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PUBLIC SERVICE COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

In the Matter of:

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

REBUTTAL TESTIMONY

OF

MICHAEL S. BEER

VICE PRESIDENT – RATES AND REGULATORY
LOUISVILLE GAS AND ELECTRIC COMPANY
KENTUCKY UTILITIES COMPANY

Filed: April 26, 2004

1 **Q. Please state your name, position and business address.**

2 A. My name is Michael S. Beer. I am the Vice President of Rates and Regulatory for
3 Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company
4 ("KU") (collectively "the Companies"). My business address is 220 West Main Street,
5 Louisville, Kentucky.

6 **Q. Have you previously testified in this proceeding?**

7 A. Yes. I filed direct testimony in this case on December 29, 2003 on behalf of LG&E and
8 KU. A statement of my qualifications was attached as Appendix A of that testimony.

9 **Q. What is the purpose of your rebuttal testimony?**

10 A. The purpose of my testimony is to rebut certain contentions concerning the calculation of
11 LG&E's and KU's revenue requirements raised by: (1) Robert Henkes for the Office of
12 the Attorney General ("AG"); (2) Kevin Higgins on behalf of The Kroger Co.
13 ("Kroger"); (3) Lane Kollen for the Kentucky Industrial Utility Customers, Inc.
14 ("KIUC"); (4) Geoff Young for the Kentucky Division of Energy ("KDOE"); (5) Keith
15 Valade on behalf of Metro Human Needs Alliance ("MHNA"); (6) Jack Burch for
16 Community Action Council ("CAC"); and (7) Kip Bowmar on behalf of the Kentucky
17 Association for Community Action ("KACA").

18 **MISO**

19 **Q. Mr. Henkes agrees with LG&E's proposal to include the ongoing annual MISO**
20 **schedule 10 administrative costs in its base rates. However, he disagrees with**
21 **LG&E's recommendation to file a limited rate proceeding should the Commission**
22 **order LG&E to withdraw from MISO. Do you agree?**

23 A. No. Mr. Henkes recommends that, if LG&E is ordered to exit MISO, the newly-
24 established base rates should continue to remain in effect without any change for the net

1 impact of the removal of the $3.3 million base rate recovery and the addition of the
2 amortization of the MISO exit fee in the regulatory asset account. Mr. Henkes further
3 recommends that LG&E should be ordered to establish a regulatory liability account for
4 the continued $3.3 million annual base rate recovery of MISO Schedule 10 costs it would
5 no longer incur, which should be used to offset the MISO exit fee in the regulatory asset
6 account in LG&E's next electric base rate proceeding.

7 LG&E does not object to Mr. Henkes' recommendation, so long as four
8 conditions are met: (1) FERC issues an Order authorizing the Company's exit from
9 MISO; (2) FERC lawfully establishes the appropriate amount of the MISO exit fee; (3)
10 MISO Schedule 10 charges concurrently cease at the time of the Company's exit from
11 MISO and incurrence of the exit fee; and (4) revenues associated with the MISO
12 Schedule 10 charges be recorded in a regulatory liability account and will offset the
13 FERC-approved MISO exit fee until the Company's next base rate proceeding.

14 **OMU NO_x Compliance**

15 **Q. Mr. Kollen says that the Commission should reject the Company's post-test year**
16 **adjustment to increase purchase power expenses for costs associated with OMU**
17 **NO_x compliance. Do you agree?**

18 A. No. The adjustment proposed by KU for the environmental compliance costs associated
19 with the OMU purchases is appropriate under 807 KAR 5:001, Section 10(1)(a), because
20 it is known and measurable. Mr. Kollen argues that KU should seek recovery of these
21 costs through the ECR mechanism. While the ECR does permit recovery of
22 environmental compliance costs that are not already included in base rates, KRS 278.183
23 does not prohibit the inclusion of environmental compliance costs in base rates. KU's
24 portion of the OMU NO_x compliance costs is not currently included in the filed KU ECR

1 plan. Although KU could seek Commission approval to amend its ECR plan to include
2 these costs, it is no less appropriate to seek the recovery of these known and measurable
3 costs in base rates. Nonetheless, should the Commission deny KU recovery of these
4 costs in base rates, the order in this proceeding should clarify that the OMU NO_x
5 compliance costs can be recovered through KU's ECR mechanism effective for the July
6 2004 expense month.

7 **Merger Surcredit**

8 **Q. Please comment on Mr. Higgins' recommendation that the Commission disregard**
9 **several key provisions in the unanimous 2003 Merger Surcredit settlement**
10 **agreement that secured the shareholder portion of the merger savings.**

11 A. In 2003, LG&E, KU, the AG, KIUC and Lexington-Fayette Urban County Government
12 ("LFUCG") submitted a unanimous settlement agreement continuing the merger surcredit
13 for an additional five years. The Commission reviewed and approved the agreement,
14 finding the settlement to be a reasonable resolution of the issues raised in the case.

15 With regard to Mr. Higgins' argument, it should be noted, as an initial matter, that
16 Kroger elected not to intervene or participate in any way in the original LG&E and KU
17 merger proceeding, the performance-based ratemaking proceedings in Case Nos. 1998-
18 00426 and 1998-00474, or the merger surcredit proceedings. As a result, Kroger should
19 not now be heard to complain about or attempt to interpret the merger surcredit
20 settlement agreement. In addition, two of the parties who participated in the Merger
21 Surcredit settlement agreement, KIUC and the AG, have expressed their continued
22 support for the agreement. See KIUC's Response to Commission Staff's First Data
23 Request, Case No. 2003-00433, Item No. 4b ("This settlement was negotiated in good
24 faith among the parties and was approved by the Commission. The Company is entitled

1 to rely upon its terms. If the Company and other parties to such settlements cannot rely
2 upon their implementation once approved by the Commission, then it will discourage
3 such settlements in the future."); KIUC's Response to Commission Staff's First Data
4 Request, Case No. 2003-00434, Item No. 6b; AG's Response to PSC Order dated April 6,
5 2003, Case No. 2003-00433, Question No. 11; and AG's Response to PSC Order dated
6 April 6, 2003, Case No. 2003-00434, Question No. 5.

7 Mr. Higgins argues that the Companies' proposed adjustment to reflect the
8 shareholder portion of merger savings results in the elimination of any future benefits to
9 customers. It is clear that his objective is to allow the embedded savings to overstate the
10 calculation of the Companies' returns. His claim is not supported by the evidence of
11 record. In fact, the Commission itself recognized in its January 7, 2000 Orders in Case
12 Nos. 1998-00426 and 1998-00474, that the adjustment to the Companies' revenue
13 requirement is necessary to "secure the shareholder portion of the merger savings."
14 Orders, pp. 82 and 80, respectively. By arguing that the Commission should disregard
15 those provisions of the settlement agreement that require the shareholders' portion of the
16 merger savings to be recognized as an upward adjustment to expense in a base rate case,
17 Mr. Higgins is asking the Commission to deny shareholders the equitable treatment that
18 was negotiated as a part of the settlement agreement. In exchange for continued sharing
19 of merger savings with customers on a 50/50 basis for an additional five years, allocation
20 of 47% of the customer portion of the savings to LG&E and 53% to KU, lump-sum
21 payments to KIUC and LFUCG, a $700,000 increase to LG&E's and KU's other
22 customers, the Companies were promised that they would continue to receive the existing
23 ratemaking treatment of the merger savings via the merger Surcredit, the Earnings

1 Sharing Mechanism, and base rates. The Commission reviewed and approved each of
2 these provisions that were negotiated in good faith. Selective enforcement of the
3 settlement agreement eliminates the benefits negotiated by the Companies and is a
4 results-oriented conclusion designed to eliminate the benefit of the Companies' bargain.

5 The claim that the Commission has the authority to reconsider merger savings in
6 the context of a rate case is also contrary to sound public policy, and will create an
7 environment whereby settlement of matters pending before the Commission will be
8 impossible. If a written unanimous settlement agreement between the Companies and
9 other consumer groups, like the AG (representing all consumers), the KIUC (representing
10 industrial customers), and LFUCG (a municipality representing its citizens), and
11 approved by the Commission, may be set aside only nine months later and less than one-
12 fifth of the way into its five year term, there will be no regulatory certainty derived from
13 settlement and thus no rational reason to ever enter into such agreements in the future by
14 any regulated company in Kentucky. And, in the event of such a punitive and arbitrary
15 decision, the Commission would need to allow LG&E and KU to recover their one-time
16 payments to certain industrial customers and LFUCG through one-month billings for the
17 sums, and to recover the merger surcredit amounts billed to date from their customers
18 over the same period of time. Absent this relief, the impact of such an order would result
19 in the unlawful confiscation of the shareholders' property.

20 **Q. Please discuss Mr. Higgins' contention that the "treatment of merger savings in a**
21 **general rate case was not the fundamental issue in those cases."**

22 A. As acknowledged by Mr. Higgins, Kroger did not participate in the merger surcredit
23 proceedings and was not a party to the negotiations leading to settlement. As a result, his

1 assertion of which issues were fundamental to the case is purely speculative. In fact, a
2 closer look at the evidence of record demonstrates that the issue was a key element in the
3 settlement. The letter I sent to the Commission on August 25, 2003 enclosing the
4 executed Settlement Agreement expressly notes that, if the shareholder portion of the
5 savings are included in the Companies' base rates or other ratemaking mechanism at the
6 end of the tenth year of operation of the Merger Surcredit mechanism, the Merger
7 Surcredit tariffs will remain in effect until otherwise ordered by the Commission.
8 Additionally, treatment of the Merger Surcredit in the event of a base rate proceeding is
9 expressly mentioned in three separate provisions of the Settlement Agreement. <u>See</u>
10 Sections 3.1.2, 3.2.2 and Section 4.1 of the Settlement Agreement.

11 **Q. Mr. Young also recommends elimination of the Merger Surcredit. Do you agree**
12 **with that recommendation?**

13 A. No. The basis for his recommendation is his concern that there are "far too many
14 adjustment clauses" which make "the price of electricity less understandable and
15 predictable for customers." This criticism is misplaced. As I discuss later in my
16 testimony, the various adjustment clauses and riders in place exist for good reason and
17 provide customers with meaningful information about the cost of their gas or electric
18 service. The Merger Surcredit mechanism has worked well for almost six years and we
19 are unaware of any customer complaints about its presence on the monthly bill. This
20 mechanism provides customers their fifty-percent share of the LG&E/KU merger savings
21 pursuant to the Settlement Agreement approved by the Commission in a clear, easy to
22 understand, and readily-accepted method. For these reasons, and for all of the same
23 reasons discussed above, that recommendation should be rejected.

1 **Value Delivery Team ("VDT") Surcredit**

2 **Q. Mr. Higgins also recommends that the Commission disregard the provisions**
3 **contained in the VDT settlement agreement by canceling the VDT surcredit rider as**
4 **well as the expense adjustment of the shareholder portion of the VDT savings. Do**
5 **you agree?**

6 A. Absolutely not. Mr. Higgins' recommendation is another example of results-oriented
7 ratemaking that is unbalanced and punitive in a case in which Kroger again did not
8 participate in any way. Mr. Higgins' recommendation, if adopted, would now award
9 100% of the VDT savings to customers. This would be a punitive result, particularly in
10 light of the Companies' almost $200 million investment to achieve VDT savings. Such
11 action would also send a clear message of discouragement to utilities from pursuing
12 initiatives to achieve efficiencies. This is so because the policy of the Commission would
13 be clearly established: benefits from such investments will not be shared fairly between
14 shareholders and customers. This is not reasonable regulation by any means, and is
15 certainly not revenue neutral to the shareholders as Mr. Higgins contends.

16 In these proceedings, LG&E and KU are seeking the same regulatory treatment
17 for the shareholders' portion of the VDT savings as the Commission approved for the
18 shareholders' portion of the LG&E/KU merger savings in Case Nos. 98-474 and 98-426.
19 Setting aside a unanimous settlement agreement that has been approved by the
20 Commission simply because the Companies had to file rate cases punishes the
21 Companies for facing cost increases beyond their control. LG&E and KU should be
22 fairly rewarded for their efforts to achieve savings and for avoiding rate cases for 13 and
23 20 years respectively.

1 **Q. Do you agree with Mr. Higgins' assertion that the Commission should not approve**
2 **an adjustment for the shareholders' portion of the VDT savings, because "whatever**
3 **the merit of the VDT activities has been, it has not been enough to avoid" the rate**
4 **increase?**

5 A. No. As demonstrated in the rebuttal testimony of Ms. Scott, significant savings were in
6 fact achieved as a result of the VDT initiative. As a result, the Companies have been able
7 to delay filing a rate case until now. Additionally, the size of the rate increase requested
8 by the Companies is smaller than it otherwise would have been in absence of the VDT
9 initiative. There are no provisions in the Settlement Agreement which prohibit the
10 Companies from filing for a rate increase at any time. Simply because the savings
11 achieved by the VDT activities were not enough to allow LG&E and KU to completely
12 avoid filing a rate case through the term of the VDT Settlement Agreement or March,
13 2006 is not cause today to punish the Companies' shareholders three and half years into
14 the term of the VDT Settlement Agreement. Sound public policy recognizes that
15 unanimous written settlement agreements provide regulatory certainty and acknowledges
16 that regulation is a two-way street. Just as in the case of the negotiated settlement of the
17 Merger Surcredit, two of the parties who participated in the VDT settlement agreement,
18 KIUC and the AG, have expressed their continued support for the agreement. See
19 KIUC's Response to Commission Staff's First Data Request, Case No. 2003-00433, Item
20 No. 1c(1); KIUC's Response to Commission Staff's First Data Request, Case No. 2003-
21 00434, Item No. 1c(1); AG's Response to PSC Order dated April 6, 2003, Case No.
22 2003-00433, Question No. 11; and AG's Response to PSC Order dated April 6, 2003,
23 Case No. 2003-00434, Question No. 5.

1 **Q. Mr. Young also recommends termination of the VDT surcredit. Do you agree?**

2 A. No. For the reasons previously discussed in response to his contention concerning the
3 Merger Surcredit, Mr. Young's recommendation to terminate the VDT surcredit should
4 also be rejected. The VDT Surcredit mechanism, like the Merger Surcredit mechanism,
5 has worked well for almost three and a half years without a single customer complaint
6 about its presence on the monthly bill. This mechanism provides customers their forty-
7 percent share of the VDT savings in a clear, easy to understand, and readily-accepted
8 format. The Companies and their customers have been treated fairly and equitably under
9 the terms of the settlement agreement for the last three and a half years. Mr. Young now
10 wants to set aside the entire agreement and upset the balance that was reviewed and
11 approved by the Commission by shifting 100% of the VDT savings to customers.

12 **Q. Mr. Higgins and Mr. Kollen contend that the Companies' Merger Surcredit and**
13 **VDT Surcredit are currently scheduled to terminate on June 30, 2008, and March**
14 **31, 2006, respectively, and recommend, upon termination of those surcredits, the**
15 **Companies' base rates be adjusted downward to remove all related costs in the**
16 **revenue requirement. Do you agree?**

17 A. No. First, the Merger Surcredit will not terminate on June 30, 2008 if the Commission,
18 consistent with its prior ratemaking treatment of the shareholders' portion of the merger
19 savings in Case Nos. 98-474 and 98-426 and the express terms of the Settlement
20 Agreement it approved on October 3, 2003, approves the adjustment to increase expenses
21 to secure the shareholders' portion of the merger savings. Pursuant to Section 4.1 of the
22 Settlement Agreement, the Merger Surcredit will continue "in effect following the

1 expiration of the tenth year until such time as the Commission issues an order on its
2 future disposition."
3 Secondly, the fact that the VDT Surcredit terminates on March 31, 2006 does not
4 cause LG&E's or KU's returns to become unreasonable or otherwise excessive. The
5 question is whether LG&E and KU are earning a fair rate of return on their electric and
6 gas operations at that time under then-existing economic circumstances. Pursuant to
7 Case No. 97-300, LG&E and KU file quarterly balance sheets and income statements
8 with the Commission indicating their earned regulated returns. If those returns indicate
9 that the Companies are earning excessive returns, the Commission can, on its own
10 motion, open investigations into their earnings, or customers can file rate complaints.

11 **ESM**

12 Q. **Mr. Kollen recommends in his testimony that the Commission should discontinue**
13 **the Earnings Sharing Mechanism ("ESM"). Do you agree?**

14 A. No. For the reasons stated in my rebuttal testimony in the ESM proceedings, the
15 Companies recommend that the ESM should continue under its existing terms, renewing
16 both the current 200 basis point dead band and the existing 60 percent shareholder/40
17 percent customer sharing outside the deadband, but resetting the return on equity value
18 with the return established by the Commission in these base rate cases. However, if the
19 Commission decides to modify the terms of the ESM, the Companies request a
20 reasonable period of time to determine whether they will continue to operate under those
21 modified terms.

22 Q. **Do the Companies' base rate filings have the effect of rejecting the ESM form of**
23 **regulation?**

1 A. Absolutely not. As discussed in my rebuttal testimony in the ESM proceedings, the filing
2 of the base rate cases did not reject the ESM form of regulation. The contention to the
3 contrary assumes that the base rate cases and the ESM are mutually exclusive forms of
4 regulation. The Companies do not agree with this premise. As the auditor for the
5 Commission concluded in its report, the ESM is like "traditional regulation with a shock-
6 absorber." *Focused Management Audit of Louisville Gas and Electric's and Kentucky*
7 *Utilities' Earning Sharing Mechanism*, Final Report ("Audit Report"), pp. I-19 and V-4,
8 August 31, 2003. Mr. Young's testimony seems to agree with this conclusion as well.
9 And, resetting base rates should mitigate the concern of the ESM auditor, as well as of
10 KIUC (which is based solely upon the Audit Report), that the ESM is likely to operate in
11 an under-recovery position during the reporting periods for the second-half of 2004 and
12 all of 2005 as a result of inadequate electric base rates. Audit Report, p. I-10. In fact, if
13 base rates are appropriately set in these proceedings, at least initially, the Companies
14 could reasonably expect to operate within the ESM deadband, instead of operating in an
15 under-recovery mode.

16 **Q. Mr. Kollen has testified that the ESM was intended as an alternative, rather than a**
17 **supplemental, form of regulation. Do you agree?**

18 A. No, I do not. In its Orders of January 7, 2000 in Case Nos. 1998-00426 and 1998-00474,
19 at pages 43 and 40, respectively, the Commission expressly recognized that "within an
20 ESM, the initial rates and earnings levels are typically set by traditional rate of return
21 methods" and acknowledged that the Companies could seek to "subsequently adjust"
22 their base rates. Indeed, the Commission conducted an extensive rate review of LG&E's
23 and KU's base rates and reset them at the start of the original three-year ESM. The

1 Companies' current base rates need to be reset at fair, just and reasonable levels. Those
2 reset rates will only affect the last six months of the 2004 ESM Reporting Period. For
3 that reason, LG&E and KU have proposed that two six-month reporting periods be used
4 in 2004 for purposes of calculating the ESM. The change in base rates on July 1, 2004
5 will have no impact on the 2003 ESM reporting period.

6 Q. **Mr. Kollen also testified that the ESM has not been an effective incentive to the**
7 **Companies to operate more efficiently. Please comment on that testimony.**

8 A. While the ESM has not served as the impetus for providing customers outstanding value
9 in retail electric service through a combination of low rates and exceptional service, it has
10 served to re-enforce existing corporate initiatives to achieve efficiency and customer
11 service. The ESM has also provided a timely means of mitigating the effects associated
12 with over- and under-earnings by providing an appropriate balance between the interests
13 of shareholders and ratepayers as envisioned by the Commission in its orders adopting
14 the ESM.

15 Q. **Do you agree with Mr. Kollen's recommendation that the Commission should**
16 **discontinue the billing of the 2003 ESM charge effective July 1, 2004, when the**
17 **change in electric base rates becomes effective?**

18 A. No. As discussed above, the change in base rates and the operation of the ESM
19 mechanism are not, as Mr. Kollen asserts, "mutually exclusive" simply because they are
20 "alternative" or different forms of regulation. Changes in base rates have occurred for
21 years with other rate mechanisms. The ESM is not a prospective mechanism, as Mr.
22 Kollen contends, but is instead a retrospective mechanism that looks back over the results
23 of the 12 month Reporting Period in question. This is no different than the fuel

1 adjustment clause or the gas supply clause, which examines the costs incurred
2 retrospectively after the reporting period has closed and allows for the deferred billing of
3 those actual costs over a limited period of time. Prior interpretation and application of
4 the ESM demonstrates that the mechanism is a retrospective look at the Companies'
5 revenues and expenses. First, in approving the ESM, the Commission established a 200-
6 basis point deadband in order to account for extraordinary events. Second, the
7 Commission approved the use of 13-month average capitalization for purposes of the
8 ESM, rather than the typical end-of-test period approach typically followed in
9 prospective rate-setting mechanisms. Third, the number of ratemaking adjustments
10 permitted during the annual ESM review is extremely limited in order to allow the pass-
11 through of the Companies' actual revenues and expenses. See Commission's Orders of
12 June 1, 2000 in Case Nos. 1998-00426 and 1998-00474, p. 14. (LG&E and KU "should
13 use actual revenues, rather than estimated revenues, in the derivation of [their] future
14 ESM factors.") Finally, the Commission's letter of April 4, 2003 denying KU's request
15 to accumulate and defer the actual storm-related costs associated with the February, 2003
16 ice storm confirms that the ESM was designed to "reflect actual revenues and expenses."
17 Base rates, in contrast, are designed to be representative levels of costs that are
18 anticipated in the future and can continue for years without adjustment. LG&E's and
19 KU's electric base rates are very good examples. Base rates are designed by adjusting a
20 test year to reflect anticipated levels of costs on a going-forward basis through known
21 and measurable changes in the test year. Base rates are thus set to recover categories of
22 costs at levels that are anticipated in the future. As costs change over time, the
23 Companies attempt to manage the changes in costs, offsetting the increases in costs

1 against the decreases or efficiency gains in order to allow base rates to produce a
2 reasonable return. Thus, there is no double recovery in these cases and the 2003 ESM,
3 because the adjusted test period for establishing the new base rates reflects a level of
4 representative costs, not specific costs, to be experienced on a going forward basis
5 beginning July 1, 2004.

6 There also will be no double- or under-recovery of costs through these concurrent
7 rate mechanisms. If the current ESM is terminated on June 30, 2004 and the change in
8 base rates is effective July 1, 2004, customers will pay rates based on the then-existing
9 mechanism. For the first six months of 2004, customers will be billed their share of any
10 charge resulting from the 2003 ESM calculation after-the-fact as is currently the case.
11 Clearly, if the new ESM is approved effective July 1, 2004 with the change in base rates,
12 that mechanism will measure the change in base rates for the second half of 2004. The
13 billing of the 2003 ESM will allow LG&E and KU to recover only 40 percent of their
14 earnings shortfall for the 12 month period ending December 31, 2003.

15 Q. **Mr. Kollen also criticizes the Companies for, in his words, failing to disclose their**
16 **plans to file a base rate case to the Commission's auditor during the conduct of the**
17 **ESM management audit. Does that criticism have any merit?**

18 A. No, it does not. To begin with, Mr. Kollen's criticism is based on the assumption that the
19 Companies had made the final decision to file their rate cases on or before June 1, 2003,
20 and that assumption is incorrect. Although the Companies expected to seek base rate
21 increases in the near term, and were certainly considering filing those cases by the end of
22 2003, no final decisions had been made. Some initial preparations for the filings were
23 being undertaken in June 2003, due to the magnitude of the work involved in presenting

1 these cases, but, again, no final decision had been made to seek base rate increases at that
2 time. It is important to note that, in June of 2003, the Companies did not even know the
3 results of the test period for the year ended September 30, 2003. Nonetheless, during the
4 audit process, the auditors were made aware of the Companies' position that they could
5 seek base rate increases while also operating under the ESM, and that the Companies
6 might in fact file rate cases at some point in the future, whether five months or five years
7 from that time. The auditors agreed with the need for the Companies to change their base
8 rates and concurred with the Companies' position that filing for a change in base rates did
9 not conflict with the ESM, because the ESM acts as a "shock absorber." Further, the
10 auditors have acknowledged that there are no restrictions that would preclude the filing of
11 a base rate proceeding during the operation of the ESM. See BWG's Response to the
12 First Set of Data Requests of KIUC dated September 29, 2003, Case Nos. 2003-00334
13 and 2003-00335, Question No. 9.

14 **Q. Do you agree with Mr. Kollen's assertion at pages 45-46 of his testimony that, if the**
15 **ESM is not discontinued, the Commission "should annualize the mid-year 2004 rate**
16 **increases as if they were in effect the entire year"?**

17 A. No, I do not. Annualizing the base rate increases and using the newly-approved return on
18 equity for the entire 2004 calendar year would unfairly overstate the Companies' earned
19 returns. During the first year of the ESM, because the rate reductions did not become
20 effective until March 1, 2000, the Companies' jurisdictional revenues for calendar year
21 2000 were annualized in order to reflect the rate reductions for that entire year. While
22 annualization during the first year of the ESM only affected two months, in the pending
23 cases, different rates and likely a different return on equity will be in effect for six

1 months of the year. The period of time which LG&E and KU will be operating under the
2 new rates and return on equity will be equal to the period of time the Companies will
3 have operated under the existing rates and return on equity. As a result, shareholder and
4 customer interests will be equally balanced only if the Commission uses the current rates
5 and return on equity for the first half of the year and the newly-approved rates and return
6 on equity for the second half. Once again, Mr. Kollen's recommendation to annualize the
7 base rate increase for the entire year is clearly results-oriented and should be rejected.

8 **Q. Do you agree with Mr. Kollen's recommendation at page 20 of his testimony that if**
9 **the ESM is extended, the ESM should be computed using average monthly**
10 **capitalization rather than year end capitalization?**

11 A. Yes. Typically, the Commission uses test-period-end capitalization for traditional
12 ratemaking proceedings that are prospective in nature. See Commission's Orders of
13 January 7, 2000 in Case No. 1998-00426 and 1998-00474 setting the appropriate level of
14 electric capitalization for LG&E's and KU's base rates. In its Order of December 3,
15 2001 approving the Global Settlement, however, the Commission approved the use of a
16 thirteen-month average capitalization when calculating LG&E's and KU's earned returns
17 for purposes of the ESM in calendar years 2001 and 2002. This approach is appropriate
18 for mechanisms that are retrospective in nature. LG&E and KU agree that this
19 methodology should also be applied on a going-forward basis.

20 **Q. Do you agree with Mr. Kollen's recommendation that the ESM, if continued, should**
21 **be conditioned upon an agreement from the Company that it will refrain from**
22 **seeking another base rate increase during the term of the ESM?**

1 A. No, I do not. The recommendation of such a condition is premised on the argument that
2 the ESM is an alternative, not a supplemental, form of regulation. For all of the reasons
3 discussed above, that entire premise is incorrect. The Companies have a right to seek a
4 base rate increase whenever needed, the use of a complimentary ratemaking tool such as
5 the ESM does not supplant that right, and it is critical that the Companies maintain the
6 flexibility to seek additional increases in base rates if circumstances warrant. It is
7 important to note that there will be no double recovery of costs from ratepayers under the
8 Companies' proposal. Nonetheless, should the Commission determine to modify the
9 terms of the ESM, including conditioning its continuance upon a stay-out provision, the
10 Companies request a reasonable period of time in which they may determine whether
11 they can reasonably operate under those modified terms.

12 <u>**System Sales Clause**</u>

13 **Q. Please comment on Mr. Kollen's recommendation that the Commission should**
14 **implement a System Sales Clause for the Companies.**

15 A. Mr. Kollen recommends that a System Sales Clause be implemented for the Companies
16 based in part on the notion that the Companies will be able to make additional off-system
17 sales in the future as the result of additional capacity (Trimble County 7-10) being added
18 to the system and being paid for by the ratepayers. Mr. Kollen contends that, "as a matter
19 of equity, if the ratepayers are required to pay for this capacity, then they should benefit
20 at least in part from the additional off-system sales margins that will be achieved due to
21 this capacity". What Mr. Kollen overlooks is that the additional capacity being added in
22 2004 and the recent capacity additions over the last several years have been natural gas
23 fired combustion turbines. These units have not been, and are not being, added to allow
24 for additional off-system sales. Rather, they are being added to ensure that the

1 Companies are able to reliably serve the peak demand requirement of their native load
2 customers. Typically, the market price throughout the non-summer months is not high
3 enough to allow for sales from combustion turbines. During the summer months when
4 prices have the potential to be higher than the operating cost of the combustion turbines,
5 the native load demand is also at its highest; thus requiring the combustion turbines to be
6 available to serve native load demand. The ratepayer will always have first call upon this
7 additional capacity.

8 The Companies believe that the ESM already provides for the equitable sharing of
9 off-system sales margins and thus, a separate tracker for these margins is unnecessary.
10 Nevertheless, should the Commission determine not to extend the Companies' ESM, an
11 off-system sales tracker may have some merit. For a number of reasons, however, the
12 Companies do not agree that such a mechanism should be patterned after the Kentucky
13 Power Company Sales Clause. To begin with, since the merger of LG&E Energy Corp.
14 and KU Energy Corporation, the generation and transmission system of LG&E and KU
15 have been operated and planned on an integrated basis. As a result, the KU/LG&E
16 system is completely different from Kentucky Power's system. Additionally, the
17 Companies have not had a sufficient opportunity in which to completely evaluate
18 Kentucky Power's sales clause mechanism and its operation. While the Companies have
19 not identified a specific mechanism that would be applicable to their operating system,
20 LG&E and KU are open to consideration of a tracking mechanism that would establish a
21 reasonable base amount and result in the equitable sharing of risks and rewards between
22 shareholders and customers.

23

1 **Elimination or Consolidation of Certain Ratemaking Mechanisms**

2 Q. **Mr. Young has recommended the elimination of the Fuel Adjustment Clause, and**
3 **has testified that the price of coal is relatively stable. Is that recommendation**
4 **reasonable?**

5 A. No, it is not. The Companies, like most every electric utility in Kentucky, have Fuel
6 Adjustment Clauses as permitted by 807 KAR 5:056, and those clauses have worked well
7 for decades. Mr. Young has offered no quantitative analysis to support his testimony on
8 this point. Moreover, his claim that the price of coal in Kentucky has historically been
9 stable is completely inaccurate. The Companies' experience and fuel adjustment clause
10 filing have shown that coal pricing is subject to significant fluctuations.

11 Q. **Mr. Young criticizes the Companies' proposed rate structure on the ground that it**
12 **rewards the utilities for investing in supply-side resources and penalizes investment**
13 **in and cooperation with demand side management programs. Instead, Mr. Young**
14 **argues that revenue indexing is the easiest way to resolve this problem. Specifically,**
15 **he recommends that the DSM recovery mechanism should be converted into a**
16 **revenue indexing mechanism based upon "statistical recoupling." Will you please**
17 **comment on that testimony?**

18 A. The Companies should not be penalized for customers failing to achieve energy
19 efficiency gains. While the Companies encourage customers to wisely use energy, any
20 energy conservation efforts are dependent upon the actions of customers. Mr. Young
21 admits that, under revenue indexing, energy pricing is also subject to tremendous
22 fluctuations that may result from external factors completely out of the control of the
23 utility or its customers. Price volatility can, of course, be a source of extreme customer

1 dissatisfaction. For these reasons, we do not believe that revenue indexing would be the
2 most effective way of regulating the Companies, or that it would be of benefit to our
3 ratepayers.

4 **Q. Mr. Young has also recommended the elimination of the Environmental Cost**
5 **Recovery Surcharge. Do you agree with that recommendation?**

6 A. No. KRS 278.183 provides that utilities are entitled to the current recovery of their costs
7 of meeting with environmental compliance requirements. The elimination of the ECR
8 surcharge is thus an issue of public policy to be addressed by the Kentucky General
9 Assembly.

10 **Q. Please comment on Mr. Young's recommendation that the Franchise Fee and**
11 **School Tax riders should be combined into a single adjustment factor.**

12 A. The Companies believe that consolidation of these factors could result in customer
13 confusion and reduce understanding of the reasons for certain costs contained on
14 customer bills. The Commission has affirmatively stated that "[c]onsumers have a right
15 to know the amount of such charges collected from them for government operating
16 expenses." *In the Matter of: General Adjustment of Rates of Kentucky Utilities*
17 *Company*, Case No. 7804, Order of October 1, 1980, p. 12. The Commission has also
18 expressly required that franchise fees assessed by local governments be listed on
19 consumers' bills as a separate item and identified as such. Id. at p. 13. Additionally,
20 KRS 160.617 requires any utility that increases its rates to pay for the school tax to
21 "separately state on the bills sent to its customers the amount of such increase and shall
22 identify such amount as "Rate increase for school tax." Mr. Young has offered no
23 compelling reason to support his recommended departure from longstanding billing

1 practices. These factors should not be consolidated and should continue to be identified
2 as separate line items on customer bills.

3 **Energy Assistance Programs**

4 **Q. Mr. Burch, Mr. Bowmar, and Mr. Valade each advocate the establishment or**
5 **expansion of energy assistance programs to assist low income customers in**
6 **managing their energy bills. Please comment on that testimony.**

7 A. Although the Companies recognize the burden of any increased cost on low income
8 households, the establishment or expansion of an energy assistance program is not a
9 proper matter for consideration in this proceeding. LG&E's Home Energy Assistance
10 pilot program proved to be an extremely unpopular program with many of our customers.
11 However, the Companies understand that many of our low-income customers may have
12 difficulty in paying their bills. As a result, LG&E and KU strive to better serve those
13 customers by offering a variety of payment options, as well as assistance through
14 programs such as Winterhelp, Wintercare, Project Warm and WeCare.

15 **Q. Does this conclude your testimony?**

16 A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Michael S. Beer**, being duly sworn, deposes and says he is the Vice President of Rates and Regulatory for Louisville Gas and Electric Company, that he has personal knowledge of the matters set forth in the foregoing testimony, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

MICHAEL S. BEER

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 23rd day of April 2004.

Carol A. Hardison (SEAL)
Notary Public

My Commission Expires:

August 5, 2004