

WHEREAS, on January 7, 2000 in *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, the Commission issued its Order which, among other things, removed all operating and maintenance ("O&M") expenses associated with the environmental surcharge in the determination of KU's final revenue requirement; and

WHEREAS, the exclusion of all operating and maintenance ("O&M") expenses associated with the environmental surcharge in the determination of KU's final revenue requirement by the Commission's Order in Case No. 98-474 inadvertently removed the Kentucky jurisdictional portion of $1,640,575 in O&M environmental expenses; and

WHEREAS, since at least June 2000, KU's environmental surcharge and base rates have not recovered the Kentucky jurisdictional portion of $1,640,575 in O&M expenses associated with KU's environmental compliance projects in KU's 1994 Environmental Surcharge Compliance Plan ; and

WHEREAS, an informal conference attended by representatives of the AG, KIUC, the Commission Staff, and KU took place on September 10, 2003 at the offices of the Commission during which the parties reached an unanimous settlement of all issues in Case No. 2003-00068; and

WHEREAS, the parties to this Settlement Agreement desire to settle all issues pending before the Commission in Case No. 2003-00068, as well as the six-month environmental surcharge billing period through July 2003, which has not yet been opened by the Commission, and the billing months of August, 2003 through October 2003.

NOW, THEREFORE, for and in consideration of the premises and conditions set forth herein, the parties hereby agree as follows:

ARTICLE 1.0 Prospective Adjustment to Environmental Surcharge Factor of KU

1.1 KU's cumulative over-recovery $6,922,047 for the periods under review shall be reduced by $900,000 to reflect settlement of the inadvertent error in the Commission's order of January 7, 2000 in Case No. *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. The $900,000 amount represents KU's under-recovery of the Kentucky jurisdictional portion of $1,640,575 in O&M expenses associated with KU's environmental compliance projects for the billing months of February 2003 through October 2003.

1.2 Beginning with monthly billing of the environmental surcharge in November 2003, KU's environmental surcharge factor shall be adjusted to distribute to KU's Kentucky retail customers the cumulative net environmental surcharge over-collection of $6,022,047 over twelve months effective November 2003 through October 2004.

1.3 In exchange for the consideration set forth in the Settlement Agreement, specifically, but not limited to Section 1.1, KU will not seek to recover the Kentucky jurisdictional portion of $1,640,575 in O&M environmental expenses inadvertently removed from base rates by the Commission's Order in Case No. 98-474 for the nine expense months December 2002 through August 2003 and corresponding billing months of February 2003 through October 2003 in subsequent environmental surcharge review proceedings. Effective with the incorporation of the surcharge amounts into KU's base rates pursuant to Article 2.0 of this Settlement Agreement, the jurisdictional portion of the $1,640,575 in environmental O&M expense will be recovered through KU's base rates and will not be recovered through the billing of the environmental surcharge beginning in November 2003 for the recovery of the environmental surcharge expenses for the month of September 2003 and thereafter.

ARTICLE 2.0 Incorporation of Surcharge Amounts into KU's Base Rates

2.1 Beginning November 2003, KU's base rates shall be adjusted by KU's proposed incorporation of $17,943,154 which includes the Kentucky jurisdictional portion of $1,640,759 environmental compliance O&M expenses. The calculation of the incorporation of the surcharge amounts into KU's base rates referenced in this article of the Settlement Agreement is set forth in Exhibit CAF-3 which is filed in the record in this proceeding.

2.2 Approval of the proposed amount to be incorporated into base rates by the Commission will prospectively correct the inadvertent exclusion of Kentucky jurisdictional portion of $1,640,759 environmental compliance O&M expenses in the Order issued on January 7, 2000 in Case No. 98-474.

2.3 The parties recommend the Commission approve the use of the base/current methodology used by KU to calculate the $17,943,154 in Section 2.0 in this Settlement Agreement.

ARTICLE 3.0 Reset of Rate of Return Every Six Months

The pollution control long-term debt rates used in the calculation of KU's environmental surcharge will be reviewed and reset during each environmental surcharge six-month review.

ARTICLE 4.0 Modification of the Environmental Surcharge True-Up Calculation

In order to verify that the revenue collected is comparable to the revenue requirement, the environmental surcharge true-up calculation will be modified to compare actual revenue collected to the allowed revenue as determined in the second preceding calendar month. This modification will be accomplished by multiplying the MESF for the second preceding month times the Retail R(m) for the second preceding month. This calculation will yield the portion of

the total revenue requirement for the second preceding month to be collected through the environmental surcharge.

ARTICLE 5.0 Earnings Sharing Mechanism Ratemaking Treatment

5.1 Environmental Rate Base Determination

Implementation of the ECR roll-in will not change the manner in which KU's 13-month average jurisdictional capitalization is adjusted for environmental compliance rate base less deferred income tax balance in the annual Earnings Sharing Mechanism ("ESM") compliance filing. In such annual ESM compliance filings the long term debt portion of 13-month average capitalization will be adjusted for the KU 1994 environmental compliance rate base less deferred income tax balance. All components of 13-month average jurisdictional capitalization will be adjusted for the KU 2001 environmental compliance rate base less deferred income tax balance. The amount of environmental compliance rate base for each environmental surcharge compliance plan that will be excluded from ESM capitalization will be impacted by the roll-in as more fully described below.

In the ESM annual compliance filing for the operating period ending December 31, 2003, KU will determine its 13-month average jurisdictional capitalization as follows: For the months of December 2002 through October 2003, monthly capitalization will exclude the month-end environmental compliance rate base less the deferred income tax balance as reported in the monthly Environmental Surcharge filings. For the months of November and December 2003, monthly capitalization will exclude an environmental compliance amount determined by calculating the difference between each month's environmental compliance rate base and the May 31, 2002 environmental compliance rate base less the related deferred income tax balance. For the 2004 and later annual ESM filings, the 13-month average jurisdictional capitalization

will be determined by excluding from monthly capitalization an environmental compliance rate base determined by calculating the difference between each month's environmental compliance rate base and the May 31, 2002 environmental compliance rate base less the related deferred income tax balance. The calculation of the 13-month average capitalization will be determined using this methodology until the next environmental surcharge roll-in for KU is ordered, at which time the determination of incremental environmental rate base will change.

5.2 Environmental Surcharge Revenues

All environmental surcharge revenues not rolled into base rates and as reported on the monthly ES Form 3.0 will be excluded from the 2003 and later annual ESM filings.

5.3 Environmental Operating Expenses and Allowance and By-Product Proceeds

Because a portion of KU's environmental operating expenses will be recovered through base rates as a result of the roll-in, the amount of environmental compliance related operating expenses to exclude from the 2003 and later annual ESM filings will no longer equal the total incurred environmental compliance related operating expenses. For the months of January through October 2003, KU will exclude from the 2003 ESM filing the total environmental compliance related operating expenses as reported on the monthly ES Form 2.00. The excluded amount will include all proceeds from allowance and byproduct sales. For the months of November and December 2003, KU will exclude from the 2003 ESM filing environmental compliance related operating expenses determined as follows: Total environmental operating expense and proceeds as reported on the monthly ES Form 2.00 will be reduced by an amount equal to 1/12th of the environmental compliance related operating expenses and proceeds included in the base rate roll-in, or $1,165,523.

Total environmental compliance related operating expense in the base rate roll-in is that amount presented in Exhibit CAF-3 in prefiled testimony in Case No. 2003-068 and includes the following components: 12 Month Depreciation and Amortization Expense of $7,149,100; 12 Month Taxes Other Than Income Taxes of $211,947; 12 Month Insurance Expense of $74,676; 12 Month Emission Allowance Expense of $110,749; and 12 Month Operating and Maintenance Expense of $6,830,800 for a total operating expense amount of $14,377,272 less Gross Proceeds from By-Product and Allowance Sales of $391,001 for a total roll-in amount of $13,986,271. One-twelfth of the total environmental compliance operating expense included in the base rate roll-in is equal to $1,165,523.

For 2004 and later annual ESM filings, environmental compliance related operating expenses excluded from the ESM filings will be the total incurred amount as reported on the monthly ES Form 2.00 less the total environmental compliance related operating expense roll-in amount of $13,986,271. This amount is to remain unchanged in the 2004 and later annual ESM filings until the next KU ECR roll-in takes effect.

ARTICLE 6.0 Approval of Settlement Agreement

6.1 Request for Approval by the Commission

Following the execution of this Settlement Agreement, the signatories shall cause the Settlement Agreement to be filed with the Commission with a request to the Commission for consideration and approval of this Settlement Agreement in October, 2003.

6.2 Recommendation for Approval to the Commission

The signatories to this Settlement Agreement shall act in good faith and use their best efforts to recommend to the Commission that this Settlement Agreement be accepted and approved.

6.3 Approval of Settlement Agreement in its Entirety

If the Commission issues a final order which accepts and approves this Settlement Agreement in its entirety, then the parties hereto hereby waive any and all claims or demands, asserted or unasserted, directly arising out of or in connection with the environmental surcharge mechanism of KU for the periods referenced above and such claims or demands shall be deemed compromised and settled under and released and discharged by this Settlement Agreement.

6.4 No Approval of Settlement Agreement in its Entirety

If the Commission does not accept and approve this Settlement Agreement in its entirety, then: (a) this Settlement Agreement shall be void and withdrawn by the parties hereto from further consideration by the Commission and none of the parties shall be bound by any of the provisions herein; and (b) neither the terms of this Settlement Agreement nor any matters raised during the settlement negotiations shall be binding on any of the signatories to this Settlement Agreement or be construed against any of the signatories.

6.5 Status Quo

Should the Settlement Agreement be voided or vacated for any reason after the Commission has approved the Settlement Agreement and thereafter any implementation of the terms of the Settlement Agreement has been made, then the parties shall be returned to the *status quo* existing at the time immediately prior to the execution of this agreement.

ARTICLE 7.0 Additional Provisions

7.1 This Settlement Agreement shall in no way be deemed to divest the Commission of jurisdiction under Chapter 278 of the Kentucky Revised Statutes.

7.2 This Settlement Agreement shall inure to the benefit of and be binding upon the parties hereto, their heirs, successors and assigns.

7.3 This Settlement Agreement constitutes the complete agreement and understanding among the parties hereto, and any and all oral statements, representations or agreements made prior hereto or contained contemporaneously herewith shall be null and void and shall be deemed to have been merged into this Settlement Agreement.

7.4 For the purpose of this Settlement Agreement only, the terms are based upon the independent analysis of the parties to reflect a just and reasonable resolution of the issues herein and are the product of compromise and negotiation. Notwithstanding anything contained in the Settlement Agreement, the parties recognize and agree that the effects, if any, of any future events upon the operating income of KU are unknown, and this Settlement Agreement shall be implemented as written.

7.5 Neither the Settlement Agreement nor any of the terms shall be admissible in any court or commission except insofar as such court or commission is addressing litigation arising out of the implementation of the settlement rates and adjustments set forth herein or the approval of this Settlement Agreement. This Settlement Agreement shall not have any precedential value in this or any other jurisdiction.

7.6 Making this agreement shall not be deemed in any respect to constitute an admission by any party hereto that any computation, formula, allegation, assertion or contention made by any other party in these proceedings is true or valid.

7.7 The signatories hereto warrant that they have informed, advised, and consulted with the respective parties hereto in regard to the contents and significance of this agreement and based upon the foregoing are authorized to execute this Settlement Agreement on behalf of the parties hereto.

7.8 This Agreement is subject to the acceptance of and approval by the Public Service Commission.

7.9 This Settlement Agreement is a product of all the parties, and no provision of this Settlement Agreement shall be strictly construed in favor of or against any party.

IN WITNESS WHEREOF, the parties hereto have hereunto affixed their signatures.

Kentucky Utilities Company

By: _____
Kendrick R. Riggs, Counsel
Linda S. Portasik, Counsel

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Commonwealth of Kentucky, ex. rel. A.B. Chandler, III, Attorney General, by and through the Office of Rate Intervention

By: _____

Elizabeth E. Blackford, Counsel

Kentucky Industrial Utility Customers, Inc.

By: _____
Michael L. Kurtz, Counsel

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