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August 2, 2004

HAND DELIVERY

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

RE: ***Application of Louisville Gas and Electric Company for an Adjustment of its Gas and Electric Rates, Terms and Conditions***
Case No. 2003-00433

Application of Kentucky Utilities Company for an Adjustment of its Electric Rates, Terms and Conditions
Case No. 2003-00434

Dear Ms. O'Donnell:

Enclosed please accept for filing two originals and five (5) copies each of Louisville Gas and Electric Company's and Kentucky Utilities Company's Response to Attorney General's Petition for Rehearing in the above-referenced matters. Please confirm your receipt of thess filings by placing the stamp of your Office with the date received on the enclosed additional copy and return them to me in the enclosed self-addressed stamped envelope.

Should you have any questions or need any additional information, please contact me at your convenience.

Very truly yours,

Kendrick R. Riggs

KRR/ec
Enclosures
cc: Parties of Record

309580.1

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR AN ADJUSTMENT OF THE GAS AND ELECTRIC RATES, TERMS AND CONDITIONS	))))	**CASE NO. 2003-00433**

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ADJUSTMENT OF THE ELECTRIC RATES, TERMS AND CONDITIONS	))))	**CASE NO. 2003-00434**

LOUISVILLE GAS AND ELECTRIC COMPANY'S
AND KENTUCKY UTILITIES COMPANY'S
RESPONSE TO ATTORNEY GENERAL'S PETITION FOR REHEARING

In response to the Petition for Rehearing ("Petition") of the Attorney General ("AG"), Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") object and state as follows:

I. The Commission Should Deny The AG's Request To Use The Effective Tax Rate

The AG's Petition urges the Commission to grant rehearing on and adoption of the Companies' effective state corporate tax rates in connection with the analysis in the June 30, 2004 orders of the utilities *pro forma* net operating income for electric operations.[1] While a witness for the AG recommended at the hearing an effective tax rate only for LG&E, the Petition

[1] AG Petition for Rehearing, pp. 2-4.

now argues the Commission should adopt the effective tax rates of 8.07% for LG&E and 7.98% for KU.[2]

The June 30, 2004 Orders correctly recognized that the Commission has used the state statutory tax rate in the Companies' past rate cases. In the absence of a more known and measurable and thus reliable tax rate, it is reasonable to continue to use the statutory rate in these cases. As explained by Mr. Rives at the hearing, the Companies' respective effective state income tax rates in 2002 were less than the statutory rates because of credits and apportionment adjustments from out-of-state activities, which may not be present at all or to the same extent in the future.[3] The continuous change in credits and out-of-state activities make the effective tax rate more uncertain and complicated than the statutory rate used in the June 30, 2004 Orders.[4] In contrast, the Kentucky statutory income tax rate of 8.25% is objective, known and measurable, easily understood and verified, and not distorted by non-recurring items or apportionment adjustments from out-of-state activities.

In addition, as shown below, the use of the effective tax rate on the calculation of the income in the electric revenue requirements has a minimal effect:

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[2] Rebuttal Testimony of S. Bradford Rives of April 26, 2004 (Case Nos. 2003-00433 and 2003-00434) ("Rives LG&E and KU Rebuttal"), p. 10. In so doing, the AG apparently has abandoned its claim for the use of the effective tax rate proposed by Mr. Henkes.

[3] Rives LG&E and KU Rebuttal, pp. 9-10.; See Response of LG&E to PSC 2-15(c)(2) and (3); Response of KU to PSC 2-15(c)(2) and (3)

[4] The decision to use an effective tax rate in Case No. 2001-00092 apparently did not involve the issues related to out-of-state taxation of off-system sales.

Impact of State Tax Rate on Revenue Increases

Company	8.25%[5]	Effective Rate [6]	Alternative Proposal[7]
LG&E	$ 45,608,365	$45,103,769	$ 43,400,000
KU	$ 49,775,329	$49,359,219	$ 46,100,000

This demonstrates that whether the Commission uses the statutory rate of 8.25% or the effective tax rates identified by the Companies in the analysis of net operating income, there is only a *de minimis* impact on the Commission's determination on the reasonableness of LG&E's and KU's alternative proposals. Those proposals remain well within the range of reasonableness set forth in the June 30, 2004 Orders.

In sum, the Commission correctly determined the use of the 8.25% statutory tax rate. The Petition fails to show why the Commission's determination should be modified to use the effective tax rate.

II. The Commission Should Deny Rehearing On AG's Petition On The Depreciation Issues

The AG's Petition regarding depreciation is nothing more than a re-argument of contentions already advanced by his witness, Michael J. Majoros. The Petition does not identify any alleged errors of law; does not assert that controlling precedent was not followed; and does not contend that calculation or other quantitative errors were made. The Petition does not contend that issues were presented that the Commission did not decide. The Petition only complains that the Commission should grant rehearing so that Mr. Majoros's arguments can be

[5] Case No. 2003-00434, Order, p. 59; Case No. 2003-000433, Order, p. 68
[6] See LG&E's and KU's August 2, 2004 Data Responses to the PSC's Orders of July 26, 2004
[7] Case No. 2003-00434, Order, p. 59; Case No. 2003-000433, Order, p. 68

reconsidered. While it is true that the Commission rejected Mr. Majoros's depreciation studies,[8] it acted completely within its authority when it did so.

The law in Kentucky and elsewhere is clear that the Commission has the duty and authority to weigh the evidence and determine the credibility of the witnesses. In the famous Dancer's Image case, Kentucky's highest court set forth its description of the rule that should apply to administrative agencies:

> The basic rule in Kentucky was expressed in *Irvin v. Madden*, 281 Ky. 7, 134 S.W.2d 942 (1939), as follows:
>
> ". . . Under a doctrine too well recognized to require citation of authority, the credibility of witnesses and the weight to be given their evidence are matters exclusively within the province of a jury. A jury may accept the evidence of one set of witnesses to the exclusion of that of another or the evidence of one witness as against the evidence of a number of witnesses and may also judge and determine the weight as between the conflicting statements of a single witness."[9]

More recently, the Court of Appeals said,

> To put it simply, "the trier of facts in an administrative agency may consider all of the evidence and choose the evidence that he believes."[10]

The Court of Appeals has held, citing the Dancer's Image case that this Commission has "the exclusive province to pass on the credibility of the witnesses and the weight of the evidence."[11] In a later decision, the Court of Appeals observed:

> Determining the weight of the evidence presented and the credibility of the witnesses is clearly within the exclusive province of the Commission as trier of fact. *Energy Regulatory Commission, supra.* The Commission's decision must be upheld if

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[8] LG&E Order at 33; KU Order at 29.
[9] *Kentucky State Racing Commission v. Fuller*, Ky., 481 S.W.2d 298, 308 (1972).
[10] *Bowling v. Natural Resources and Environmental Protection Cabinet*, Ky. App., 891 S.W.2d 406, 410 (1995), citing *Com. Transp. Cabinet v. Cornell*, Ky. App., 796 S.W.2d 591, 594 (1990).
[11] *Energy Regulatory Commission v. Kentucky Power Company*, Ky. App., 605 S.W.2d 46, 50 (1980).

> the evidence introduced by the company was unpersuasive or if substantial evidence supports the Commission's findings. *Id.*[12]

Under the foregoing standards, this Commission was perfectly justified in choosing not to agree with Mr. Majoros and in rejecting his depreciation study and his methodologies. Indeed, the record demonstrates the basis for the Commission's determination to reject the AG's recommendation. In his direct testimony, Mr. Majoros cited three orders in support of his approach to the treatment of net salvage,[13] but failed to advise the Commission that the two Kentucky rulings cited by Mr. Majoros were substantially qualified or that the Missouri order had been reversed by the Missouri Court of Appeals. He offered a strained interpretation of FERC Order No. 631 that was not defensible under cross-examination.[14] As the Commission noted, the AG's witness selected service lives for contested property accounts that were so weighted toward the lowest rates available that they were unreasonable.[15] When he appeared at the hearing, the AG's witness acknowledged that he had made a mistake in his direct testimony and offered to withdraw an adjustment provided he could explain it. When the "explanation" became improper surrebuttal and was stopped by the Commission, he rescinded his adjustment withdrawal,[16] even though he had admitted that the adjustment was erroneous. He consistently refused to answer questions on cross-examination through the use of obfuscation, lectures and rhetoric.[17] Based on the record of evidence, the AG should not be heard to complain that the Commission did not entertain Mr. Majoros' arguments.

The AG has offered no valid reason to grant rehearing on the depreciation issues. In fact, the Petition is nothing more than a re-argument of the same approach that Mr. Majoros took in

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[12] *South Central Bell Telephone Company v. Public Service Commission*, Ky. App., 702 S.W.2d 447, 451 (1985).
[13] Direct Testimony of Michael J. Majoros, Jr. of March 23, 2004 (Case Nos. 2003-00433 and 2003-00434) ("Majoros Depreciation Direct") at 30-31.
[14] Majoros Depreciation Direct at 28-29; Transcript of Evidence ("T.E."), Volume II at 167-171.
[15] LG&E Order at 33; KU Order at 29.
[16] T.E., Volume III at 136, 141.
[17] T.E., Volume III at 142-171.

his direct testimony and cross-examination. While the Petition implies that the Commission rejected the AG's evidence and accepted without exception the evidence offered by the Companies, the record and the Commission's orders show the Commission rejected the depreciation studies offered by both the Companies and the AG.[18] Having rejected the two studies, the Commission then properly considered the parties' stipulation calling for the use of the depreciation rates that were then in effect as a reasonable resolution of the depreciation rate issues.[19]

A. Rehearing should not be granted to reconsider whether to use existing depreciation rates.

The AG first argues that the existing rates should not be used because Mr. Majoros and the Companies' depreciation witness, Earl M. Robinson, were in agreement on the service lives for several of the accounts of the Companies. He asserts, "There is nothing in the record that would warrant the use of depreciation rates that fail to reflect the matters upon which the only experts in the case were in agreement."[20] The AG is incorrect.

All of the parties to the proceeding (including the AG) executed the Partial Settlement Agreement, Stipulation and Recommendation dated May 12, 2004 (the "Stipulation"). At Section 3.3 thereof, the following text appears:

> The signatories hereto, except the AG, agree that the depreciation rates of the Utilities shall remain the same as approved in the orders of December 3, 2001, in Case Nos. 2001-140 and 2001-141, until the approval by the Commission of new depreciation rates for the Utilities, for which the Utilities shall seek approval by the filings made in their next general rate cases or June 30, 2007, whichever occurs earlier. The Utilities' depreciation filings shall be based on plant in service as of a date no earlier than one (1) year prior to such filing. From and after the effective date hereof, the

[18] LG&E Order at 32, 33; KU Order at 27, 29.
[19] LG&E Order at 35; KU Order at 30.
[20] AG's Petition, p. 4.

> Utilities shall maintain their books and records so that net salvage amounts may be identified.

The Stipulation was entered after the filing of all of the testimony by Mr. Majoros and Mr. Robinson that discussed the service lives for the Companies' property accounts. Thus, when the Stipulation was made, eleven of the twelve parties to the proceeding agreed that the depreciation rates approved in the Global Settlement of December 2001, including their service lives, should be in effect. As a result, at the time the Commission made its decision on the appropriate depreciation rates, it is not true that the "only experts in the case were in agreement." Expert testimony relating to depreciation rates was offered by the AG, the Companies and KIUC. After the Stipulation was made, the Companies and KIUC (as well as nine other parties) agreed that at a minimum the depreciation rates currently in effect and the result of a unanimous settlement agreement approved by the Commission on December 3, 2001[21] should be utilized. Only the AG refused to enter the Stipulation.

The approved depreciation rates were the subject of the Global Settlement dated December 3, 2001, in Case Nos. 2001-140 and 2001-141. The AG was a party to the Global Settlement and specifically agreed in December 2001 to the use of the depreciation rates that he now disclaims.

In arriving at the final orders of June 30, 2004 herein, the Commission carefully evaluated the depreciation studies submitted by both Mr. Majoros and Mr. Robinson. The Commission, clearly acting within its discretionary authority, rejected both studies. Having rejected both studies, the only alternative available is to continue in effect the existing depreciation rates, which is precisely what the Commission did.

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[21] *Application of Kentucky Utilities Company for an Order Approving Depreciation Rates*; Case No. 2001-00140; *Application of Louisville Gas and Electric Company for an Order Approving Revised Depreciation Rates*, Case No. 2001-00141.

B. The existing depreciation rates do not contain "double counted inflation."

The AG next argues that the Commission approved depreciation rates that include "double counted inflation." This argument is based on a gross misinterpretation of the final orders in these proceedings. The AG cites to the statement made by the Commission in both final orders to the effect that the AG's study recognized the Companies' "double counting of inflation."[22] The reference in the orders was not to the rates approved in the Global Settlement, but rather to the rates proposed by Mr. Robinson in his testimony. There is no evidence in this proceeding that the depreciation rates approved in the Global Settlement, and in the final orders, contain "double counted inflation" as the AG would have this Commission believe. Indeed, it is unlikely that the AG would have agreed to them, or that the Commission would have approved them, in December 2001 if the depreciation rates included "double counted inflation."

The AG cites testimony by Mr. Majoros in response to a question by the Chairman at the hearing to support his argument that the existing depreciation rates include "double counted inflation." Again, the AG misinterprets the record. The Chairman asked Mr. Majoros for an example of an asset for which a company has no legal obligation of removal. In response to that question, Mr. Majoros lectured the Chairman about Mr. Majoros's interpretation of SFAS No. 143 and FERC Order No. 631 and, in passing, offered his (unsupported) belief that "the typical way utilities calculated depreciation" prior to those accounting pronouncements was to include an "inflated estimate" of future net salvage.[23] There was no discussion of inflation. There was no discussion of the Global Settlement depreciation rates. There was not even any discussion of the rates proposed by Mr. Robinson.

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[22] LG&E Order at 32; KU Order at 27.
[23] T.E., Volume III at 134-142.

Simply stated, the depreciation rates approved in the final orders do not contain "double counted inflation" and there is no reason for rehearing on the subject.

C. Rehearing should not be granted to reconsider whether to include a five-year average of removal costs in operating expenses rather than the inclusion of removal costs as a component of depreciation rates.

Next, the AG repeats his argument that, in setting depreciation rates, the Commission should include a five-year average of removal costs in operating expenses rather than include removal costs as a component of the depreciation rates.[24] Again, the AG has misinterpreted the final orders. Under the Petition's argument, the Commission purportedly rejected Mr. Majoros's proposed five-year average only because it contains unrepresentative data concerning inter-company transfers. The Petition tells only part of the story. It is true that one of the problems with Mr. Majoros's approach is the existence of unrepresentative data. The Commission, however, went on to say:

> The real question is whether it is reasonable to capitalize the cost of removal in order to recover those costs over the life of the investment. Capitalizing the cost of removal is a common practice and it has been accepted by this Commission for a number of years. The AG has not presented sufficient evidence in this case to persuade us to change this practice.

The AG offers no more evidence on the use of a five-year average of removal costs. Therefore, there is still insufficient evidence to persuade the Commission to change the long standing practice of including these costs within depreciation rates.

The AG argues, alternatively, that the Commission should clarify what net salvage is being charged because he asserts that the net salvage reserve is "many times what the Companies are actually spending."[25] This topic was discussed at length in Mr. Majoros's direct testimony and at the hearing. In each instance, Mr. Majoros offered no support for this assertion. In fact,

[24] AG's Petition, pp. 6-7
[25] AG's Petition, p. 7.

when pushed on the subject on cross-examination, he admitted that no one from the Companies had told him that the Companies would not be spending the money accumulated in the net salvage reserve.[26]

As to the amount of net salvage to be included in depreciation rates going forward, the Companies agreed in Section 3.3 of the Stipulation to "maintain their books and records so that net salvage amounts may be identified." That provision should alleviate any concern that the AG may have about the ability to determine the amount of net salvage in depreciation rates.

D. Rehearing should not be granted to reconsider whether to require the repayment of amounts booked in depreciation reserve.

The final portion of the depreciation sections of the Petition is again nothing more than a re-argument of Mr. Majoros's proposal that the Companies be required to pay back over ten years alleged over-collections of depreciation expenses. The AG also proposes to introduce evidence that he could have, and would have, with the exercise of reasonable diligence, introduced at the former hearing. Rehearing should be denied on the amortized repayments and the proffered evidence should be rejected.[27]

The Commission specifically addressed the alleged over-collections in both final orders; and there is no reason to do so again. The AG offers no new arguments or theories. He simply asserts, with no support, that each utility has over-collected depreciation expense over the years by including a provision for cost of removal in depreciation rates. The AG has elevated the rhetoric with the use of terms such as "phantom expenses," "over-inflated expenses" and "theoretical reserve" in order to divert from the record. There is absolutely no evidentiary support for those statements. In response to this argument after it was initially made, the Commission described the traditional methodology in the final orders and concluded that the

[26] T.E., Volume III at 163-164.
[27] KRS 278.400.

traditional methodology was a better way to deal with the depreciation reserve than Mr. Majoros's approach.

Aside from being improperly offered into evidence, the two attachments included with the Petition do not support the Petition. On Attachments 1 and 2, the AG has set forth dollar amounts of assets, depreciation rates, depreciation expense amounts and the difference between Mr. Majoros's depreciation expense amounts and current depreciation expense amounts. Near the end of the schedules, a row for "10-Year Amortization of Prior Non-Legal ARO Collection" is included. This row cross-references to the Companies' responses to the Commission's First Staff Data Request No. 56(c). The amounts in the 10-Year Amortization row of Attachments 1 and 2 are 1/10th of the total Cost of Removal Depreciation Reserve as of December 31, 2002. The AG also includes in the spreadsheets a presentation of the five-year average of his net salvage allowance as an operating expense. Thus, the attachments tell the Commission what Mr. Majoros has said in several different ways throughout this proceeding: he believes that every single dollar in the reserve was improperly collected and that net salvage should be collected as part of operating expenses.

The Commission again exercised its discretionary authority in choosing to follow the traditional methodology for the treatment of cost of removal, and should reject the AG's final argument for rehearing on depreciation.

Conclusion

The Commission should issue an order denying the Attorney General's Petition for Rehearing for the reasons stated herein.

Dated: August 2, 2004

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Response was served on the following persons on the 2nd day of August 2004, U.S. mail, postage prepaid:

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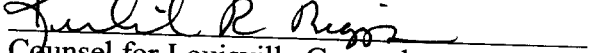

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