

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS RATES OF THE)	CASE NO.
UNION LIGHT, HEAT AND POWER COMPANY)	2005-00042

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O R D E R

The Union Light, Heat and Power Company (“ULH&P”) a wholly owned subsidiary of The Cincinnati Gas and Electric Company (“CG&E”),¹ is an electric and gas utility that purchases, sells, stores, and transports natural gas to 92,414 customers² in six counties in Kentucky.³

BACKGROUND

On January 24, 2005, ULH&P filed notice of its intent to apply for an increase in its gas rates utilizing a forward-looking test period and to request approval to continue

¹ ULH&P is a Kentucky corporation and the primary utility subsidiary of CG&E. CG&E is an Ohio corporation and a public utility subsidiary of Cinergy Corp. (“Cinergy”), a registered public utility holding company that was created in October 1994.

² ULH&P had 92,414 retail gas customers and 130,909 retail electric customers as of May 31, 2005; See ULH&P’s Updated Filing pursuant to KRS 278.192(2)(b) and 807 KAR 5:001, Section 10(8)(d), filed July 15, 2005, WPB-5.1f.

³ The six counties are Boone, Campbell, Gallatin, Grant, Kenton, and Pendleton. ULH&P distributes and sells electricity in Boone, Campbell, Grant, Kenton, and Pendleton counties in Kentucky.

its Accelerated Main Replacement Program (“AMRP”) Rider.⁴ On February 25, 2005, ULH&P filed its application in which it sought an increase in gas revenues of \$14,048,768, an increase of 10.79 percent. ULH&P also sought approval to continue the AMRP Rider through 2011, approval to increase its bad check and reconnection charges, and approval to assume ownership of customer service lines at the time of installation. ULH&P proposed that its new rates become effective on April 1, 2005. Finding that additional proceedings were necessary to determine the reasonableness of the request, the Commission, pursuant to KRS 278.190(2), suspended the proposed rates for 6 months up to and including September 30, 2005.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention (“AG”), requested and was granted full intervention.

On March 21, 2005 and April 28, 2005, the Commission issued procedural schedules that provided for discovery, intervenor testimony, rebuttal testimony by ULH&P, and a public hearing. A public hearing was held on August 15 and 16, 2005. ULH&P and the AG filed written briefs on September 21, 2005.

⁴ In its January 31, 2002 Order in Case No. 2001-00092 the Commission authorized the AMRP Rider for an initial 3-year period. The Commission told ULH&P if it wished to continue the AMRP Rider beyond the initial 3-year period, it would need to file a general rate application to “roll-in” the AMRP Rider into base rates and to justify the continuation of the AMRP Rider. ULH&P’s notice filing on January 24, 2005 was in compliance with this directive. See Case No. 2001-00092, Adjustment of Gas Rates of The Union Light, Heat and Power Company, final Order dated January 31, 2002 at 80.

On September 14, 2005, ULH&P moved for interim approval of a new AMRP Rider to take effect with the first billing cycle in October 2005.⁵ ULH&P contended that the Commission had the jurisdiction to approve the new AMRP Rider rates because those rates were lower than the full increase it had the legal right to place into effect, the Commission had already held a hearing on the pending rate increase, and the implementation of the new AMRP Rider rates would avoid customer confusion. The AG opposed the request, citing his continuing challenge to the lawfulness of the AMRP Rider and noting that the Commission had previously refused to grant the requested relief in Case No. 2004-00403.⁶ In its September 29, 2005 Order the Commission denied ULH&P's motion, finding that the AG's action for review of the Orders in Case No. 2001-00092 deprived the Commission of jurisdiction to consider ULH&P's motion.⁷

On September 30, 2005, pursuant to KRS 278.190(2), ULH&P gave notice of its intention to place its proposed rates into effect for services rendered on and after October 1, 2005. In its October 3, 2005 Order, the Commission found that it was unable

⁵ ULH&P proposed that the new AMRP Rider would take effect subject to refund and would remain in effect until it implemented the new general gas rates to be established in this case. The new AMRP Rider rates would remain at the same level as the AMRP Rider rates that were scheduled to expire at the end of the September 2005 billing cycle. ULH&P stated that if the Commission granted its request, it would refrain from placing its proposed general gas rates into effect subject to refund for October 2005; however, ULH&P reserved the right to place its proposed general gas rates into effect subject to refund beginning in November 2005.

⁶ Case No. 2004-00403, The Union Light, Heat and Power Company's Motion for Extension of Filing Date and Continuation of Its Current Rider AMRP Rates, final Order dated January 27, 2005.

⁷ The Commission also found that ULH&P had offered no authority to support any of its positions in the motion. See September 29, 2005 Order at 3-4.

to complete its investigation within the suspension period and that ULH&P had complied with the statutory provisions to place the proposed rates into effect, subject to refund.

All information requested at the public hearing has been filed and the case now stands submitted for a decision.

TEST PERIOD

Pursuant to KRS 278.192, any application utilizing a forward-looking test period shall include a base period and the forward-looking test period. The base period cannot begin more than 9 months prior to the date of filing. It cannot have less than 6 months of actual historical data and no more than 6 months of estimated data at the time of filing. The forward-looking test period corresponds to the first 12 consecutive calendar months the proposed increase would be in effect after the maximum suspension provided in KRS 278.190(2).

ULH&P proposed that its base period in this case would be June 1, 2004 through May 31, 2005. It also proposed that its forward-looking test period would be October 1, 2005 through September 30, 2006. In his evaluation of ULH&P's proposed revenue increase, the AG used the same forward-looking test period. The AG stated his belief that the proposed forward-looking test period represented a reasonable starting point to determine ULH&P's revenue needs.⁸

When a forward-looking test period approach is used, the Commission's focus is on determining the reasonableness of the utility's budgeting and other processes used to arrive at the forward-looking test period balances. One of the methods used to determine the reasonableness of the budgeting process is a review of the utility's

⁸ Transcript of Evidence ("T.E."), Volume I, August 15, 2005, at 175.

budget versus actual results variance analysis. Concerning this analysis, ULH&P stated:

Prior to 2004, there was less emphasis on budgeting by particular legal entities within the Regulated Businesses Unit and, as a result, there were some significant variances in the actual results vs. the budget for these accounts. Beginning in 2004, the Regulated Businesses Unit placed greater emphasis on budgeting by legal entity. . . . As can be seen, the 2004 budget has much smaller variances to plan than prior years.⁹

* * * * *

In 2004 Cinergy implemented a new budgeting system that is part of the new financial and accounting system. The new budgeting system requires costs to be budgeted by "line of business." . . . This will facilitate a better understanding of the costs required to serve gas and electric customers. Since the budget and actual will be captured this way, it will also facilitate better actual to plan variance analyses by commodity.¹⁰

The Commission recognizes that corporate entities the size of Cinergy often will follow a function-oriented approach when it comes to internal financial monitoring. However, since Cinergy has regulated operations in three states, some recognition of the legal entities should be incorporated into the internal financial monitoring process. The Commission has reviewed the budget versus actual results variance analysis supplied by ULH&P, and believes the analysis does show improvements in the variances beginning in 2004. ULH&P's new budgeting system does appear to provide for improved analysis. ULH&P is reminded that there is still a need to recognize the existence of the various legal entities when performing its analysis.

⁹ Supplemental response to the Commission Staff's First Data Request dated February 15, 2005, Item 6, filed April 4, 2005.

¹⁰ Response to the Commission Staff's Third Data Request dated May 10, 2005, Item 1(a)(2).

While reviewing the budget versus actual results variance analysis, the Commission noted several instances where an expense was budgeted in one account, but actually charged to a different account. When reviewing the variance analysis at the account number level, this practice produced some misleading results. ULH&P explained that it budgets by activity, which represents a certain type of expense, and that one or more activities correspond to an account. ULH&P stated that it was difficult to anticipate which accounts would be charged a year in advance, but that the focus is to budget all expenses as accurately as possible.¹¹

The Commission understands the challenge ULH&P faces in developing its budget on an activity basis. However, ULH&P must understand that with the budget versus actual results variance analysis being performed at the account level, it is incumbent on ULH&P to make every effort to use the same accounts when developing its budgets as will be used to record the actual expenses. ULH&P should implement any changes to its current process that are necessary to achieve this improved matching for the budgeted and actual expense accounts.

In addition to the budget versus actual results variance analysis submitted, the Commission has examined ULH&P's voluminous budgeting and accounting manuals that were used to prepare the forward-looking test period information. Based upon this review, the Commission finds that the use of a base period from June 1, 2004 through May 31, 2005 and a forward-looking test period from October 1, 2005 through September 30, 2006 in this proceeding are reasonable. The Commission encourages

¹¹ Response to the Commission Staff's Third Data Request dated May 10, 2005, Item 7.

ULH&P to continue to improve its variance analysis processes, especially if ULH&P plans to file subsequent general rate cases using the forward-looking test period option.

RATE BASE

In its application, ULH&P proposed an adjusted jurisdictional gas rate base of \$167,499,239,¹² which it revised in its rebuttal testimony to \$170,107,832.¹³ The AG proposed an adjusted jurisdictional gas rate base of \$162,980,160.¹⁴ Both ULH&P and the AG utilized these jurisdictional gas rate bases to determine their respective jurisdictional rate base ratios, which were applied to ULH&P total company jurisdictional capitalization to determine ULH&P's jurisdictional gas capitalization. In its application ULH&P determined its jurisdictional rate base ratio to be 25.899 percent,¹⁵ but in its

¹² Application, Schedule B-1.

¹³ Prior to filing its rebuttal testimony, ULH&P had filed a revised adjusted jurisdictional gas rate base of \$167,838,698. Pursuant to 807 KAR 5:001, Section 10(8)(d), ULH&P was permitted to file corrections of mathematical errors in the forward-looking test period or revisions reflecting statutory or regulatory enactments that could not, with reasonable diligence, have been included in the forecast. ULH&P's revision, filed on July 15, 2005, reflected the effects of House Bill 272 which lowered the Kentucky corporate income tax rate from 8.25 percent to 7.00 percent during the period from January 1, 2005 through December 31, 2006. House Bill 272 was passed by the Kentucky General Assembly during the 2005 Regular Session and signed by the Governor on March 18, 2005. See ULH&P's Updated Filing dated July 15, 2005, Schedule B-1, for the revised adjusted jurisdictional gas rate base and Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 4 of 25, for the rebuttal jurisdictional gas rate base.

¹⁴ Henkes Direct Testimony, Schedule RJH-4.

¹⁵ Application Workpaper WPA-1d.

rebuttal testimony revised the ratio to 25.423 percent.¹⁶ The AG determined the jurisdictional rate base ratio to be 25.337 percent.¹⁷

In previous ULH&P general rate cases filed using the historic test period, the Commission has allocated ULH&P's total jurisdictional capitalization between electric and gas operations using the jurisdictional rate base ratio. Both ULH&P and the AG have followed this approach in this case, where the forward-looking test period has been utilized. The Commission finds the use of the jurisdictional rate base ratio to allocate total company jurisdictional capitalization is reasonable and should be applied in this case. However, before discussing the calculation of the ratio in this case, the Commission first will address "slippage," a topic commonly encountered in forward-looking test period cases.

"Slippage Factor" Adjustment

As part of the capital budgeting process, utilities will estimate the level of capital construction that will be undertaken during the year. Because of delays, weather conditions, or other events, the actual level of construction will often vary from the level budgeted. The difference between the actual and budgeted levels is reflected in the calculation of a "slippage factor," which serves as an indicator of the utility's accuracy in predicting the cost of its utility plant additions and when new plant will be placed into service. The Commission has routinely applied a slippage factor in the forward-looking

¹⁶ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 3 of 25. When ULH&P filed its update pursuant to 807 KAR 5:001, Section 10(8)(d), it recalculated the jurisdictional rate base ratio, and determined the ratio should be 25.889 percent. See ULH&P's Updated Filing dated July 15, 2005, Workpaper WPA-1d.

¹⁷ Henkes Direct Testimony, Schedule RJH-4.

test period rate cases for Kentucky-American Water Company.¹⁸ The Commission has usually utilized a slippage factor calculated by determining the annual slippage during the most recent 10-year period and then calculating the mathematic average of the annual slippage factors. The slippage factor is normally applied to the utility plant in service balance and the construction work in progress (“CWIP”) balance to determine the slippage adjustment.

In its application, ULH&P did not calculate a slippage factor or recognize a slippage adjustment in its determination of the jurisdictional gas rate base or the jurisdictional rate base ratio. In response to data requests, ULH&P did calculate 10-year slippage factors for both its gas and electric operations.¹⁹ For its gas operations, ULH&P calculated a slippage factor for its non-AMRP capital construction projects, the AMRP capital construction projects,²⁰ and all capital construction projects. The gas slippage factor for all capital construction projects was 97.045 percent. The electric operations slippage factor reflected all capital construction projects, and was determined to be 100.600 percent.

ULH&P does not believe a slippage adjustment is appropriate in this case because over the past several years it has consistently spent what was budgeted for

¹⁸ See Case No. 2000-00120, The Application of Kentucky-American Water Company to Increase its Rates, final Order dated November 27, 2000 at 2-4 and Case No. 2004-00103, Adjustment of the Rates of Kentucky-American Water Company, final Order dated February 28, 2005 at 3, 4, and 10.

¹⁹ Response to the Commission Staff’s Second Data Request dated April 5, 2005, Item 105 and Response to the Commission Staff’s Fourth Data Request dated July 29, 2005, Item 1.

²⁰ The slippage factor for the AMRP capital construction projects only reflected a 4-year period, since the AMRP began in 2001.

gas operations capital expenditures. ULH&P notes the only exceptions to this practice were in 2003 and 2004, when, late in the planning and construction cycle, the Kentucky Department of Transportation notified ULH&P of budget reductions that affected road improvement work.²¹ In the event the Commission decided to apply a slippage factor, ULH&P suggested that the slippage factor should be based on an 8-year period and not reflect the unusual years of 2003 and 2004. If the Commission concluded that a 10-year period should be reflected in the slippage factor, ULH&P recommended the use of the all capital construction projects factor of 97.045 percent.²²

The AG recommended that a slippage factor adjustment should be made to the gas utility plant in service. The AG proposed the slippage factor be 93.952 percent, which is the 10-year period slippage factor for ULH&P's non-AMRP capital construction projects. The AG argued that the slippage factor should not include the effects of the AMRP capital construction projects, as the cost recovery provided those projects under the AMRP Rider was different than the recovery provided through base rates, the AMRP Rider expired prior to the beginning of the forward-looking test period, and the slippage experience for the AMRP-related projects was only for a 4-year period.²³ The AG noted that the Commission has previously utilized a slippage factor reflecting a 10-

²¹ Hebbeler Rebuttal Testimony at 2-3.

²² Id. at 3-4. ULH&P calculated that the 8-year period slippage factor, which excluded 2003 and 2004, was 98.673 percent. See Hebbeler Rebuttal Testimony, Attachment GJH-Rebuttal-1.

²³ Henkes Direct Testimony at 17.

year period and contended that ULH&P had offered no reason to use a shorter period of time.²⁴

The Commission believes that a slippage factor based on a 10-year period and the mathematical average of the annual variances reflects a reasonable approach to recognize the variance between budgeted and actual capital construction amounts. As ULH&P's own historic data shows, there are always differences between the budgeted and actual amounts spent on capital construction projects. The slippage factor adjustment provides a means to recognize this fact, based upon ULH&P's own experience. The Commission is not persuaded by ULH&P's claims that the budget variances from 2003 and 2004 warrant special treatment and should be excluded from the determination of the slippage factor. ULH&P's historic data shows that the variance between budgeted and actual amounts was similar to or higher than the 2003 and 2004 experience in 3 other years.²⁵ The use of a 10-year period lessens the impact of extreme fluctuations in the annual variances. In previous cases where the slippage factor adjustment has been made, the slippage factor has reflected the mathematical average, and the Commission believes it is reasonable to continue that practice in this case.

The Commission is not persuaded by the AG's arguments that only the non-AMRP capital construction projects slippage factor should be used to calculate a slippage factor adjustment. The AG has provided no evidence to demonstrate that the

²⁴ AG's Post-Hearing Brief at 2.

²⁵ Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 105, page 3 of 3. The capital construction projects analysis shows similar or higher slippage factors for 1999, 1997, and 1996.

variance in budget and actual construction amounts experienced for the AMRP projects is related to the cost recovery provided by the AMRP Rider. The AG has provided no evidence demonstrating that the 4 years of AMRP-related projects have skewed the annual slippage factor for those years. In addition, the AG's proposal would apply the non-AMRP capital construction projects slippage factor to all capital construction projects. Such a proposal is not appropriate since the AG's slippage factor is based on a subset of all capital construction projects but applied to all capital construction projects.

Therefore, the Commission finds that the slippage factor for gas operations should be 97.045 percent and the slippage factor for electric operations should be 100.600 percent.

Jurisdictional Rate Base Ratio

In previous Commission decisions when a jurisdictional rate base ratio has been utilized, the rate base used to calculate the ratio has not been the same as the rate base used for rate-making purposes.²⁶ The jurisdictional rate base ratio reflects the jurisdictional rate base for the forward-looking test period before recognizing rate-making adjustments applicable to either electric or gas operations. The Commission

²⁶ See Case No. 1991-00370, Application of The Union Light, Heat and Power Company to Adjust Electric Rates, final Order dated May 5, 1992 at 9 and Appendix B; Case No. 1992-00346, The Application of The Union Light, Heat and Power Company for an Adjustment of Rates, final Order dated July 23, 1993 at 10 and Appendix B; Case No. 1998-00426, Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of Its Rates and Service, final Order dated January 7, 2000 at 63 and Appendix B; Case No. 2000-00080, The Application of Louisville Gas and Electric Company to Adjust its Gas Rates and to Increase Its Charges for Disconnecting Service, Reconnecting Service and Returned Checks, final Order dated September 27, 2000 at 23 and Appendix C; and Case No. 2001-00092, final Order dated January 31, 2002 at 5-21 and Appendix B.

has reviewed the proposed jurisdictional gas rate base ratios and has made the following modifications:

Utility Plant in Service. In its application, ULH&P did not recognize a slippage factor adjustment in the determination of the jurisdictional utility plant in service for either its gas or electric operations. The AG proposed a slippage factor adjustment for the jurisdictional gas rate base that was calculated by applying his proposed slippage factor to the net gas plant in service growth from the end of the base period to the 13-month average balance in the forward-looking test period.²⁷ The AG did not propose a slippage factor adjustment for the jurisdictional electric rate base.

The Commission has included a slippage factor adjustment for both the jurisdictional gas rate base and the jurisdictional electric rate base. As the slippage factor adjustment recognizes the difference between the budgeted and actual capital construction expenditures, the Commission finds it is reasonable to include this adjustment to the rate bases used to determine the jurisdictional rate base ratio. The Commission has calculated the slippage factor adjustment for both the gas and electric operations by applying the slippage factors found reasonable to the net plant in service growth from the end of the base period to the 13-month average balance in the forward-looking test period.²⁸ The Commission has reduced ULH&P's jurisdictional gas utility

²⁷ Henkes Direct Testimony at 19 and Schedules RJH-4 and RJH-5.

²⁸ The base period balances used in the AG's adjustment reflected the base period filed as part of ULH&P's application. Pursuant to KRS 278.192(2)(b), ULH&P was required to file the actual results for the estimated portion of the base period no later than 45 days after the last day of the base period. ULH&P made this filing on July 15, 2005. The AG's testimony was filed on June 8, 2005 and the AG did not revise his adjustment to reflect the actual results for the base period. The Commission's adjustment utilizes the actual results for the base period.

plant in service by \$523,768 and increased its jurisdictional electric utility plant in service by \$386,262.

CWIP. In its application, ULH&P proposed no adjustment to its forward-looking test period balance for CWIP. However, in its rebuttal testimony, ULH&P noted that an automated meter reading program it had included in its forecasted CWIP balance would not begin until after the end of the forward-looking test period. Consequently, ULH&P proposed to remove this program from its CWIP balance.²⁹ The AG did not propose any adjustments to the CWIP balance. The AG noted that all of the CWIP included in the forward-looking test period was subject to Allowance for Funds Used During Construction (“AFUDC”) accrual, and since a corresponding AFUDC offset was included as “above-the-line” income, there was no revenue requirement associated with the CWIP in rate base and no need to calculate a slippage factor adjustment.³⁰

The Commission agrees with ULH&P that the automated meter reading program should be removed from the CWIP balance included in the jurisdictional gas rate base. This adjustment should also be reflected in the gas rate base used to determine the jurisdictional rate base ratio. The Commission does not agree with the reasoning expressed by the AG concerning the need for a slippage factor adjustment to the CWIP balance. The AG should be aware that whether or not an adjustment to rate base impacts the revenue requirement is not the appropriate basis to use in determining the need for an adjustment to the rate base. The Commission has calculated a slippage factor adjustment for both the gas and electric operations by applying the slippage

²⁹ Hebbeler Rebuttal Testimony at 4-5.

³⁰ Henkes Direct Testimony at 20.

factor found reasonable to the CWIP balances included in the forward-looking test period. For the gas operations, this calculation was made after excluding the CWIP associated with the automated meter reading program. The Commission has reduced ULH&P's jurisdictional gas CWIP by \$654,153 and increased its jurisdictional electric CWIP by \$135,432.

PSC Assessment. ULH&P included as a prepayment the 13-month average balance of its PSC Assessment in the determination of its jurisdictional rate base ratio and the calculation of its jurisdictional gas rate base. ULH&P acknowledged that the Commission has excluded the PSC Assessment from the rate base in its last four general rate cases, but still contended that the PSC Assessment is a prepayment that properly should be included in rate base.

In its application, ULH&P argued that the PSC Assessment “funds the Commission’s anticipated operations for the upcoming fiscal year and is allocated to the utilities regulated by the Commission based on their respective share of total intrastate revenues during the prior calendar year.”³¹ ULH&P noted that KRS 278.130 states that each utility will be notified of the PSC Assessment on or before July 1. ULH&P further noted that the assessment is due by July 31 and applies to the period from July 1 of the current year through June 30 of the following year. Based on these facts, ULH&P reasoned that the payment of the PSC Assessment applies to the succeeding 12 months, properly constitutes a prepayment, and is properly amortized over the succeeding 12 months. ULH&P further argued that as the assessment is paid well in

³¹ Wathen Direct Testimony at 7.

advance of its being expensed, it represents a prepayment upon which it should be allowed to earn a return.³² In its rebuttal testimony, ULH&P argued that,

[t]his annual July expenditure is a prepayment of costs it will incur in the subsequent year. The payment provides for the service the Company receives from the Commission for the twelve months following payment of the invoice. In order for the Company to “match” the expense of those services with the receipt of the services, it must account for that payment as a prepayment and apportion it over the periods during which it receives the services.³³

The AG removed the PSC Assessment from the rate bases used to determine the jurisdictional rate base ratio and the calculation of the jurisdictional gas rate base. The AG proposed this adjustment based on the Commission’s previous decisions that the PSC Assessment was not considered a prepayment for rate-making purposes. The AG also noted that ULH&P had not presented any new or previously considered reasons to change the Commission’s past treatment.³⁴

In its January 31, 2002 Order in Case No. 2001-00092, the Commission directed ULH&P to “include in its next rate case a narrative explanation of why the PSC Assessment should not be recorded as an accrued liability rather than a prepayment.”³⁵ ULH&P instead has provided narratives explaining why it continues to believe the PSC Assessment should be recorded as a prepayment.

³² Id. at 7-8.

³³ Wathen Rebuttal Testimony at 7.

³⁴ AG’s Post-Hearing Brief at 3.

³⁵ Case No. 2001-00092, January 31, 2002 Order at 9.

This is the fifth ULH&P rate case since 1990 where the inclusion of the PSC Assessment as a prepayment in the rate base has been addressed.³⁶ The Commission has also addressed this issue in three other rate cases since 2000.³⁷ In each of the seven previous cases, the Commission considered the arguments presented by the utilities and in each case found that the PSC Assessment should not be included in rate base. In this case, the Commission again has considered the arguments presented by ULH&P in support of its contention that the PSC Assessment should be included in the jurisdictional gas rate base and the determination of the jurisdictional rate base ratio.

The PSC Assessment provides the funds to maintain the Commission and cover the cost of regulating the utilities subject to its jurisdiction. Utilities subject to the assessment are notified annually of the amount on or before July 1. The assessment is due and payable on or before July 31 of that same year. Consequently, the PSC Assessment is incurred by the utilities and paid within the month of July each year. Therefore, ULH&P's contention that the PSC Assessment is incurred over the months between the notices of assessment dates is not correct.

ULH&P has argued that since the PSC Assessment funds the Commission's anticipated operations for the upcoming fiscal year, the PSC Assessment is properly

³⁶ See Case No. 1990-00041, An Adjustment of Gas and Electric Rates of The Union Light, Heat and Power Company, final Order dated October 2, 1990 at 10; Case No. 1991-00370, May 5, 1992 Order at 4-5; Case No. 1992-00346, July 23, 1993 Order at 4-5; and Case No. 2001-00092, January 31, 2002 Order at 7-10.

³⁷ See Case No. 1998-00474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of its Rates and Service, final Order dated January 7, 2000 at 52; Case No. 2000-00080, September 27, 2000 Order at 16-17; and Case No. 2004-00067, Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates, final Order dated November 10, 2004 at 3-5.

classified as a prepayment. The Commission disagreed with this reasoning in ULH&P's last gas rate case, stating

ULH&P appears to be arguing that since the assessment provides the funding of the Commission's ongoing operations, this establishes the payment of the assessment as a prepayment. The proper accounting classification of this transaction should be dependent upon what the payment of the PSC Assessment represents to ULH&P and not the fact that the Commission's ongoing operations are funded by it.³⁸

ULH&P has presented nothing during this proceeding to cause the Commission to reach a different conclusion concerning this argument.

The Commission does not agree with ULH&P's analogy that the Commission provides "services" to ULH&P in return for the payment of the PSC Assessment. The regulatory activities of the Commission do not constitute a vendor's menu of services from which ULH&P can pick and choose. Consequently, there is nothing to "match" between the expense of and the receipt of the "services."

The Commission is not persuaded by ULH&P's arguments that the nature of the PSC Assessment constitutes a prepayment. The PSC Assessment is not paid in advance of when it is due and, as an annual assessment, the amount is not applicable to future periods. Therefore, the Commission finds that the PSC Assessment should not be included in the determination of the jurisdictional rate base ratio³⁹ nor in the calculation of the jurisdictional gas rate base. However, for accounting purposes, utilities have classified the PSC Assessment as a prepayment in order to allow the recognition of the expense over an entire year, rather than in the month of payment.

³⁸ Case No. 2001-00092, January 31, 2002 Order at 9.

³⁹ The PSC Assessment will be excluded from the prepayment balances from both jurisdictional gas and electric operations.

The Commission has not been, nor is it now, opposed to the concept of spreading this expense over a 12-month period for accounting purposes.

Accumulated Deferred Income Taxes. In its application, ULH&P included \$33,244,980 of accumulated deferred income taxes (“ADIT”) in its jurisdictional gas rate base and jurisdictional rate base ratio calculations.⁴⁰ The AG contended that the appropriate balance to include was \$36,403,825.⁴¹ The AG argued that the ADIT balance should reflect the effects of the lowered Kentucky corporate income tax rate and the removal of ADIT associated with unbilled gas revenues.⁴² In its rebuttal testimony, ULH&P agreed with the AG that ADIT balances should reflect these adjustments. ULH&P proposed that an ADIT balance of \$36,359,585 be used for the determination of the jurisdictional rate base ratio.⁴³ ULH&P further noted that it needed to eliminate the ADIT balance associated with its purchased gas costs from its jurisdictional gas rate base calculations, which was consistent with the Commission’s Order in Case No. 2001-00092. While ULH&P made this adjustment to its jurisdictional gas rate base, it stated that since its rates had typically been set based on allocated capitalization rather than rate base, there was no impact from making the adjustment.⁴⁴

⁴⁰ Application Schedule B-1 and Workpaper WPA-1d.

⁴¹ Henkes Direct Testimony, Schedule RJH-7.

⁴² The trial balance for the base period revealed there was no ADIT balance for unbilled revenues for ULH&P’s electric operations. See Response to the Commission Staff’s First Data Request dated February 15, 2005, Item 30.

⁴³ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, pages 3 and 10 of 25.

⁴⁴ Wathen Rebuttal Testimony at 8-9.

ULH&P's rebuttal jurisdictional gas rate base included an ADIT balance of \$30,039,766.⁴⁵

The Commission agrees with ULH&P and the AG that the effects of the reduction in the Kentucky corporate income tax rate and the removal of the ADIT balance associated with unbilled revenues should be reflected in the determination of the jurisdictional rate base ratio. The Commission further agrees with ULH&P that the ADIT balance associated with purchased gas costs should be eliminated from the determination of the jurisdictional gas rate base. The Commission notes that while ULH&P and the AG agree on the adjustments to reflect in the jurisdictional rate base ratio, there is no agreement on the amounts. After reviewing the information provided, the Commission finds the amounts provided by ULH&P to be reasonable and will utilize those balances in the determination of the jurisdictional rate base ratio and the calculation of the jurisdictional gas rate base.

Concerning ULH&P's comment about making adjustments to the jurisdictional gas rate base, the Commission reminds ULH&P that when determining the valuation of a utility to be used in calculating revenue requirements, we are guided by KRS 278.290(1), which states in part:

In fixing the value of any property under this subsection, the commission shall give due consideration to the history and development of the utility and its property, original cost, cost of reproduction as a going concern, capital structure, and other elements of value recognized by the law of the land for rate-making purposes.

⁴⁵ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 4 of 25.

Consequently, the Commission is obligated to determine as accurately as possible the jurisdictional gas rate base of ULH&P during this proceeding, regardless of whether ULH&P's revenue requirement will be determined using rate base or capitalization.

Cash Working Capital Allowance. ULH&P and the AG determined the cash working capital allowance using the 45 day or 1/8th formula methodology, reflecting the impacts of adjustments each proposed to the gas operation and maintenance ("O&M") expenses. As noted previously, the rate bases used to determine the jurisdictional rate base ratio do not reflect rate-making adjustments. Therefore, for purposes of determining the jurisdictional rate base ratio, the Commission has used the level of gas and total company O&M expenses reported for the forward-looking test period, before any rate-making adjustments.⁴⁶

Based upon the previous findings, the Commission has determined that ULH&P's jurisdictional rate base ratio is 25.345 percent. The calculations of the forward-looking test period jurisdictional gas rate base and the total company jurisdictional rate base, which support the determination of the jurisdictional rate base ratio, are shown on Appendix B.⁴⁷

Jurisdictional Gas Rate Base

The Commission has determined ULH&P's jurisdictional gas rate base for rate-making purposes by beginning with the jurisdictional gas rate base utilized to determine

⁴⁶ This approach is consistent with the Commission's determination of the jurisdictional rate base ratio in previous ULH&P rate cases. See Case No. 2001-00092, January 31, 2002 Order at 20.

⁴⁷ As noted previously, these rate bases do not reflect rate-making adjustments used to determine ULH&P's final jurisdictional gas rate base.

the jurisdictional rate base ratio. The Commission has incorporated three adjustments for rate-making purposes. As noted previously in this Order, the ADIT associated with purchased gas costs has been removed from the ADIT balance. The cash working capital allowance has been adjusted to reflect the accepted rate-making adjustments to O&M expenses, which are discussed later in this Order. Finally, as discussed later in this Order, the Commission has reduced the gas accumulated depreciation balance by the same amount as the reduction to ULH&P's gas depreciation expense. Neither ULH&P nor the AG recognized an adjustment to the gas accumulated depreciation balance based on the proposed reductions to gas depreciation expense. However, the Commission normally recognizes such an adjustment in the determination of the rate base used for rate-making purposes. The Commission finds it is reasonable to make a similar adjustment in this case.

Based upon the previous findings, we have determined ULH&P's jurisdictional gas rate base for rate-making purposes as of September 30, 2006 to be as follows:

Total Plant in Service	\$280,689,337
Add:	
Gas Stored Underground	5,462,513
Materials and Supplies	909,518
Cash Working Capital Allowance	<u>2,320,187</u>
Subtotal	\$ 8,692,218
Deduct:	
Accumulated Depreciation	85,069,563
Customer Advances	2,721,042
Accumulated Deferred Income Taxes	30,039,766
Investment Tax Credits (3 percent)	<u>33,782</u>
Subtotal	\$117,864,153
 NET ORIGINAL COST RATE BASE – GAS	 <u>\$171,517,402</u>

CAPITALIZATION

In its application, ULH&P proposed a jurisdictional gas capitalization of \$165,719,193,⁴⁸ which was the result of multiplying its total company jurisdictional capitalization of \$634,529,178 by its jurisdictional rate base ratio of 25.899 percent and adding the jurisdictional gas Job Development Investment Tax Credits (“JDIC”) of \$1,382,481.⁴⁹ In its rebuttal testimony, ULH&P proposed a jurisdictional gas capitalization of \$161,960,977,⁵⁰ which had been determined using the same approach as in the application, but reflecting a total company jurisdictional capitalization of \$631,626,858 and a jurisdictional rate base ratio of 25.423 percent.⁵¹

The AG proposed a jurisdictional gas capitalization of \$162,296,080, which was the result of multiplying his total company jurisdictional capitalization of \$635,080,922 by his jurisdictional rate base ratio of 25.337 percent and adding the jurisdictional gas JDIC of \$1,382,481.⁵²

⁴⁸ Application Schedule A.

⁴⁹ Application Workpaper WPA-1c.

⁵⁰ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 1 of 25. There was no change in the amount of jurisdictional gas JDIC from that shown in the application.

⁵¹ As noted previously, on July 15, 2005, ULH&P filed revisions to its application reflecting the effects of House Bill 272, which lowered the Kentucky corporate income tax rate. These revisions were permitted pursuant to 807 KAR 5:001, Section 10(8)(d). In the July 15, 2005 filing, ULH&P determined that its jurisdictional gas capitalization was \$165,798,581. ULH&P followed the same approach to determine the capitalization as was used in the application. The total company jurisdictional capitalization used in this determination was \$635,080,922, with a jurisdictional rate base ratio of 25.899 percent. The jurisdictional gas JDIC was the same as used in the application.

⁵² Henkes Direct Testimony, Schedule RJH-3.

The Commission has determined that ULH&P's jurisdictional gas capitalization is \$161,468,581. The calculation of this amount is shown on Appendix C. The Commission's determination of the jurisdictional gas capitalization followed the same approach as utilized by ULH&P and the AG, and reflects the application of the Commission's jurisdictional rate base ratio of 25.345 percent.

REVENUES AND EXPENSES

In its application, ULH&P determined that its net operating income for the forward-looking test period was \$5,315,878.⁵³ ULH&P proposed a series of adjustments to the revenues and expenses for the forward-looking test period, resulting in an adjusted net operating income of \$6,312,696.⁵⁴ In its rebuttal testimony, ULH&P revised its net operating income to reflect the effects of House Bill 272 to income taxes and its agreement, in whole or part, with several adjustments proposed by the AG. ULH&P determined that its net operating income based on its rebuttal testimony was \$6,748,367. The AG also proposed numerous revenue and expense adjustments, resulting in adjusted net operating income of \$9,756,674.⁵⁵

The Commission finds that six of the adjustments proposed in ULH&P's application and accepted, or not opposed, by the AG are reasonable and should be accepted. In addition, the Commission finds that six of the adjustments proposed by the

⁵³ Application Schedule C-2.

⁵⁴ Response to the AG's First Data Request dated April 5, 2005, Item 148.

⁵⁵ Henkes Direct Testimony, Schedule RJH-8.

AG and accepted by ULH&P through rebuttal testimony are reasonable and should be accepted. These 12 adjustments are set forth in detail in Appendix D.⁵⁶

The Commission makes the following modifications to the remaining proposed adjustments:

Weather Normalization Adjustment

To normalize weather in its forward-looking test period, ULH&P used the National Oceanic and Atmospheric Administration's ("NOAA") Heating Degree Days ("HDD") for the 10-year period 1990-1999, rather than NOAA's latest published 30-year "normals" for the period 1971-2000. ULH&P argued that a 10-year period is a better forecaster of weather in its service territory than the 30-year period. ULH&P also believed that a 10-year period is appropriate because it uses 10 years in its internal forecasting models.

To support its position, ULH&P filed congressional testimony given by the director of the National Climatic Data Center describing changes NOAA has made in how it develops and provides weather data, an article by that director and two scientific articles that studied the optimal time span for developing normals. The articles concluded that the optimal time span for calculating climate normals for temperature data was 10 years.⁵⁷ For the period 1995-2004, ULH&P argued that NOAA data shows that HDDs have declined for Covington, Kentucky, the location of the official federal weather station in its service area. ULH&P further argued that the NOAA HDD normals

⁵⁶ The impact these adjustments have on uncollectible accounts, the PSC Assessment, and federal and state income taxes is discussed later in this Order.

⁵⁷ Riddle Direct Testimony at 10-13.

for seven of the last 10 years show actual annual HDDs below the 30-year normal HDD level of 5,200.⁵⁸

The AG supported using a 30-year period for ULH&P's weather normalization. He contested the way ULH&P performed its weather normalization and disagreed with ULH&P's contention that the best period to use is 10 years. Even if the Commission accepts a 10-year period, the AG stated that ULH&P used the wrong 10 years. He believed that ULH&P supplied wrong data for both the 10-year 1990-1999 HDD and the 30-year period. The AG used revised data issued by NOAA in February 2002 for these periods, not the preliminary data issued December 1, 2001 that ULH&P used.⁵⁹ The revised data showed that HDDs were evenly distributed for the 10-year period, five above and five below the average, rather than skewed toward warmer weather as ULH&P claimed. The AG also pointed out that ULH&P used both preliminary and revised data in its exhibits.⁶⁰ The AG believed the proposed 10-year period suffers from selectiveness and that ULH&P used the 1990-1999 period because it produced the best results. The AG noted that other 10-year periods available for selection produced results closer to those of the 30-year period. The AG argued the shorter period allowed a single year that is far from the norm to have a significant impact on the results. The AG stated that NOAA does not endorse the use of a 10-year period and only makes the data available for shorter periods, since all heating degree normals provided by NOAA

⁵⁸ Id. at 8.

⁵⁹ Brown Kinloch Testimony at 5.

⁶⁰ Id. at 6.

are still based on a 30-year period. The AG's proposal increased revenues by \$731,516 compared to the level proposed by ULH&P based on a 10-year period.

The Commission, as it did in ULH&P's previous gas rate case, agrees with the AG and concludes that using a longer period of time prevents a single year from having too great an impact on the results. However, we share, to some extent, ULH&P's concerns that a 30-year period may not adequately reflect recent weather experience. The Commission finds that use of 25 years, a period of time that has been accepted in other cases, is appropriate in this instance. For this case, the most recent 25 years is the period 1980-2004. This period is not so short as to cause the problems of ULH&P's 10-year period, yet it eliminates 3 years of extremely cold weather experienced in the late 1970s, which, taken together, can have the same type of impact on a 30-year average as a single extreme year can have on a 10-year average. The use of 25 years produces, in our opinion, a more representative overall result. The resulting revenues are \$549,794 greater than those proposed by ULH&P.

Firm Transportation ("FT") Adjustment

ULH&P forecasted a decrease of three FT customers, from 55 to 52, between the base period and forward-looking test period. Because of this loss, and the impact of increasing natural gas prices, ULH&P forecasted a 26 percent decrease in FT volumes. Such a decrease resulted in a \$829,639 reduction in FT revenues.⁶¹

The AG disagreed with ULH&P's forecasted decrease in FT volumes. He argued that the volumes of gas sales transported by FT customers change in response to the

⁶¹ Application Workpaper WPC-2a and 2b.

economy rather than to just gas prices.⁶² The AG argued that FT volumes should grow, not decline, and recommended recognizing a growth rate of 9.08 percent.⁶³ He also recommended using the 55 FT customers that were served during the base period.

ULH&P claimed the AG's focus on just the forecast for FT volumes is too narrow. ULH&P stated that it performs a total company forecast of sales and transportation volumes and then assigns those volumes to different customer classes. While its FT volumes have not declined since the base period, as was forecast, ULH&P noted that volumes for other customer classes have declined with the result being that total actual sales and transportation volumes since the base period have been consistent with its total company forecast. According to ULH&P, if we were to adopt the AG's proposal, it would be necessary to do so for all customer classes, not just the FT class.

On this issue, the Commission is persuaded by ULH&P's argument. The AG's criticism of the forecast for the FT class ignores the forecasts for the other customer classes. ULH&P's actual sales and transportation volumes for all customer classes, on a combined basis, are consistent with its total forecast. Given the nature of forecasting, it is not proper, in our view, to separately critique the forecast of a single customer class and ignore the other customer classes. Given the accuracy of ULH&P's total forecast, the Commission will accept the FT volumes incorporated in ULH&P's forecast period.

Miscellaneous Charges

ULH&P proposed to increase three of its miscellaneous charges: (1) the bad check charge, (2) the reconnection charge for gas only service, and (3) the

⁶² Brown Kinloch Testimony at 10.

⁶³ Id. at 11.

reconnection charge for gas and electric service. It proposed to increase the bad check charge from \$11.00 to \$20.00, the gas only reconnection charge from \$15.00 to \$25.00, and the gas and electric reconnection charge from \$21.00 to \$38.00.

ULH&P did not provide any cost justification for increasing its bad check charge, arguing that its proposed charge is comparable to bad check charges imposed by other businesses and that it needed to make the charge high enough to deter people from purposefully presenting bad checks as payment. In response to information requests, ULH&P was unable to provide cost estimates for employee's time, postage, etc. in support of its proposed charge. The AG opposed granting ULH&P an increase in its bad check charge because of the lack of cost justification for its proposed increase. The Commission agrees that ULH&P has not supported its proposal for an increase in its bad check charge and therefore finds that no increase should be granted.

ULH&P did, however, provide adequate cost support for both of its reconnection charges.⁶⁴ While finding no fault with the cost information, the AG argued that the charges should be increased by a percentage no greater than the overall percentage increase allowed by the Commission in this case for ULH&P's total revenues. The AG stated that existing reconnect fees are already burdens to financially strained customers who are disconnected and that significant increases will only expand that burden. Traditionally, the Commission has approved cost-based miscellaneous charges on the basis that the cost causer should be responsible for the costs. If miscellaneous charges do not recover the full cost of the service being provided, then the cost must be rolled

⁶⁴ Response to the Commission Staff's Second Data Request dated April 19, 2005, Item 48.

into base rates and be recovered from all customers. The Commission finds that ULH&P has provided sufficient support for the proposed increase in both reconnection charges and will approve the proposed increases, which results in \$4,667 in additional revenues.

Depreciation Expense

Prior to the filing of this rate case, ULH&P had a depreciation study performed on its utility plant in service as of September 30, 2004, which resulted in new depreciation rates for most items of utility plant. ULH&P's last depreciation study reflected its utility plant in service as of December 31, 1999, and was approved for accounting and rate-making purposes in Case No. 2001-00092. The new depreciation rates were calculated using the equal life group depreciation procedure, the straight-line method, and the remaining life basis. ULH&P proposed to normalize its depreciation expense by applying the new proposed depreciation rates to its utility plant in service as of the end of the forward-looking test period. ULH&P proposed to reduce its depreciation expense by \$545,635.⁶⁵

The AG reviewed ULH&P's depreciation study and proposed several adjustments to the proposed depreciation rates. The AG then applied his revised depreciation rates to the utility plant in service as of the end of the forward-looking test period. The AG proposed to reduce ULH&P's depreciation expense by \$2,559,000.⁶⁶

⁶⁵ Application Schedule D-2.23.

⁶⁶ Henkes Direct Testimony, Schedule RJH-16. The AG proposed a reduction of \$2,013,365 in addition to the reduction of \$545,365 proposed by ULH&P.

The Commission has identified two areas that need to be addressed regarding the proposed depreciation rates. In addition, the Commission will address the AG's proposal to establish a regulatory liability for the future cost of removal on assets for which there is no legal obligation for removal. These areas are discussed below.

Service Lives. ULH&P and the AG conducted analyses of the appropriate service lives for ULH&P's utility plant in service. These analyses on service lives produced similar results, with the exception of six subaccounts:

- Plant Account No. 205.0 – Production – Structures and Improvements;
- Plant Account No. 211.0 – Production – Liquid Petroleum Gas Equipment;
- Plant Account No. 274.1 – Distribution – Rights of Way;
- Plant Account No. 276.1 – Mains – Cast Iron and Copper;
- Plant Account No. 276.3 – Mains – Plastic; and
- Plant Account No. 280.1 – Services – Cast Iron and Copper.

For four of the six subaccounts, the AG proposed longer service lives. The AG was critical of ULH&P's reliance on professional judgment calls, past estimates of remaining service lives, and the use of estimated remaining service lives from other utilities to support ULH&P's proposed remaining service lives.⁶⁷ ULH&P was critical of the AG's approach of relying exclusively on statistics to determine remaining service lives and the AG's failure to apply judgment in determining the remaining service lives.⁶⁸

⁶⁷ AG's Post-Hearing Brief at 10-14.

⁶⁸ Spanos Rebuttal Testimony at 30-34.

For the remaining two subaccounts, Plant Account Nos. 276.1 and 280.1, the AG's recommendation of shorter service lives was based upon the fact the subaccount contained utility plant that was being replaced under ULH&P's AMRP.⁶⁹ ULH&P contended that its proposed remaining service lives for these subaccounts did take into consideration the effects of the AMRP and reflected the fact that not all of the plant in these subaccounts would be retired as a result of the AMRP. However, ULH&P stated it had no objection to using the AG's shorter remaining service lives, as it would help to offset concerns ULH&P had regarding inadequate accruals for negative net salvage for these subaccounts.⁷⁰

The Commission is well aware that a depreciation study involves the analysis of a significant amount of information and the preparer's judgment and experience. After considering the arguments and the evidence of record, the Commission finds that ULH&P has proposed reasonable remaining service lives for five of the six subaccounts in dispute and will use those remaining service lives to determine ULH&P's depreciation rates. Concerning Plant Account No. 280.1, the record shows that for both the base period and the forward-looking test period, this subaccount is fully depreciated.⁷¹ As this subaccount is fully depreciated, the Commission finds that no depreciation rate

⁶⁹ AG's Post-Hearing Brief at 14.

⁷⁰ Spanos Rebuttal Testimony at 32-33.

⁷¹ Application Schedule B-3, pages 2 and 6 of 8. The schedule shows accumulated depreciation exceeding utility plant in service by approximately \$621,000.

needs to be established for this subaccount. This is consistent with ULH&P's own treatment of two other subaccounts identified as being fully depreciated.⁷²

Negative Net Salvage Values. The AG argued that ULH&P had incorporated excess negative net salvage into its proposed depreciation rates for subaccounts of Plant Account No. 276 and subaccounts of Plant Account No. 280. For Plant Account No. 276.1, the AG contended that a net salvage factor of zero was appropriate because the cost of removal was small in proportion to overall replacement expenditures, there was confusion as to whether the proposed net salvage related to this plant account, and this plant coupled with Plant Account No. 280.1 was over-depreciated.⁷³ For the remaining subaccounts of Plant Account No. 276, the AG opposed the use of the most recent 5-year average salvage data, which supported a negative 20 percent net salvage factor, and recommended a negative net salvage factor of 5 percent, which was based on ULH&P's historic salvage data for the period 1980 through 2004.⁷⁴ For Plant Account No. 280.1, the AG recommended a net salvage factor of zero because the account was directly affected by the AMRP. For the remaining subaccounts of Plant Account No. 280, the AG rejected the proposed negative net salvage factor of 35 percent, and argued that this proposal did not accurately reflect ULH&P's current

⁷² See Application Schedule B-3.2, page 1 of 4, Plant Account No. 204.1 – Rights of Way and page 3 of 4, Plant Account No. 296.0 – Power Operated Equipment.

⁷³ AG's Post-Hearing Brief at 14.

⁷⁴ Majoros Direct Testimony at 17 through 19 of 40 and AG's Post-Hearing Brief at 14-15.

retirement and removal practices. The AG recommended a negative net salvage factor of 5 percent, the same as he proposed for the subaccounts of Plant Account No. 276.⁷⁵

ULH&P disagreed with the AG's net salvage factor recommendations for the subaccounts of Plant Account Nos. 276 and 280. ULH&P stated that using a zero net salvage factor for Plant Account Nos. 276.1 and 280.1 was inappropriate, as the costs to retire are part of the service lives and should be recovered regardless of how small the costs. In addition, the historic salvage data for these accounts were well represented in the historical analysis and the remaining life basis was already reducing the accrual rate to reflect the excess accumulated depreciation balance.⁷⁶ Concerning the remaining subaccounts of Plant Account No. 276, ULH&P argued that the use of the overall average for the 1980 through 2004 period ignored trends in the cost of retiring mains and the gross salvage recorded for mains.⁷⁷ ULH&P contended that the most recent 5-year net salvage data was more representative of the trends it was experiencing.⁷⁸ Concerning the remaining subaccounts of Plant Account No. 280, ULH&P argued that the AG's recommendation ignores the fact that costs previously allocated as the cost of retiring services now is considered the cost of retiring mains. ULH&P acknowledged that this change in policy on the net salvage percentages for

⁷⁵ Majoros Direct Testimony at 19 through 21 of 40 and AG's Post-Hearing Brief at 15.

⁷⁶ Spanos Rebuttal Testimony at 35-36.

⁷⁷ Id. at 34-35.

⁷⁸ Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 16(c).

mains and services is difficult to quantify, but reasoned it was more appropriate to continue with the historic net salvage factors until the changes have become apparent.⁷⁹

The Commission is concerned that ULH&P maintains the historical net salvage data for the subaccounts of Plant Account Nos. 276 and 280 at the account level rather than the subaccount level.⁸⁰ While ULH&P stated that this treatment is not an issue, as the costs of retiring mains and services and the gross salvage do not vary with the type of material,⁸¹ it has not produced any evidence to support this contention.

The Commission has considered the arguments of the AG and ULH&P, and makes the following findings. For the subaccounts of Plant Account No. 276, the Commission is not persuaded by ULH&P's argument that the net salvage factor should only reflect the most recent 5-year period salvage data. Consequently, the Commission finds it is more reasonable to base the net salvage factor on all the historic salvage data available. For Plant Account No. 276.1, the Commission finds that the impact of the AMRP alone is not sufficient justification to set the net salvage factor to zero. The lack of historic accounting data at the subaccount level also influences this determination. Therefore, the Commission finds that a negative net salvage factor of 5 percent is reasonable and should be incorporated into the depreciation rates for all of these subaccounts. For the subaccounts of Plant Account No. 280, other than No. 280.1, the lack of historic accounting data at the subaccount level, the change in retirement and removal procedures, and the shift in the accounting for the retirement costs from

⁷⁹ Spanos Rebuttal Testimony at 36-37.

⁸⁰ Id. at 34 and 36.

⁸¹ Id.

services to mains convinces the Commission to find that, in this instance, using the same net salvage factor for the services subaccounts as the mains subaccounts is reasonable. For Plant Account No. 280.1, as noted previously, this subaccount is fully depreciated and the Commission finds that no net salvage factor needs to be established.

Summary on Depreciation Rates. The Commission finds that the depreciation rates proposed by ULH&P are reasonable and should be approved, except for the modifications discussed in this Order. Appendix E contains a schedule of the depreciation rates modified by this Order for the appropriate plant subaccounts.

Based upon the depreciation rates found reasonable and approved, the Commission has recalculated ULH&P's depreciation expense based on the utility plant as of the end of the forward-looking test period. This recalculation also reflects an adjustment for the \$523,768 slippage factor adjustment⁸² to utility plant in service discussed previously in this Order. The Commission has determined that ULH&P's depreciation expense should be reduced by \$2,160,084.

Creation of a Regulatory Liability. On April 9, 2003, the Federal Energy Regulatory Commission ("FERC") issued its Order No. 631, which dealt with the accounting, financial reporting, and rate filing requirements for Asset Retirement

⁸² The \$523,768 slippage factor plant adjustment was broken down into the categories of Production Plant, Distribution Plant and Common Plant. The composite depreciation rate for each category was applied to the plant adjustment when recalculating ULH&P's depreciation expense.

Obligations (“ARO”).⁸³ Through Order No. 631, FERC essentially adopted the accounting and reporting treatment required by Statement of Financial Accounting Standards (“SFAS”) No. 143 for AROs. However, for those assets which a utility has no legal obligation at retirement FERC stated:

37. The purpose of this rule is to establish uniform accounting requirements for the recognition of liabilities for legal obligations associated with the retirement of tangible long-lived assets. The accounting for removal costs that do not qualify as legal retirement obligations falls outside the scope of this rule. The Commission is aware that there is an ongoing discussion in the accounting community as to whether the cost of removal should be considered as a component of depreciation. However, this issue is beyond the scope of this rule and we are not convinced that there is a need to fundamentally change accounting concepts at this time.

38. Instead we will require jurisdictional entities to maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes. . . .⁸⁴

The AG contends that due to the incorporation of unrealistically high estimates of future removal costs into depreciation rates over the years, the accumulated depreciation balances of ULH&P contain excessive costs that have been collected from ratepayers. Citing the issuance of SFAS No. 143 and FERC Order No. 631, the AG argued that there is a need for enhanced and transparent accounting that would require the separation within depreciation of the capital recovery and future removal cost components. The AG stated his belief that this transparent and enhanced reporting will

⁸³ An ARO is a liability resulting from a legal obligation to retire or decommission a plant asset. The types of work activities typically include removing or dismantling the asset.

⁸⁴ FERC Docket No. RM02-7-000, Order No. 631, April 9, 2003, paragraphs 37 and 38.

ultimately demonstrate that depreciation rates have included estimated future costs of removal that exceed the actual costs experienced for the retirement or removal of the assets for which the costs were estimated. The AG recommended that a regulatory liability be created for accounting and rate-making purposes, on a going forward basis, so that in the event it is proven that ratepayers have shouldered “phantom” expense, ULH&P would not keep the benefit of such a windfall.⁸⁵

ULH&P disagreed with the AG and stated that the creation of such a regulatory liability was not necessary. ULH&P noted that the Uniform System of Accounts defines depreciation as the loss in service value, and service value is defined as original cost less net salvage. ULH&P argued that if past depreciation accruals recorded to the accumulated depreciation account for future cost of removal were not spent, there is a provision in remaining life deprecation for the reduction of future accruals.⁸⁶

The Commission is not persuaded by the AG’s arguments. The AG has not demonstrated the need for this “transparent and enhanced reporting” and why it is necessary to establish a regulatory liability for the portion of accumulated depreciation related to net salvage. The AG presumes that excessive depreciation expense accruals exist because of his belief that the estimated cost of removal far exceeds the actual cost of removal. However, the AG has provided no analysis of plant retirements or removals that compare the estimated and actual costs. The AG also appears to have overlooked how the remaining life approach adjusts depreciation rates when there have been over-

⁸⁵ AG Post-Hearing Brief at 37-39.

⁸⁶ Spanos Rebuttal Testimony at 10 and 13.

accruals.⁸⁷ As defined in the Uniform System of Accounts, prescribed by FERC and adopted by this Commission, depreciation means the loss of service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance.⁸⁸ Service value means the difference between original cost and net salvage value of gas plant.⁸⁹ The definition of depreciation is not the recovery of capital investment.

Therefore, the Commission finds that the AG's request to establish a regulatory liability should be denied.

Employee Incentive Plans

ULH&P's forward-looking test period included \$656,697 in gas O&M expenses associated with its three current employee incentive plans. The AG proposed removing this expense based on his belief that the performance goals incorporated into the incentive plans placed more weight on the interests of ULH&P's shareholders than its ratepayers. The AG argued this was consistent with the Commission's treatment of this expense in ULH&P's last gas rate case.⁹⁰

In its rebuttal testimony, ULH&P contended that its incentive plan expenses were reasonable and a necessary cost of doing business and should be fully recovered in

⁸⁷ The Commission does note that in order for the remaining life approach to be effective, utilities must undertake full depreciation studies on a regular basis.

⁸⁸ 18 CFR 201 at 507.

⁸⁹ Id. at 510.

⁹⁰ Henkes Direct Testimony at 38-39.

rates. However, ULH&P offered an alternative proposal where the incentive plan expenses would be shared between shareholders and ratepayers. ULH&P proposed that the incentive plan expenses be allocated between shareholders and ratepayers based on a breakdown of each plan's component goals. Under this alternative proposal, ULH&P recommended that O&M expenses be reduced by \$175,340.⁹¹ The AG opposed the alternative offered by ULH&P and continued to recommend a reduction of \$656,697.⁹²

The Commission has reviewed ULH&P's alternative proposal and believes the concept has merit. A review of the incentive plan components reveals areas where the focus is not predominately the interest of ULH&P's shareholders, as well as areas where the focus could be viewed as a balance between shareholders and ratepayers. After reviewing ULH&P's proposed sharing allocation, the Commission finds that the sharing allocation is reasonable with the exception of two components.⁹³ The Commission believes the Regulated Business Unit Operational Goals component should be shared 50 percent to shareholders and 50 percent to ratepayers. Further, the Commission believes the Total Shareholder Return component should be allocated 100 percent to shareholders. Based on these revised allocations, the Commission finds that ULH&P's incentive plan expense should be reduced \$294,290.

⁹¹ Verhagen Rebuttal Testimony at 2-8.

⁹² AG's Post-Hearing Brief at 7-9.

⁹³ The components are the Annual Incentive Plan – Regulated Business Unit Operational Goals and the Long-Term Incentive Plan – Total Shareholder Return.

Property Tax Expense

Based upon his analysis of previous years' actual property tax bills, the AG argued that the level of property tax incorporated into the forward-looking test period should be reduced by \$535,245. The AG stated that ULH&P had included the full effect of its initial property tax assessment in the forecasted data. The AG noted that ULH&P had consistently been able to negotiate with the Kentucky Department of Revenue that the initial assessment was too high and succeeded in getting the actual tax lowered from the level based on the initial assessment.⁹⁴

ULH&P initially opposed the AG's proposal, and argued that the amount included in the forward-looking test period was reasonable. ULH&P cited the receipt of its 2005 tentative assessment, which reflected significant increases in that assessment compared to the previous year. Based on the 2005 tentative assessment ULH&P contended the forecasted amount was reasonable. At the public hearing ULH&P indicated that it could file a protest of the 2005 tentative assessment by August 19, 2005. ULH&P was requested to file a copy of the 2005 final assessment as soon as it became available.⁹⁵

ULH&P filed copies of the 2005 revised assessment on September 21, 2005. The 2005 revised assessment was lower than the tentative assessment, and ULH&P recalculated its property tax using the same assumptions as it did for its originally forecasted amount. Based on those calculations, ULH&P concluded its property taxes

⁹⁴ Henkes Direct Testimony at 42-44.

⁹⁵ T.E., Volume I, August 15, 2005, at 110.

should be reduced by \$360,476⁹⁶ from the level incorporated into the forward-looking test period.

The Commission has reviewed the property tax information and finds that a reduction of \$360,476 is reasonable and should be made to the forward-looking test period balance for property tax expense.

Amortization of Unprotected Excess ADIT

As discussed previously in this Order, House Bill 272 resulted in the lowering of the Kentucky corporate income tax rate from 8.25 percent to 7.00 percent. The lowering of the tax rate resulted in excess ADIT for ULH&P's gas operations of \$526,919. This excess deferred income tax was classified as "unprotected," meaning that there are no accounting or tax code rules preventing the Commission from returning the tax benefit of the excess ADIT to ratepayers faster than would occur under the average rate assumption method.⁹⁷ The AG recommended that ULH&P be required to amortize this excess ADIT over a 5-year period, instead of using the average rate assumption method. A 5-year amortization of the unprotected excess ADIT would result in a \$105,384 reduction in tax expenses. In support of his recommendation, the AG stated it was his understanding that the Commission had required this accelerated return of unprotected excess ADIT in previous cases.⁹⁸

⁹⁶ ULH&P originally proposed a property tax expense of \$2,550,000. Its recalculation of the property taxes based on the 2005 revised assessment supported a property tax expense of \$2,189,524. ULH&P Brief at 24.

⁹⁷ The average rate assumption method attempts to return the tax benefits from excess ADIT over the life of the assets or transaction producing the original tax benefit.

⁹⁸ Henkes Direct Testimony at 46-47.

ULH&P opposed this proposal, noting that the AG had assumed from the information provided in a data response that the unprotected excess ADIT was a deferred tax liability account. ULH&P stated that this was actually a deferred tax asset account. ULH&P contended that the AG's recommendation would increase, rather than decrease, its revenue requirement needs. ULH&P argued that it followed the average rate assumption method for the amortization of this ADIT and it was appropriate to continue to do so.⁹⁹

Based on a review of the information provided, the Commission finds that this unprotected excess ADIT is a deferred tax asset account. We further find that it is reasonable, in this case, to not accelerate the amortization of the excess ADIT, but to allow the amortization to occur as provided for under the average rate assumption method. Therefore, the AG's recommendation is rejected.

Interest Synchronization

In its application, ULH&P proposed to decrease its interest expense by \$206,257, which resulted in an increase to state and federal income taxes of \$83,250.¹⁰⁰ ULH&P's calculation began with the long-term and short-term debt components of its jurisdictional gas capitalization. It then deducted the debt portion of its CWIP subject to AFUDC. The applicable interest cost rates were multiplied by the net debt components to arrive at ULH&P's normalized gas interest expense. ULH&P determined the decrease in its

⁹⁹ Torok Rebuttal Testimony at 4-5.

¹⁰⁰ Application Workpaper WPD-2.18a. When ULH&P filed its revisions due to the effects of House Bill 272, this adjustment was also revised. In the updated filing, ULH&P proposed to decrease interest expense by \$207,817 and increase state and federal income taxes by \$82,192. See ULH&P's Updated Filing dated July 15, 2005, Workpaper WPD-2.18a.

interest expense by comparing its normalized gas interest expense with the gas book interest expense for the forward-looking test period. After determining the change in its interest expense, ULH&P calculated the corresponding state and federal income tax effect.

The AG followed the same approach as ULH&P, but included his determination of jurisdictional gas capitalization and cost of long-term debt. The AG also corrected for an error in the forward-looking test period interest expense identified in a data response. The AG determined that interest expense should be reduced \$41,225, resulting in an increase in state and federal income taxes of \$16,305.¹⁰¹

In its rebuttal testimony, ULH&P agreed with the AG's cost of long-term debt and the correction to the forward-looking test period interest expense. ULH&P recalculated its adjustment, reflecting these items and its jurisdictional gas capitalization proposed in the rebuttal testimony, and determined that interest expense should be increased by \$209,224, which resulted in a decrease in state and federal income taxes of \$82,748.¹⁰²

In Case No. 2001-00092, the Commission detailed the calculation of this adjustment, including the removal of certain other interest expenses not included to determine this adjustment.¹⁰³ In this case, neither ULH&P nor the AG included an adjustment to remove these previously disallowed other interest expenses. The Commission believes this adjustment is still necessary. The Commission has

¹⁰¹ Henkes Direct Testimony, Schedule RJH-18.

¹⁰² Wathen Rebuttal Testimony at 9 and Attachment WDW-Rebuttal-1, pages 16 and 17 of 25.

¹⁰³ Specifically, the Commission excluded the interest on Customer Deposits and "Gas Refund – PUCO Rule 28."

recalculated the interest synchronization adjustment, reflecting the debt components of ULH&P's jurisdictional gas capitalization, the corresponding interest cost rates, and CWIP subject to AFUDC found reasonable in this Order as well as the adjustment to other interest expense. The Commission has determined that ULH&P's interest expense should decrease \$89,157, resulting in an increase in state and federal income taxes of \$35,262. The calculation of this adjustment is shown on Appendix F.

AFUDC Offset

ULH&P proposed to increase its revenues by \$362,024 to recognize an offset to its revenue requirements associated with including CWIP subject to AFUDC in rate base.¹⁰⁴ ULH&P calculated its proposal by multiplying the \$4,120,000 balance of CWIP subject to AFUDC by the requested rate of return on capitalization of 8.787 percent. ULH&P revised this adjustment in its rebuttal testimony to an increase of \$308,784 to reflect changes identified in its rebuttal testimony.¹⁰⁵

ULH&P has followed the approach the Commission has used in previous cases. The Commission has recalculated the AFUDC offset to reflect the slippage factor adjustment, discussed previously in this Order, and the rate of return on capitalization authorized in this Order. This results in an increase in net operating income of \$280,803 for rate-making purposes.

¹⁰⁴ Application Schedule D-2.20

¹⁰⁵ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 19 of 25. The CWIP subject to AFUDC was adjusted to reflect the removal of the automated meter reading program and the return on capitalization was revised to reflect the capital structure and debt cost rates accepted from the AG's testimony.

PSC Assessment

In conjunction with five revenue-related proposals,¹⁰⁶ ULH&P calculated a corresponding impact on its PSC Assessment. Based on these adjustments, ULH&P determined a net decrease in its PSC Assessment of \$454.¹⁰⁷ The AG calculated a further adjustment to the PSC Assessment based on certain revenue-related proposals he offered, and determined a net increase in the PSC Assessment of \$7,613.¹⁰⁸ Both ULH&P and the AG used the PSC Assessment rate of 1.726, which was in effect as of the filing of ULH&P's application.

The Commission agrees that the PSC Assessment should be adjusted to reflect the impact of any of the approved revenue-related proposals and that the current assessment rate of 1.670 should be applied. The Commission has recalculated the adjustment, and determined that there should be a net increase in ULH&P's PSC Assessment of \$467. In addition, the Commission finds it reasonable to use the current

¹⁰⁶ The revenue-related adjustments were for annualization of affiliated company rental revenues, elimination of revenues associated with facilities devoted to other than ULH&P customers, elimination of demand-side management related revenues, elimination of unbilled revenues and gas cost recovery revenues, and proposed increase in bad check charges and reconnection charges.

¹⁰⁷ Application Schedule D-2.17, page 3 of 3; Schedule D-2.19, page 5 of 6; Schedule D-2.21, page 3 of 3; Schedule D-2.24, page 3 of 3; and Schedule D-2.25, page 3 of 3.

¹⁰⁸ Henkes Direct Testimony, Schedules RJH-9 through RJH-11. The AG's adjustments are the adjustment for weather normalization based on 30-year period data, adjustment for FT transportation revenues, and his rejection of the proposed increase in bad check charges and reconnection charges.

PSC Assessment rate in the determination of ULH&P's gross revenue conversion factor.¹⁰⁹

Uncollectible Accounts Expense

In conjunction with four revenue-related proposals, ULH&P calculated a corresponding impact on its uncollectible accounts expense.¹¹⁰ Based on these adjustments, ULH&P determined a net increase in uncollectible accounts expense of \$2,088.¹¹¹ The AG calculated a further adjustment to the uncollectible accounts expense based on certain revenue-related proposals he offered, and determined a net increase in the uncollectible accounts expense of \$52,080.¹¹²

ULH&P began selling its accounts receivables to an affiliate of Cinergy in March 2002. ULH&P is limited on the amount of its accounts receivable that it can sell in any given month, and not all accounts receivable meet the eligibility requirements for a sale.¹¹³ The sale of the accounts receivable provides ULH&P funds more quickly than

¹⁰⁹ ULH&P had agreed that the current assessment rate should be reflected in the gross revenue conversion factor. See Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 46(b).

¹¹⁰ The revenue-related adjustments were for annualization of affiliated company rental revenues, elimination of demand-side management related revenues, elimination of unbilled revenues and gas cost recovery revenues, and proposed increase in bad check charges and reconnection charges.

¹¹¹ Application Schedule D-2.17, page 2 of 3; Schedule D-2.21, page 2 of 3; Schedule D-2.24, page 2 of 3; and Schedule D-2.25, page 2 of 3.

¹¹² Henkes Direct Testimony, Schedules RJH-9 through RJH-11. The AG's adjustments are the adjustment for weather normalization based on 30-year period data, adjustment for FT transportation revenues, and his rejection of the proposed increase in bad check charges and reconnection charges.

¹¹³ Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 110.

would be available if it waited for the payment of the accounts receivable. The sale of the accounts receivables has been recognized in ULH&P's capitalization as a form of short-term debt. As a result of it selling its accounts receivable, ULH&P has not recorded any amount as an uncollectible accounts expense since the program began in 2002.¹¹⁴ The uncollectible accounts factor ULH&P used in its calculation of the adjustment was 1.18 percent,¹¹⁵ which reflected the 33-month average of the discount rate it paid in conjunction with the sale of its accounts receivable. The discount rate components include the weighted average net charge-off percentage, the weighted average late charges percentage, a collection fee, the monthly interest rate with mark-up, and the weighted average turnover rate.¹¹⁶

In previous ULH&P rate cases, the Commission has recognized an adjustment to uncollectible accounts expense similar to that requested in this case. The Commission has also incorporated an uncollectible accounts factor in the determination of the gross revenue conversion factor. The uncollectible accounts factor was based upon a test-year provision for uncollectibles viewed as a percentage of total revenues. Including this factor recognized the fact that all revenues granted in a rate case would not necessarily be collected.

The Commission has reviewed the information concerning ULH&P's sale of its accounts receivable and its proposal to use the discount rate to determine an

¹¹⁴ Response to the Commission Staff's Third Data Request dated May 10, 2005, Item 45.

¹¹⁵ Application Workpaper WPH-a.

¹¹⁶ Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 46(a).

adjustment to uncollectible accounts expense and inclusion in the gross revenue conversion factor. Based on that review, the Commission finds that it is not appropriate to use the discount rate as a substitute for the provision for uncollectible accounts approach permitted in ULH&P's previous rate cases. The discount rate formula is a complex calculation that takes into consideration variables that have not been previously recognized in uncollectible account adjustments or the gross revenue conversion factor. The Commission also notes that the monthly interest rate has already been recognized through the inclusion of the sale of accounts receivable in ULH&P's jurisdictional gas capitalization and overall rate of return on capitalization. The fact that ULH&P is not recording any uncollectible accounts expense for its gas operations further brings into question the need for the adjustment or its incorporation into the gross revenue conversion factor. Consequently, the Commission finds that the proposed adjustment to uncollectible accounts expense is rejected and there should be no uncollectible accounts factor incorporated into ULH&P's gross revenue conversion factor utilized in this case.

Federal and State Income Tax Expense

ULH&P calculated the federal and state income tax effect for each proposed revenue or expense adjustment. Based on the adjustments proposed in its application, ULH&P proposed to increase its income tax expense by \$389,310.¹¹⁷ In its rebuttal testimony, ULH&P revised its proposed revenue and expense adjustments, and determined the tax effect of the revised adjustments as well as the effects of House Bill

¹¹⁷ Application Schedule D-1, pages 5 and 6 of 6. The \$389,310 does not include the Interest Synchronization adjustment to income taxes.

272. These revisions resulted in an increase in income tax expense of \$549,452.¹¹⁸ The AG also reflected the income tax effect on his proposed adjustments, and determined that income tax expense should be increased by \$1,248,125.¹¹⁹

The Commission has calculated the income tax effects of each adjustment found reasonable in this Order by applying the Kentucky corporate income tax rate of 7.00 percent and the Federal corporate income tax rate of 35.00 percent. Therefore, the Commission finds that income tax expense should be increased \$930,768.

Federal and State Deferred Income Tax Expense

ULH&P calculated the federal and state deferred income tax effect for its adjustments to eliminate revenues and expenses associated with facilities devoted to other than ULH&P customers and depreciation expense. In its application, ULH&P proposed to increase its deferred income tax expense by \$96,000.¹²⁰ In its rebuttal testimony, ULH&P revised this adjustment to reflect the effects of House Bill 272, resulting in an increase in deferred income tax expense of \$53,310.¹²¹ The AG

¹¹⁸ ULH&P's Updated Filing dated July 15, 2005, Schedule D-1, pages 5 and 6 of 6 and Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, pages 12 and 13 of 25. The Interest Synchronization adjustment to income taxes is not included in this calculation.

¹¹⁹ Henkes Direct Testimony, Schedules RJH-8 through RJH-15 and RJH-17. The Interest Synchronization adjustment is not included in this amount.

¹²⁰ Application Schedule D-1, pages 5 and 6 of 6.

¹²¹ ULH&P's Updated Filing dated July 15, 2005, Schedule D-1, pages 5 and 6 of 6 and Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, pages 12 and 13 of 25.

calculated the deferred income tax effect of his proposed depreciation adjustment only, and determined deferred income tax expense should be increased by \$796,286.¹²²

The Commission has calculated the deferred income tax effects for the two adjustments identified by ULH&P, based on the Commission's findings on these adjustments as discussed in this Order. The Commission finds that deferred income tax expense should be increased \$732,868.

Pro Forma Net Operating Income Summary

After consideration of all pro forma adjustments and applicable income taxes, the adjusted net operating income for ULH&P's jurisdictional gas operations is as follows:

Operating Revenues	\$130,771,397
Operating Expenses	<u>122,852,707</u>
Net Operating Income before AFUDC Offset	7,918,690
AFUDC Offset to Net Operating Income	<u>280,803</u>
 ADJUSTED GAS NET OPERATING INCOME	 <u><u>\$ 8,199,493</u></u>

RATE OF RETURN

Capital Structure

ULH&P proposed an adjusted forward-looking test period capital structure containing 38.196 percent long-term debt, 7.382 percent short-term debt, and 54.415 percent common equity.¹²³ ULH&P allocated adjustments for its gas JDIC on a pro rata basis to all components of capitalization. The AG proposed an adjusted forward-looking test period capital structure containing 38.164 percent long-term debt, 7.382 percent

¹²² Henkes Direct Testimony, Schedule RJH-16.

¹²³ Application Schedule J-1, page 2 of 2.

short-term debt, and 54.454 percent common equity.¹²⁴ The AG's proposed capital structure reflected adjustments ULH&P had determined relating to the reduction in the Kentucky corporate income tax rate.¹²⁵ In its rebuttal testimony, ULH&P proposed the same capital structure as proposed by the AG.¹²⁶

As shown on Appendix C, the Commission finds ULH&P's jurisdictional gas capital structure is as follows:

	<u>Percent</u>
Long-Term Debt	38.164
Short-Term Debt	7.382
Common Equity	<u>54.454</u>
 Total Gas Capital Structure	 100.000

Cost of Debt

ULH&P proposed a cost of long-term debt of 6.302 percent and short-term debt of 3.875 percent.¹²⁷ The AG proposed a cost of long-term debt of 5.926 percent and agreed with ULH&P on the cost of short-term debt.¹²⁸ The AG noted that the 5.926 percent rate reflected the change in how ULH&P planned on financing generating

¹²⁴ Henkes Direct Testimony, Schedule RJH-2.

¹²⁵ See Response to the Commission Staff's Second Data Request dated April 5, 2005, Item 21, page 39 of 40.

¹²⁶ Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, page 24 of 25.

¹²⁷ Application Schedule J-2, page 2 of 2 (short-term debt) and Schedule J-3, page 2 of 2 (long-term debt).

¹²⁸ Woolridge Direct Testimony at 9.

assets it is acquiring from CG&E.¹²⁹ In its rebuttal testimony, ULH&P agreed with the AG's proposed cost of long-term debt.¹³⁰

The Commission finds it appropriate and reasonable to recognize the revision to the cost of long-term debt as it accurately reflects the financing plans of ULH&P concerning its acquisition of generating facilities. Therefore, the Commission finds the cost of long-term debt to be 5.926 percent and the cost of short-term debt to be 3.875 percent.

Return on Equity

When ULH&P's application was filed in February, 2005, it recommended a return on equity ("ROE") of 11.200 percent, from a range of 9.100 percent to 12.800 percent. ULH&P based its recommendation on using three different methodologies: the Capital Asset Pricing Model ("CAPM"), the Risk Premium method, and the Discounted Cash Flow ("DCF") methodology. At the August 2005 hearing, ULH&P revised its ROE recommendation downward to 10.8 percent, from a range of 8.900 percent to 11.900 percent, to better reflect current market conditions.¹³¹

ULH&P compared its results to several different proxy groups. For the CAPM analyses, UHL&P used a sample of publicly traded natural gas distribution companies. A second proxy group consisted of investment grade combination gas and electric utilities covered by the Value Line Investment Survey ("Value Line"). A third proxy

¹²⁹ See Response to the Commission Staff's Third Data Request dated May 10, 2005, Items 9 and 16 and AG's Response to ULH&P's First Data Request dated June 22, 2005, Item 57.

¹³⁰ Wathen Rebuttal Testimony at 10 and 11.

¹³¹ ULH&P Hearing Exhibit No. 1 and T.E., Volume II, August 16, 2005, at 57-61.

group was also used which consisted of electric utilities covered by Value Line.¹³² The Risk Premium analyses included historical analyses on the natural gas distribution industry and the electric utility industry as proxies for ULH&P's energy delivery business. An additional study was conducted using the allowed Risk Premiums implied in the returns on equity allowed by regulatory commission over the last decade for natural gas utilities and contemporaneous long term Treasury bonds.¹³³ The DCF analyses focused on studies of investment grade natural gas distribution utilities from the Value Line Gas Distribution Group and from a group of investment grade combination gas and electric utilities as proxy groups for ULH&P.¹³⁴

ULH&P included a flotation cost adjustment of 0.3 percent in its recommendation. The 0.3 percent adjustment is a weighted average cost factor to capture the average cost of various equity vintages and types of equity capital raised by ULH&P. ULH&P argued that that this is a reasonable adjustment to recover the costs of issuing common equity.¹³⁵

The AG recommended a ROE of 8.700 percent. This recommendation is based primarily upon the DCF methodology using natural gas distribution companies as a proxy group. Even though a CAPM study was performed, the AG did not accord the

¹³² Morin Direct Testimony at 26.

¹³³ Id. at 33-35.

¹³⁴ Id. at 39.

¹³⁵ Id. at 47-50.

results much weight.¹³⁶ The AG's recommendation does not include a flotation cost adjustment.

For his DCF analysis,¹³⁷ the AG utilized a proxy group of eleven natural gas distribution companies tracked by Value Line. Three parameters were employed to obtain this proxy group: at least 50 percent of revenues must be derived from gas distribution, dividends must be paid, and the company's debt must be investment grade.¹³⁸ The AG employed the constant growth DCF model to obtain his ROE estimates. For this version of the model, the AG used the dividend yield for the gas distribution proxy group and then adjusted it by one half the expected dividend growth rate. The DCF growth rate was obtained by taking the midpoint of a range of expected growth rates of earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS").¹³⁹

For the AG's CAPM analysis,¹⁴⁰ he used the risk free rate from yields on the 10-year Treasury bonds. The estimate for Beta is the average for the proxy group of eleven gas distribution companies tracked by Value Line. The "Building Blocks" approach, along with the results of an academic study, was used to obtain the equity risk premium.

¹³⁶ Woolridge Direct Testimony at 15-16.

¹³⁷ Woolridge Direct Testimony, Exhibit_(JRW-7).

¹³⁸ Woolridge Direct Testimony at 8.

¹³⁹ Id. at 21-25.

¹⁴⁰ Woolridge Direct Testimony, Exhibit_(JRW-8).

The AG argued that ULH&P's initial ROE recommendation was excessive and he focused on four main points. ULH&P's use of a forecasted risk-free interest rate was in excess of current long term rates. ULH&P used excessive risk premium estimates in the risk premium methods. The growth rates used in the DCF estimates were upwardly biased. Finally, the use of a flotation cost adjustment was not appropriate. The AG argued that ULH&P used questionable assumptions that, when applied to the various methodologies, produced an upward bias in the results.¹⁴¹ At the hearing, the AG also questioned the validity of including some natural gas companies in the natural gas proxy group for some of ULH&P's analyses.¹⁴² Similarly, the AG questioned the appropriateness of ULH&P's using proxy groups of electric companies and of combination gas and electric companies.¹⁴³

ULH&P offered its own critique of the AG's ROE recommendation. ULH&P stated that the AG's ROE recommendation was well below what other commissions have allowed major natural gas and electric utilities. There were several criticisms regarding the application of and the inputs used in the DCF model. ULH&P argued that the constant growth DCF model tends to understate the cost of equity in today's environment. ULH&P also argued that the growth rates were derived using inappropriate assumptions. The AG understated the dividend yield component of the model, both in its derivation and because it did not allow for flotation costs. Also, the

¹⁴¹ Woolridge Direct Testimony at 2, and 56-79.

¹⁴² T.E., Volume II, August 16, 2005, at 72-85.

¹⁴³ Id. and Woolridge Direct Testimony at 51-52.

stock price did not correctly match expected growth estimates. Generally, AG inappropriately derived and or relied upon inaccurate inputs to the DCF model.¹⁴⁴

ULH&P also offered criticism of the AG's use of the CAPM model. ULH&P argued that the AG's version of the CAPM model understates ROE estimates for low Beta securities. In addition, it argued that the AG's use of the yield on 10-year Treasury bonds is inappropriate. The market risk premium was derived under questionable assumptions and the Beta estimates were questionable.¹⁴⁵

The Commission takes note of several issues raised by both the AG and ULH&P. Arguments for the use of a flotation cost adjustment have typically not been accepted, and they are not in this case. ULH&P has not issued equity during the test year. When those issuance costs are incurred, they are treated as expenses. The Commission agrees with UHL&P that it is more appropriate to rely upon a variety of methods to estimate ROE. The Commission encourages the appropriate use of the DCF, the Risk Premium, and the CAPM methods. These are well known and accepted methodologies to obtain ROE estimates within the industry. Also, it is appropriate in this case to include forecasts, as well as historical measures of inputs in the models.

The Commission agrees with the AG that certain companies should not have been included in ULH&P's proxy groups as ULH&P has filed for an adjustment to rates for its gas operations only. Since the electric side of its business is neither being examined nor adjusted, it is appropriate to use only natural gas companies in a proxy group to estimate the ROE for ULH&P's natural gas business. The Commission also

¹⁴⁴ Morin Rebuttal Testimony at 4-6 and 8-38.

¹⁴⁵ Id. at 6 and 39-56.

notes that the continuance of the AMRP Rider, discussed later in this Order, tends to reduce the overall level of risk that ULH&P faces in the market. The Commission recommends a ROE of 10.200 percent that is the midpoint of a range of 9.700 percent to 10.700 percent.

Rate of Return Summary

Applying the rates of 5.926 percent for long-term debt, 3.875 percent for short-term debt, and 10.200 percent for common equity to the capital structure produces an overall cost of capital of 8.102 percent, which we find to be fair, just, and reasonable. The cost of capital produces a rate of return on ULH&P's jurisdictional gas rate base of 7.627 percent, which the Commission also finds fair, just, and reasonable.

REVENUE REQUIREMENTS

The Commission has determined, based upon a jurisdictional gas capitalization of \$161,468,581 and an overall cost of capital of 8.102 percent, that the net operating income found reasonable for ULH&P's gas operations is \$13,082,184. ULH&P's pro forma net operating income for the forward-looking test period is \$8,199,493. Thus, ULH&P needs additional annual operating income of \$4,882,691. After the provision for the PSC Assessment and state and federal taxes, there is a revenue deficiency of \$8,090,750, which is the amount of additional revenue granted herein. The net operating income found reasonable for ULH&P's gas operations will allow it the opportunity to pay its operating expenses and fixed costs and have a reasonable amount for equity growth.

The calculation of the overall revenue deficiency is as follows:

Net Operating Income Found Reasonable	\$13,082,184
Pro Forma Net Operating Income	<u>8,199,493</u>
Net Operating Income Deficiency	4,882,691
Gross Revenue Conversion Factor ¹⁴⁶	<u>1.6570269</u>
Overall Revenue Deficiency	<u>\$ 8,090,750</u>

The additional revenue granted will provide a rate of return on the jurisdictional gas rate base of 7.627 percent and an overall return on jurisdictional gas capitalization of 8.102 percent. The \$8,090,750 increase represents an increase of 4.58 percent over the normalized gross operating revenues.¹⁴⁷

The rates and charges in Appendix A are designed to produce gross operating revenues, based on the adjusted forward-looking test period, of \$184,666,864. The gas operating revenues reflect the gas cost adjustment approved for ULH&P in Case No. 2005-00457.¹⁴⁸

¹⁴⁶ The gross revenue conversion factor recognizes the impact the overall revenue deficiency will have on the PSC Assessment, state income taxes, and federal taxes. The Commission's calculation of the gross revenue conversion factor follows the same approach as ULH&P provided in Application Schedule H. As discussed previously in this Order, the Commission did not include a provision for uncollectible accounts in the calculation. The Commission used the same rates as ULH&P did in its Updated Filing dated July 15, 2005, Schedule H, with the exception that the current PSC Assessment rate of 1.670 was used.

¹⁴⁷ The normalized operating revenues reflect the impact of ULH&P's most recent gas cost adjustment.

¹⁴⁸ Case No. 2005-00457, The Purchased Gas Adjustment of The Union Light, Heat and Power Company, final Order dated November 29, 2005.

PRICING AND TARIFF ISSUES

Cost of Service Study & Revenue Allocation

A Cost of Service Study (“COSS”) 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.

ULH&P submitted a fully allocated class COSS for its forward-looking test period. Similar to the approach taken in its last gas rate case, ULH&P reversed the order of the usual steps taken in performing a COSS by allocating costs as the first step in the process and then functionalizing costs as the second step. Based on the study results, ULH&P proposed to allocate 83.6 percent of the increase to the residential class, 13.7 percent to the commercial class, 1.5 percent to FT customers, and 1.2 percent to its interruptible customers.¹⁴⁹ This translated into a 13.9 percent increase in rates to residential (“RS”) customers, a 4.6 percent increase to general service (“GS”) customers, a 10.9 percent increase to FT customers, and a 17.6 percent increase to interruptible (“IT”) customers.¹⁵⁰ ULH&P adjusted its proposed increases by 50 percent of its calculated subsidy/excess revenues in order to prevent rate shock and to adhere to the principle of gradualism.¹⁵¹

¹⁴⁹ Application Schedule M, page 1 of 1.

¹⁵⁰ Bailey Direct Testimony at 3.

¹⁵¹ Ochsner Direct Testimony at 15.

The AG objected to ULH&P's use of forecasted, historical and combined data in its COSS.¹⁵² He cited problems with the way ULH&P allocated costs between rate classes. The AG objected to how ULH&P allocated the cost of regulators between rate classes. He also described ULH&P's methodology as unorthodox, since the functionalization of costs is usually the first step in constructing a COSS. Performing the steps in reverse, according to the AG, makes it difficult to track the source of expenses.¹⁵³ The AG did, however, maintain ULH&P's method in his analysis in order to provide an "apples to apples" comparison.

The AG disagreed with the allocation proposed by ULH&P, which he claimed assigns over 90 percent of the rate increase to the residential class.¹⁵⁴ He proposed that the allocation be based on present revenues and suggests moving class rates of return toward the COSS results more gradually than ULH&P proposes. The AG recommended moving one-third of the way toward the rates indicated by the COSS.

The AG argued that ULH&P allocated 68 percent of these costs of regulators to residential customers while residential customers only account for 54 percent of the costs. Since the regulator costs for the residential class are known, actual costs should be used. The AG objected to using capitalization as the starting point in the allocation process, citing that this method assigns a larger share of the increase to the residential class than would be assigned using present revenues as the starting point. The AG proposed to allocate 77.2 percent of the increase to the residential class, 20.8 percent

¹⁵² Brown Kinloch Testimony at 3.

¹⁵³ Id. at 16.

¹⁵⁴ The 90 percent calculation is exclusive of the roll-in of AMRP revenues.

to the commercial class, 1.5 percent to FT customers, and 0.5 percent to interruptible customers.¹⁵⁵

ULH&P countered that the AG's recommended allocation does not move all customer classes closer to the average rate of return in its COSS. It contended that its proposed allocation is the only proposal that does move all customer classes closer to the average rate of return. ULH&P also argued that its allocation and functionalization is consistent with the uniform system of accounts prescribed by the FERC.

Although ULH&P and the AG disagree on several points, the end results of both parties' studies are quite similar. In light of these results, and given the Commission's long-standing practice of using COSS results only as a guide for revenue allocation and rate design, we will accept ULH&P's COSS. However, sharing some of the concerns expressed by the AG, we will allocate the increase in a manner that approximates the mid-point between the percentage increases contained in the two studies.

Rate Design

ULH&P proposed to roll the AMRP charges approved in previous cases into base rates; the amounts would be collected through delivery charges for the FT and IT rate classes and through the monthly customer charges for the RS and GS rate classes. It proposed to increase the RS and GS customer charges by roughly one-third of the amount needed to fully recover what it calculates as customer costs for the two classes. ULH&P proposed the following rate changes:

¹⁵⁵ Brown Kinloch Testimony at 15.

	<u>Current</u>	<u>Proposed</u>
Rate RS (Residential)		
Customer Charge	\$8.30	\$15.00
All Ccf	\$0.2334	\$0.298534
Rate GS (Commercial)		
Customer Charge	\$15.35	\$38.50
All Ccf	\$0.2049	\$0.2054
Rate IT (Interruptible)		
Administrative Charge	\$330	\$430
All Ccf	\$0.0715	\$0.08334
Rate FT-L (Transportation)		
Customer	\$330	\$430
All Ccf	\$0.1714	\$0.18624
SSIT (Spark Spread)		
Administrative Charge	\$330	\$430

The AG objected to how ULH&P derived the proposed monthly customer charges, specifically the costs included in the fixed charges.¹⁵⁶ ULH&P included the cost of mains in its calculation and the AG believed this does not meet the definition of a fixed charge related to customers. The AG's analysis indicated that monthly residential customer costs are \$15.29. Following ULH&P's proposal to increase the RS customer charge by one-third of the indicated increase, the AG proposed a residential customer charge of \$10.63. Using the same methodology, the AG proposed a customer charge for the GS class of \$22.84.

Based on the amount of the increase being awarded, the roll-in of the AMRP charges, and the allocation approach discussed previously in this Order, the rate design

¹⁵⁶ Id. at 17-20.

approved herein moves in the direction proposed by ULH&P. However, it is tempered somewhat by gradualism and, to a greater extent, by the difference between ULH&P's requested revenue increase and the revenue increase being awarded. The resulting RS customer charge is \$12.00 while the GS customer charge will increase to \$30.00. The other classes' customer charges will be increased as proposed by ULH&P with the remainder of the increases assigned the different classes being recovered through increases in their respective volumetric charges.

Continuation of the AMRP Rider

In Case No. 2001-00092, we stated,

The Commission finds the replacement of ULH&P's cast iron and bare steel mains within 10 years to be necessary and in the public interest. We also recognize the significant impact the accelerated main replacement program will have on ULH&P over the next 10 years. The Commission believes we have the statutory authority to establish, and that we should establish, a method of recovery that will help to eliminate any impediment to the success of the program. However, because the AMRP Rider proposal is a case of first impression for the Commission, we believe that it should be established for an initial 3-year period. Having found that the replacement program is in the public interest and having recognized the impact on ULH&P, the Commission finds at this time no reason to believe that the mechanism cannot be continued for 10 years. However, we believe that establishing the Rider for an initial 3-year period will allow both ULH&P and the Commission an opportunity to review the operation of the mechanism and make a decision on its renewal

* * * * *

Therefore, for the reasons mentioned earlier, the Commission believes it is reasonable to authorize the AMRP Rider for an initial 3-year period. The 3-year period will be effective as of the date of this Order. If ULH&P wishes to continue the AMRP Rider, it will need to file a general rate application to "roll-in" the Rider and to justify its continuation. The Commission believes it will be necessary to examine ULH&P's total gas operations in conjunction with a review to continue the AMRP Rider. It will also allow the Commission the opportunity to "roll-in" the replacement lines into the base rates of ULH&P and, if the AMRP Rider is continued,

prevent the AMRP Rider from becoming too large a portion of the customer bill.¹⁵⁷

In its application ULH&P proposed to continue the AMRP Rider. In support of its request, ULH&P stated that through December 2004, it has replaced approximately 90 miles of cast iron and bare steel mains and plans to replace another 111 miles of such mains by 2010.¹⁵⁸ ULH&P further argued that, based upon a 45 percent decline in discovered leaks between 1999 and 2004, AMRP improved the safety and reliability of its gas distribution system.¹⁵⁹ It also pointed to the reduction in its Account No. 887 – Maintenance of Main expense of approximately 44 percent¹⁶⁰ as evidence of the AMRP's benefits. ULH&P stated that the replacement of gas mains under the AMRP is on schedule and within budget and that it has maintained a replacement rate to permit completion of all designated mains by 2010 as originally anticipated.¹⁶¹ ULH&P argued that the AMRP Rider had allowed it to obtain current recovery of the costs associated with the AMRP in more economical and efficient manner than a typical general rate case. ULH&P also argued that the AMRP Rider has allowed the replacement of a significant portion of ULH&P's cast iron and bare steel mains without a significant impairment of ULH&P's financial condition.¹⁶²

¹⁵⁷ Case No. 2001-00092, January 31, 2002 Order at 78-80.

¹⁵⁸ Hebbeler Direct Testimony at 5.

¹⁵⁹ Id. The incidence of leaks repaired dropped from 983 in 1999 to 537 in 2004.

¹⁶⁰ Id. The expense recorded in Account No. 887 decreased from \$1,500,000 in 1999 to \$846,000 in 2004.

¹⁶¹ Id. at 7.

¹⁶² Steffen Direct Testimony at 8.

Since ULH&P filed this case utilizing a forward-looking test period, all AMRP related construction through September 30, 2006 has been incorporated into base rates. ULH&P proposed to make the next filing under its AMRP Rider in March 2008, and then annually through 2011.¹⁶³ The March 2008 filing would cover AMRP-related construction for the period from October 1, 2006 through December 31, 2007. The remaining AMRP Rider filings would cover a calendar year period. ULH&P's AMRP Rider filing in March 2011, if approved, would continue in effect until ULH&P's next general gas rate case.

The AG opposed the establishment of the AMRP Rider in Case No. 2001-00092, contending that it constituted single-issue rate-making and that the Commission lacked the statutory authority to authorize the AMRP Rider. He has brought in Franklin Circuit Court actions to review the Commission's decision to authorize the AMRP Rider in Case No. 2001-00092 as well as our decisions in three subsequent cases that established the annual AMRP Rider surcharge.¹⁶⁴

In this case, the AG opposed the continuation of the AMRP Rider and renewed his argument that the Commission lacks the statutory authority to establish the Rider.

¹⁶³ As ULH&P has to incur the construction costs before requesting recovery through the AMRP Rider, the March 2011 filing would cover the AMRP-related construction for calendar year 2010, the last year of the program.

¹⁶⁴ The three cases that established annual AMRP Rider surcharge were Case No. 2002-00107, An Adjustment of Rider AMRP of The Union Light, Heat and Power Company, final Order dated August 30, 2002 and rehearing Order dated November 21, 2002; Case No. 2003-00103, An Adjustment of Rider AMRP of The Union Light, Heat and Power Company, final Order dated August 25, 2003 and rehearing Order dated August 29, 2003; and Case No. 2004-00098, An Adjustment of Rider AMRP of The Union Light, Heat and Power Company, final Order dated August 24, 2004.

He refers to two recent cases¹⁶⁵ in which the Commission refused to establish cost trackers in non-general rate cases and acknowledged that certain findings in our Order in Case No. 2001-00092 regarding our rate-making authority “may be overly broad when viewed in light of the Supreme Court’s decision in the above-cited *KIUC v. KU* case.”¹⁶⁶ The AG also argued that the recently enacted KRS 278.509 does not authorize the Commission to impose single-issue rate increases or approve a new AMRP Rider outside of a general rate proceeding.¹⁶⁷

The AG also took exception to certain aspects of the proposed AMRP Rider. First, he contended that ULH&P’s proposed AMRP Rider tariff fails to comply with KRS 278.509. The AG argued that KRS 278.509 permits the recovery of the costs of investment only, and not any return on AMRP-related investment. He asserted that if the Kentucky General Assembly had intended for a utility to receive a return on investment as well as the cost of the investment it would have specifically stated a

¹⁶⁵ Case No. 2004-00459, The Application of Louisville Gas and Electric Company for Approval of New Rate Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates and Case No. 2004-00460, The Application of Kentucky Utilities Company for Approval of New Rate Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates, final Orders dated April 15, 2005.

¹⁶⁶ AG’s Post-Hearing Brief at 31-32. The AG did, however, acknowledge that the Commission in those two recent cases specifically distinguished ULH&P’s AMRP Rider because it was considered within the context of a general rate case, which is the same distinction that the AG made in a reply memorandum in those cases. See Case Nos. 2004-00459 and 2004-00460, Reply of the Attorney General to the Response of Louisville Gas and Electric Company and Kentucky Utilities Company to the Attorney General’s Motion to Dismiss the Companies’ request for MISO expense trackers at 7. The AG has now argued that the distinction is without meaning.

¹⁶⁷ Id. at 33.

return on investment was permitted. The AG also argued that KRS 278.509 makes no provision for the offset of costs for investment with decreases in O&M expense as the proposed AMRP Rider does.¹⁶⁸

The AG stated that any new AMRP Rider should permit collection of the charges from Residential and General Service classes by a mix of demand and customer charges or a volumetric charge instead of the customer charge approach. He contended this approach is consistent with ULH&P's COSS.

The AG also stated that the AMRP Rider should be clearly designated as a line item on customers' bills.¹⁶⁹ He suggested that the Commission should either approve the AMRP Rider for a 3-year period only or attach a sunset clause that would match with the end of the AMRP. Lastly, the AG advocated that ULH&P be required to file a general rate case to "roll-in" to base rates the AMRP Rider.¹⁷⁰

ULH&P opposed these arguments. In its rebuttal testimony, ULH&P noted that the AG's objections were addressed and rejected in Case No. 2001-00092. It contended that the AMRP Rider is good public policy as it allowed ULH&P to recover the costs associated with the AMRP in a timely manner and avoid possible financial impairment. ULH&P emphasized the AMRP's safety and reliability benefits, its reduction of regulatory lag, and its maintenance of the sound financial condition of ULH&P. It described the Rider as a fair and balanced rate mechanism.¹⁷¹ ULH&P

¹⁶⁸ Id. at 33-34.

¹⁶⁹ Id. at 35.

¹⁷⁰ Id. at 35-36.

¹⁷¹ Steffen Rebuttal Testimony at 1-3.

argued that recovering the AMRP Rider from Residential and General Service customers through a customer charge was reasonable, as the AMRP-related costs were fixed costs for capital expenditures that benefit all customers on its distribution system.¹⁷² In its brief, ULH&P argued that the AG's contention that KRS 278.509 did not provide the Commission with authority to approve the AMRP Rider was without merit and should be rejected. ULH&P contended that the Commission already has the authority to establish the AMRP Rider and that KRS 278.509 simply strengthens the argument in support of that authority. ULH&P noted that the AG offered no evidence regarding the benefits of the AMRP or the financial impacts to the program if the AMRP Rider were discontinued.¹⁷³

The AG's arguments have not convinced us that our earlier decision was erroneous. We previously held our authority to establish fair, just, and reasonable rates includes the authority to review and approve the AMRP Rider.¹⁷⁴ Contrary to the AG's belief, whether a surcharge was authorized as part of a general rate case or outside of a general rate case is a significant distinction. As we noted in our decisions in Case Nos. 2004-000459 and 2004-00460,

The Commission does acknowledge that certain findings in Case Nos. 1999-00046 and 2001-00092 regarding our rate-making authority may be overly broad when viewed in light of the Supreme Court's decision in the above-cited *KIUC v. KU* case. To the extent that our prior findings are inconsistent with those of the Court, our findings must yield. However, the Commission also recognizes that Case No. 1999-00046 was ultimately consolidated into a general rate application, and that Case No. 2001-

¹⁷² Id. at 4-5.

¹⁷³ ULH&P Brief at 35-36.

¹⁷⁴ Case No. 2001-00092, January 31, 2002 Order, at 76.

00092 was a general rate case application that complied with 807 KAR 5:001, Section 10. Thus, regardless of the findings therein on our statutory authority, the proposed rates were reviewed in conjunction with general rate cases.¹⁷⁵

We further do not accept the AG's position that KRS 278.509 precludes or prohibits the inclusion of a component for return on investment in the AMRP. KRS 278.509 states:

Notwithstanding any other provision of law to the contrary, upon application by a regulated utility, the commission may allow recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility. No recovery shall be allowed unless the costs shall have been deemed by the commission to be fair, just, and reasonable.

It is generally accepted in rate-making that the return on an investment is properly considered part of the cost of that investment. The AG has failed to provide any legal authority or precedent for the exclusion of a return on utility plant investment that the Commission has determined to be reasonable.

The AMRP Rider language on O&M expense reductions as offsets is not specific as to how those reductions were actually recognized in the determination of the annual AMRP Rider. The revenue requirement of the net plant additions, which is in effect the cost of the investment, is the sum of the return on net AMRP-related utility plant and operating expenses. The only operating expenses included in the AMRP calculations are depreciation expense and Account No. 887 – Maintenance of Mains. The O&M

¹⁷⁵ Case Nos. 2004-00459 and 2004-00460, April 15, 2005 Order at 7-8 (emphasis added)(footnotes omitted).

expense reductions have been in Account No. 887, and have been used as an offset to the AMRP-related depreciation expense.¹⁷⁶

The Commission is not persuaded by the AG's arguments concerning the recovery of the AMRP Rider from the Residential and General Service customers and finds that ULH&P's proposal on this point should be approved. When this AMRP Rider is rolled into base rates, however, the Commission will consider arguments for the use of a COSS to allocate those costs.

In our January 31, 2002 Order in Case No. 2001-00092, we found that the AMRP was in the public interest, recognized the impact the AMRP would have on ULH&P, and found at that time no reason to believe that the AMRP Rider could not be continued for 10 years. Based on the evidence in this case, the Commission finds the AMRP is still in the public interest, will still have a financial impact on ULH&P, and an AMRP Rider should be authorized for the remaining years of the AMRP. The Commission further finds that the AMRP Rider should be determined using the same approach approved in Case No. 2001-00092 and modified in Case No. 2002-00107.

In addition, the Commission makes the following findings concerning the AMRP and AMRP Rider:

1. ULH&P should make the first filing under the renewed AMRP Rider by March 31, 2008. This filing should cover AMRP-related construction for the period October 1, 2006 through December 31, 2007;
2. ULH&P should make filings under the renewed AMRP Rider for 2009 and 2010 by March 31 of those years. These filings should cover AMRP-related construction for the previous calendar year period;

¹⁷⁶ See Case No. 2002-00107, August 30, 2002 Order, Appendix B for a calculation of the AMRP revenue requirement.

3. The AMRP Rider contained in the annual filings should be effective for service rendered on and after a specific date;
4. The AMRP Rider should be collected from the customer classes as proposed by ULH&P;
5. The AMRP Rider should be disclosed as a separate line item on customers' bills;
6. The reasonable rate of return on the AMRP rate base should be the overall cost of capital found reasonable in this proceeding, grossed up for federal and state income taxes only;
7. The Commission will endeavor to complete its review of the annual AMRP Rider filings within 60 days. Because a hearing will be necessary and the review may be extensive, however, the Commission may extend the length of the review period;
8. ULH&P should serve complete copies of the annual AMRP Rider filing on the AG when it submits such filings with the Commission; and
9. ULH&P should continue to annually seek Certificates of Public Convenience and Necessity for its AMRP-related construction.

As to the annual AMRP Rider filing that is due on March 31, 2011, the Commission agrees with the AG's suggestion to "roll-in" the AMRP Rider into ULH&P's base rates at the AMRP's end. We find that based upon the assumption that the AMRP is completed by 2010, ULH&P should synchronize the filing of a general gas rate case to coincide with the termination of the AMRP Rider authorized from the March 31, 2010 filing. ULH&P should verify in writing in its March 31, 2010 AMRP Rider filing whether the AMRP will be completed in 2010.

The Commission further finds that the AMRP Rider tariff should contain a more precise description of how the AMRP Rider is calculated. At a minimum, this description should state that the AMRP Rider revenue requirement includes:

- a. The AMRP net rate base is AMRP-related plant in service minus AMRP-related accumulated depreciation minus ADIT associated with AMRP-related plant in service;
- b. All components of the AMRP net rate base reflect adjustments to exclude retirements or removals of plant related to the AMRP construction;
- c. The rate of return on the AMRP net rate base is the overall rate of return on capital authorized in this case, grossed up for federal and state income taxes;
- d. Operating expenses included in the revenue requirement are depreciation expense and Account No. 887 – Maintenance of Mains; and
- e. Reductions in Account No. 887 expenses will be reflected in the determination of the revenue requirement.

Ownership of Service Lines

ULH&P requested approval to be responsible for making all new installations of customer service lines and for thereafter maintain the lines in accordance with Commission regulations. Under 807 KAR 5:022, Section 9(17)(a)(2), “The customer, or the company at its option and with commission approval, shall furnish and lay necessary pipe to make the connection from curb stop to place of consumption and shall keep the service line in good repair and in accordance with reasonable requirements of the utility’s rules and the commission’s administrative regulations.”

In Case No. 2001-00042, ULH&P was granted approval to assume ownership of service lines it replaced in conjunction with the AMRP. In its January 31, 2002 Order, the Commission stated that before ULH&P could assume responsibility for the customer service lines, it would need to seek a deviation from 807 KAR 5:022, Section 9(17), and include in its application for a Certificate of Public Convenience and Necessity for the

AMRP a deviation request.¹⁷⁷ ULH&P sought and was granted the deviation in Case No. 2002-00089.¹⁷⁸

ULH&P's ownership of the service lines would make it responsible for the maintenance and repair of those lines. Currently, the customer has responsibility for the initial installation of the service line. Once ULH&P replaces a line through the AMRP it assumes ownership and responsibility for maintenance and repair costs. In requesting to broaden its ownership as of the initial installation, ULH&P would have more control over the installation. The United States Department of Transportation, Office of Pipeline Safety now requires the utility to inspect third persons who perform installation work. ULH&P would prefer to have its own employees or contractors perform the installations in order to ensure that only qualified personnel perform the work. The AG did not oppose ULH&P's proposal.

The Commission finds that the request is reasonable and that ULH&P should be granted a deviation of 807 KAR 5:022, Section 9(17).

Tariff Language Changes

ULH&P proposed new tariff language in the service line section that updates the tariff language to reflect the ownership of the service lines upon installation. ULH&P also proposed a change in its Rate ASFRAS to clarify for customers that the customer is responsible for charges for gas transported over CG&E's pipeline system for delivery

¹⁷⁷ Case No. 2001-00092, January 31, 2002 Order at 82.

¹⁷⁸ Case No. 2002-00089, Application of The Union Light, Heat and Power Company for a Certificate of Public Convenience and Necessity to Construct Gas Distribution Facilities Within Its Service Territory and for a Deviation from Administrative Regulation 807 KAR 5:022, Section 9(17), final Order dated August 29, 2002.

to ULH&P's system. The charges would be at FERC-approved rates. The proposed change to Rate ASFRAS reflects ULH&P's current billing practice.

The Commission finds that, consistent with the approval of ULH&P's request to assume ownership of the service lines, it is reasonable to approve the proposed new tariff language for the service line section. The Commission also finds the proposed changes to Rate ASFRAS are reasonable and should be approved.

REFUND REQUIREMENTS

As noted previously, on September 30, 2005 ULH&P gave notice of its intention to place its proposed rates into effect for services rendered on and after October 1, 2005. In its October 3, 2005 Order, the Commission found that it was unable to complete its investigation within the suspension period and that ULH&P had complied with the statutory provisions to place the proposed rates into effect, subject to refund. Given the difference in the increase granted herein and the amounts proposed, the Commission finds that ULH&P should refund to its customers all rates and charges exceeding the rates and charges prescribed in this Order. The Commission notes that the rates approved herein are for service rendered on and after October 1, 2005. ULH&P shall not retroactively apply such rates for service rendered prior to October 1, 2005. Billings based upon meter readings taken on October 1, 2005 or earlier clearly involve gas service received before October 1, 2005 and should not be based upon the rates approved in this Order. Any amount of excess revenues collected from October 1, 2005 through the date of this Order should be refunded with interest based on each customer's usage while the proposed rates were in effect.

The Commission notes that ULH&P has had three different gas cost adjustments (“GCA”) in effect during the time since it put its proposed base rates into effect on October 1, 2005. These GCAs were approved in Case No. 2005-00363¹⁷⁹ to be effective September 29, 2005, Case No. 2005-00420¹⁸⁰ to be effective October 30, 2005, and Case No. 2005-00457 to be effective November 30, 2005. With the approval herein of base rates that differ from the proposed rates it placed in effect, ULH&P will be required to file revised tariffs that supersede the tariffs filed in compliance with the October 3, 2005 Order issued in this proceeding as well as the Orders referenced herein issued in Case Nos. 2005-00420 and 2005-000457.¹⁸¹

SUMMARY

The Commission, after consideration of all matters of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A are the fair, just, and reasonable base rates for ULH&P to charge for service rendered on and after October 1, 2005.
2. The rates proposed by ULH&P would produce revenue in excess of that found reasonable herein and should be denied.

¹⁷⁹ Case No. 2005-00363, Notice of Purchased Gas Adjustment Filing of The Union Light, Heat and Power Company, final Order dated September 22, 2005.

¹⁸⁰ Case No. 2005-00420, Notice of Purchased Gas Adjustment Filing of The Union Light, Heat and Power Company, final Order dated October 24, 2005.

¹⁸¹ The effective date of the GCA approved in Case No. 2005-00363 precedes the date ULH&P placed its proposed base rates in effect; therefore, there is no need to revise the tariffs filed pursuant to the September 22, 2005 Order issued in that case.

3. The depreciation rates contained in ULH&P's depreciation study filed in this case, as modified herein, are reasonable and should be approved for use as of the date of this Order.

4. ULH&P should be granted permission to deviate from 807 KAR 5:022, Section 9(17), and permitted to assume the ownership of service lines at the point of installation.

5. The proposed tariff language changes for service lines and Rate ASFRAS should be approved.

6. The AMRP Rider, as modified and discussed herein, is reasonable and should be approved.

IT IS THEREFORE ORDERED that:

1. The base rates in Appendix A are approved for service rendered on and after October 1, 2005.

2. The rates proposed by ULH&P are denied.

3. ULH&P shall, within 20 days of the date of this Order, file its revised tariff sheets setting out the base rates approved herein together with the two GCAs approved by the Commission that went into effect after October 1, 2005, and have been in effect since that date, up to and including the date of this Order.

4. The depreciation rates contained in ULH&P's depreciation study filed in this case, as modified herein, are approved for use as of the date of this Order.

5. The request for permission to deviate from 807 KAR 5:022, Section 9(17), is approved. ULH&P is granted approval to install, own, and maintain all new service lines.

6. The proposed tariff language changes for service lines and Rate ASFRAS are approved.

7. The AMRP Rider, as modified and discussed herein, is approved.

8. The proposed increase in the reconnection charges is approved.

9. The proposed increase in the bad check charge is denied.

10. Within 30 days of the date of this Order, ULH&P shall file with the Commission a report on the amount of excess revenues collected from October 1, 2005 through the date of this Order and a plan for refunding these revenues. This plan shall include interest for the period the excess revenues were collected at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. The refunds will be based on each customer's usage while the proposed rates were in effect and shall be made at a one-time credit to the bills of current customers and by check to customers that have discontinued service since October 1, 2005.

11. ULH&P shall file a general base rate case in 2011 to roll-in the AMRP Rider into base rates, as discussed herein.

Done at Frankfort, Kentucky, this 22nd day of December, 2005.

By the Commission

ATTEST:


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

The following rates and charges are prescribed for the customers in the area served by The Union, Light, Heat and Power Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

	<u>Base Rate</u>
Rate RS Residential Service	
Monthly Customer Charge	\$12.00
All Ccf	\$.26840
Rate GS General Service	
Monthly Customer Charge	\$30.00
All Ccf	\$.21010
Rate FT-L Firm Transportation Service	
Monthly Administrative Charge	\$430.00
All Ccf	\$.17733
Rate IT Interruptible Transportation Service	
Monthly Administrative Charge	\$430.00
All Ccf	\$.07640
Reconnection Charge-Gas Only	\$25.00
Reconnection Charge-Combined Gas and Electric Service	\$38.00

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

The jurisdictional net original cost rate base of ULH&P's combined and gas operations at September 30, 2006 is as follows:

	Combined	Gas
Total Utility Plant in Service	\$1,380,887,031	\$280,689,337
Add:		
Fuel Inventory	5,710,000	0
Materials & Supplies –		
Propane Inventory	677,245	677,245
Other Materials & Supplies	9,844,000	232,273
Total Materials & Supplies	10,521,245	909,518
Gas Stored Underground	5,462,513	5,462,513
Cash Working Capital Allowance	9,883,163	2,501,515
Subtotal	34,078,436	8,873,546
Deduct:		
Reserve for Accumulated Depreciation	613,594,647	87,229,647
Accumulated Deferred Income Taxes	154,618,576	36,359,585
Customer Advances for Construction	2,721,042	2,721,042
Investment Tax Credits (3 percent)	33,782	33,782
Subtotal	770,968,047	126,344,056
Jurisdictional Net Original Cost Rate Base	\$ 643,997,420	\$163,218,827

Ratio of Kentucky jurisdictional gas operations to jurisdictional Total Company operations is 25.345 percent.

NOTES:

1. Combined amounts are on a Kentucky jurisdictional basis.
2. Cash working capital allowance was determined by taking 1/8th of forward-looking test period actual operations and maintenance expenses less purchased power and purchased gas costs.

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

DETERMINATION OF JURISDICTIONAL GAS CAPITALIZATION AND GAS CAPITAL STRUCTURE

Determination of Total Company Jurisdictional Capitalization:

	<u>Total Company Balances 09/30/2006</u>	<u>Capital Structure Percentage</u>	<u>Non- Jurisdictional Adjustment</u>	<u>Total Company Jurisdictional Balances</u>
Long-Term Debt	\$247,448,802	38.164%	(\$ 6,396,170)	\$241,052,632
Short-Term Debt	47,866,829	7.382%	(1,237,200)	46,629,629
Common Equity	<u>353,072,000</u>	<u>54.454%</u>	<u>(9,126,325)</u>	<u>343,945,675</u>
Total Long-Term Debt, Short-Term Debt, and Common Equity	<u>\$648,387,631</u>	<u>100.000%</u>	<u>(\$16,759,695)</u>	<u>\$631,627,936</u>

To arrive at the jurisdictional gas capitalization, the jurisdictional rate base ratio of 25.345 percent is applied to each component of the total company jurisdictional balances.

Determination of Jurisdictional Gas Capitalization:

	<u>Jurisdictional Gas Balances 09/30/2006</u>	<u>Allocation of Gas JDIC</u>	<u>Adjusted Gas Balance</u>	<u>Adjusted Gas Capital Structure</u>
Long-Term Debt	\$ 61,094,790	\$ 527,610	\$ 61,622,400	38.164%
Short-Term Debt	11,818,279	102,055	11,920,334	7.382%
Common Equity	<u>87,173,031</u>	<u>752,816</u>	<u>87,925,847</u>	<u>54.454%</u>
Total Long-Term Debt, Short-Term Debt, and Common Equity	\$160,086,100	\$1,382,481	\$161,468,581	<u>100.000%</u>
Gas JDIC	<u>1,382,481</u>	<u>(1,382,481)</u>	<u>0</u>	
Total Capitalization	<u>\$161,468,581</u>	<u>\$ 0</u>	<u>\$161,468,581</u>	

Determination of Non-Jurisdictional Adjustment:

	<u>Non- Jurisdictional Other</u>	<u>Non- Jurisdictional Gas</u>	<u>Total Non- Jurisdictional</u>
Non-Jurisdictional Rate Base Items –			
Utility Plant in Service	(\$19,127,000)	(\$11,102,340)	(\$30,229,340)
Propane Inventory	0	(1,257,742)	(1,257,742)
Reserve for Accumulated Depreciation	6,722,000	6,987,417	13,709,417
Accumulated Deferred Income Taxes	(1,547,654)	(2,850,922)	(4,398,575)
Investment Tax Credits (3%)	<u>5,415,817</u>	<u>728</u>	<u>5,415,089</u>
Total Net Non-Jurisdictional Adjustment	<u>(\$ 8,536,836)</u>	<u>(\$ 8,222,859)</u>	<u>(\$ 16,759,695)</u>

NOTES:

1. The Total Non-Jurisdictional Adjustment has been allocated to the components of capitalization utilizing the capital structure percentages.
2. The balance for the Gas JDIC was taken from Application Schedule B-6, lines 6 and 7. The JDIC treatment is consistent with previous Commission decisions.

APPENDIX D

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

SCHEDULE OF ADJUSTMENTS

ULH&P Proposals. The following adjustments were proposed by ULH&P in its application, accepted or not opposed by the AG, and have been found reasonable and accepted by the Commission. The “+” indicates an increase while “-” indicates a decrease. The impact these adjustments have on uncollectible accounts, the PSC Assessment, and federal and state income taxes are discussed separately in the Order.

<u>Description</u>	<u>Application Reference</u>	<u>Change to Revenues</u>	<u>Change to Expenses</u>
1. Rate Case Expenses.	Sch. D-2.16	0	+\$65,000
2. Affiliate Company Rents.	Sch. D-2.17	+\$1,097,076	+\$387,624
3. Elimination of Facilities Devoted To Other than ULH&P Customers.	Sch. D-2.19, pg. 1-4 of 6	-\$439,140	-\$431,478
4. DSM-related Revenues and Expenses.	Sch. D-2.21	-\$1,014,000	-\$1,014,000
5. Miscellaneous Expenses.	Sch. D-2.22	0	-\$151,671
6. Unbilled Revenue and Gas Costs.	Sch. D-2.24	+\$81,000	+\$79,000

AG Proposals. The following adjustments were proposed by the AG, accepted in total by ULH&P in its rebuttal testimony, and have been found reasonable and accepted by the Commission. The “+” indicates an increase while “-” indicates a decrease. The impact these adjustments have on uncollectible accounts, the PSC Assessment, and federal and state income taxes are discussed separately in the Order.

<u>Description</u>	<u>Testimony Reference</u>	<u>Change to Revenues</u>	<u>Change to Expenses</u>
1. Injuries and Damages. (Original Adjustment by ULH&P Withdrawn)	Sch. RJH-12	0	0
2. Lobbying Expenses.	Sch. RJH-15	0	-\$12,159
3. Corporate Sponsorship Expenses.	Sch. RJH-15	0	-\$40,120
4. Investment Tax Credits.	Sch. RJH-8	0	-\$69,130
5. Base Payroll Adjustment.	Sch. RJH-13	0	-\$9,900
6. Governmental Affairs Expenses.	Sch. RJH-15	0	-\$11,196

APPENDIX E

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

The Commission has approved the depreciation rates proposed by ULH&P for all plant subaccounts, with the exception for the subaccounts listed below. The following depreciation rates shall be used by ULH&P for these subaccounts.

<u>Subaccount Title and Number</u>	<u>Approved Rate</u>
276.1 Mains – Cast Iron & Copper	0.49%
276.2 Mains – Steel	2.04%
276.3 Mains – Plastic	2.56%
276.5 Mains – Feeder	2.04%
276.7 Mains – Steel	2.04%
276.8 Mains – Plastic	2.56%
280.1 Services – Cast Iron & Copper	0.00%
280.2 Services – Steel	1.35%
280.3 Services – Plastic	2.80%
280.4 Services – Steel	1.35%
280.5-.7 Services – Plastic	2.80%
Composite Rate for Distribution Plant	2.44%

APPENDIX F

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2005-00042 DATED December 22, 2005

INTEREST SYNCHRONIZATION CALCULATION

	<u>Long-Term Debt</u>	<u>Short-Term Debt</u>
Capital Structure Percentages	38.164%	7.382%
Debt Portion of Jurisdictional Gas Capitalization	\$61,622,400	\$11,920,334
Less: Jurisdictional Gas CWIP Subject to AFUDC –		
\$3,465,847 times 38.164%	1,322,706	0
\$3,465,847 times 7.382%	<u>0</u>	<u>255,849</u>
Debt Component less Applicable Portion of Gas CWIP Subject to AFUDC	60,299,694	11,664,485
Debt Component multiplied by appropriate Annual Cost Rates	<u>5.926%</u>	<u>3.875%</u>
Annualized Gas Interest Expense for each Debt Component	<u>\$ 3,573,360</u>	<u>\$ 451,999</u>
Total Annualized Gas Interest Expense		\$ 4,025,359
Forward-Looking Test Period Gas Interest Expense (calculated)		<u>4,114,516</u>
Decrease in Gas Interest Expense		<u>\$ (89,157)</u>
<u>Determination of Income Tax Effect:</u>		
Decrease in Gas Interest Expense		\$ (89,157)
Kentucky Income Tax Rate		<u>7.00%</u>
Kentucky Income Tax Effect of Decreased Gas Interest Expense		<u>\$ 6,241</u>
Decrease in Gas Interest Expense	\$ (89,157)	
Less: Kentucky Income Tax Effect	<u>6,241</u>	
Decrease in Gas Interest Expense – Federal		\$ (82,916)
Federal Income Tax Rate		<u>35.00%</u>
Federal Income Tax Effect of Decreased Gas Interest Expense		<u>\$ 29,021</u>
Total Income Tax Effect of Decreased Gas Interest Expense		<u>\$ 35,262</u>

NOTES:

1. The CWIP Subject to AFUDC has been adjusted to reflect the Slippage Factor Adjustment
2. The calculation of the Forward-Looking Test Period Gas Interest Expense is shown on the second page of this Appendix.

Calculation of Forward-Looking Test Period Gas Interest Expense:

ULH&P reported its book interest expense for the forward-looking test period on a total company basis and a jurisdictional gas operations basis. However, it was not clear how ULH&P arrived at the jurisdictional gas operations interest expense. The Commission has allocated the total company balances between gas and electric operations using the jurisdictional rate base ratio.

Interest on Long-Term Debt:

Total Company Interest on Long-Term Debt (July 15, 2005 Update Filing – Schedule I)	\$14,904,962
Total Company Amortization of Debt Discount & Premium (July 15, 2005 Update Filing – Schedule I)	<u>405,144</u>
Total Company Interest on Long-Term Debt	\$15,310,106
Jurisdictional Rate Base Ratio	<u>25.345%</u>
 Interest on Long-Term Debt – Gas	 <u>\$ 3,880,346</u>

Interest on Short-Term Debt:

The forward-looking test period Other Interest Expense of \$1,230,837 was taken from the July 15, 2005 Update Filing, Schedule I. The Other Interest Expense balance includes items not included in the determination of short-term interest expense. To remove these items, the Commission has allocated the \$1,230,837 in Other Interest Expense to reflect the mix of items reported in ULH&P's FERC Form 2 for 2004.

	<u>FERC Form 2, Page 340</u>	<u>Percentage of Form 2 Totals</u>	<u>Allocation of \$1,230,837</u>
Account No. 430 – Interest on Debt to Assoc. Cos.			
MoneyPool – ULH&P to CG&E	\$ 4,565	0.551%	\$ 6,782
MoneyPool – ULH&P to Cinergy Services	103,536	12.503%	153,892
MoneyPool – ULH&P to Cinergy Corp.	159,705	19.286%	237,379
Account No. 431 – Other Interest Expense			
Customer Deposits	206,446	24.930%	306,848
Gas Refund – PUCO Rule 28	44	0.005%	61
Capital Lease	430,567	51.995%	639,974
Interest – Assigned from Service Company	(76,916)	(9.288%)	(114,320)
Interest – Other	<u>146</u>	0.018%	<u>221</u>
Total Account Nos. 430 & 431	<u>\$ 828,093</u>		<u>\$1,230,837</u>
 Remove Interest Expense not included for Short-Term Debt –			
Customer Deposits			(306,848)
Gas Refund – PUCO Rule 28			<u>(61)</u>
Allocated Interest Expense on Short-Term Debt – Total Company			\$ 923,928
Jurisdictional Rate Base Ratio			<u>25.345%</u>
 Interest on Short-Term Debt – Gas			 <u>\$ 234,170</u>
 Total Forward-Looking Test Period Gas Interest Expense			 <u>\$4,114,516</u>