COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF KENTUCKY UTILITIES COMPANY FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY TO CONSTRUCT FLUE GAS DESULPHURIZATION SYSTEMS AND APPROVAL OF ITS 2OO4 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	Case No. 2004-00426

and

THE APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR APPROVAL OF ITS 2OO4 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	Case No. 2004-00421

BRIEF OF

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

I. INTRODUCTION

On January 10, 2005 Kentucky Utilities Company ("KU") and the Louisville Gas & Electric Company ("LG&E") (collectively the "Companies") filed their Applications for approval of their 2004 environmental compliance plans with the Kentucky Public Service Commission ("Commission"). The Kentucky Attorney General ("AG") and the Kentucky Industrial Utilities Customers, Inc. ("KIUC") intervened.

II. SUMMARY

The costs associated with LG&E's 2004 environmental compliance plan are relatively small. However, the fixed costs associated with the installation of six scrubbers and other capital projects on the KU system are huge. The capital costs of the KU projects total $702.5 million.[1] Once the six scrubbers and other projects are fully operational in 2009, KU's proposed environmental surcharge of $100.4 million will be more than double its base rate increase awarded last year.[2] Therefore, the proper allocation of KU's demand related scrubber and other fixed costs is just as important, if not more so, than the allocation of costs in a base rate case. The five cost of service studies submitted by KIUC, which were undisputed by any party, all reveal that the Industrial customers are paying far above their cost of service. Due in part to economic development considerations KIUC requests that the Commission allocate KU's environmental surcharge costs on the basis of "total revenues minus fuel". This allocation will slightly reduce subsidies contained in current rates and will more closely track environmental cost-causation than the "total revenues" method.

KIUC also recommends several adjustments to the Companies' proposed environmental cost recovery ("ECR") revenue requirements, which would have the effect of lowering the ECR revenue requirement by $14.335 million annually for KU and by $3.532 million annually for LG&E. The only affirmative evidence regarding the Companies' appropriate return on equity ("ROE") was presented by KIUC and the AG. The "black box" settlement setting the ECR ROE at 11% by its very terms is not admissible in this case, has no precedential value, and therefore cannot constitute substantial evidence.

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[1] KU Application at p. 6.

[2] Response to Staff Set One, Item 3 at p 4 of 4.

III. ARGUMENT

A. Surcharge Allocation

1. Commission Precedent And Fundamental Ratemaking Principles Require That Cost-of-Service Be The Predominant Consideration In Setting Rates.

It is particularly important to assign costs according to cost of service in the KU ECR proceeding because of the magnitude of the costs involved. The capital costs of KU's six new scrubbers and other projects will exceed $700 million. KU has requested a rate increase which will be more than 13% by 2009, or $100.4 million per year.[3] The magnitude of KU's Application warrants an allocation that will move rates incrementally closer to cost of service rather than perpetuating the subsidies contained in existing rates. Commission precedent holds that cost of service is, and should be, the predominant consideration in setting rates.

> *"The Commission reemphasizes its concern that one segment of LG&E's operation that is earning an excessive rate of return should not subsidize a segment that is under earning. The customers of the individual gas and electric operations should pay no more or no less than the cost of service. ... The primary objective of a cost-of-service study is to determine the rates of return on a company's investment at present and proposed rates for each rate class. ... A cost-of-service study may also be used as a guide in developing an appropriate rate design for each customer class."* (emphasis added) (Case No. 2000-080, September 27, 2000 Order at 66.)

* * *

> *"Costs properly allocable to wholesale customers cannot, and must not, be reallocated to retail customers merely because such costs are not being recovered from wholesale customers. Reallocating such costs to retail customers violates the principle that costs be allocated to the cost-causer."* (emphasis added) (Case No. 2000-107, February 8, 2001 Order at 5.)

* * *

> *"To adopt Kentucky Power's proposal would require the Commission to abandon the bedrock principle of basing rates on cost causation. Nothing in the record justifies such a drastic step."* (emphasis added) (Case No. 2002-

[3] KU Response to KPSC Set One, Item 3 at p. 4 of 4.

> 00169, March 1, 2003 Order at 39.)
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> * * *
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> *"Assigning cost liability to the cost-causer is fundamental in utility regulation."* (emphasis added) (Kentucky Power Siting Board, Case No. 2002-00150, December 5, 2003 Order at 11.)

The Commission's belief in the importance of cost of service in setting rates is not limited to its own ECR and rate cases, but also characterizes the Commission's view on national energy policy. The Commission has consistently argued in proceedings at the FERC that interstate cost allocations should follow cost of service.[4] In the Commission's Initial Comments in FERC Docket No. RM1-12-000, concerning FERC's proposed Standard Market Design ("SMD") the Commission makes strong arguments that cost should be assigned on the basis of cost of service:

> "*It is of paramount importance that the costs associated with SMD be borne by those who benefit. Yet, the rules proposed in the SMD NOPR, if implemented, are certain to unfairly increase the price paid by Kentucky retail ratepayers who would realize little, if any, benefit.*"[5]
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> * * *
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> "[T]*he principle of cost causation demands that the costs of developing a robust wholesale market be borne by the participants in the wholesale market, not by bundled retail ratepayers. Kentucky's utilities have been able to use the existing regulatory framework, which contemplates sales of excess power through bilateral contracts, with great success. Wholesale market participants and customers in retail choice states must be financially responsible for supporting the development of the market designed to serve them. However, previous FERC decisions on cost allocation favor spreading costs over a larger group of participants rather than just those who directly benefit. If success of competition hinges on socializing costs to customers who do not want it, have not asked for it, and do not benefit from it, then there is no reasonable justification for electricity restructuring.*
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> *This principle of cost causation is also applicable to the issue of transmission expansions and upgrades. These projects must be participant*

[4] FERC Docket No. RM01-12-000, Initial Comments of Kentucky Public Service Commission at p. 3-4.
[5] Id. at p. 10.

funded, with those who directly benefit paying the costs." (emphasis added)[6]

It would be hypocritical for the Commission to criticize FERC for ignoring cost of service when setting interstate wholesale power and transmission rates, only to then share the same disregard when setting Kentucky retail rates.

In addition, there is near unanimous agreement among regulators and utility scholars that except for jurisdictions that have deregulated cost of service should be the primary consideration in setting rates.[7] The most persuasive source may be the National Association of Regulatory Commissions' Electric Cost Allocation Manual (January 1992) which states:

> *"Cost of service studies are among the basic tools of ratemaking. While opinions vary on the appropriate methodologies to be used to perform cost studies, few analysts seriously question the standard that service should be provided at cost. Non-cost concepts and principles often modify the cost of service standard, but it remains the primary criterion for the reasonableness of rates."*[8]

It is a fundamental tenet of ratemaking that service should be provided at or as near as possible to cost. Additionally, the Commission has long observed the importance of cost of service and has made strong arguments that cost of service should be a primary consideration in determining who should bear the costs associated with establishing interstate power markets. Kentucky has wisely chosen not to

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[6] Id. at 12-13.

[7] Re: Kentucky Utilities Co., 15 FERC ¶61,222 (1981). *"The Commission's long standing practice has been to base class revenue allocations on the cost-of-service."* The Rhode Island Supreme Court described cost-of-service as the "*golden rule*" of ratemaking and of "*paramount importance*" in rate design. 150 PUR 4th 31, 635 A.2d 1135 (R.I. Supreme Court, 1993). See also Connecticut Power and Light, 144 PUR 4th 161 (Connecticut Department of Public Utility Control, 1993) (Commission moved all rates of return closer to company average thus reducing cost-of-service differentials and improving the state's business climate); Re Niagara Mohawk Power Corp., 140 PUR 4th 481 (New York PSC, 1993) (Commission approved rate design based on cost-of-service study which resulted in residential rate increase of 5.8% versus industrial rate increase of 1.4%); Re North Carolina Power, 142 PUR 4th 117 (North Carolina PUC, 1993) (utility was directed to realign its rates to move toward equalized rates of return. Finally, the most widely accepted authorities in the field of public utility regulation also follow the premise that rates should be set at cost. *"Nevertheless, one standard of reasonable rates can fairly be said to outrank all others in the importance attached to it by experts and public opinion alike – the standard of costs of service. ..."* James C. Bonbright, Principles of Public Utility Rates, Second Edition 1988 at 109-110.

[8] See KIUC Cross Exhibit 1.

deregulate its retail electricity market. As long as that holds true, it is appropriate that cost-of-service govern the allocation of costs, including environmental surcharge costs.

2. All Five Cost Of Service Studies In This Record Reveal That Industrial Customers Are Paying Far Above Their Cost Of Service.

KIUC has submitted five cost of service studies. All five studies show that the KU residential class is paying far below its cost of service and that industrial customers are paying far above their cost of service. Although the AG has challenged KIUC's proposal on the grounds that the Commission does not have authority to change the environmental surcharge allocation methodology it previously adopted, it is important to note that no party has submitted any testimony critical of KIUC's cost of service results. In fact, KU agrees with the results and stated on cross-examination that the KIUC cost of service studies are consistent with cost of service studies conducted by Steven Seelye of The Prime Group.[9]

Figure 1 below shows the rates of return by customer class reflected in the five cost of service studies conducted by KIUC witness Stephen Baron. These studies all reflect the Commission-approved increases in the last KU base rate case.[10] These are the same five methodologies that Mr. Baron used in Case No. 2003-434 to address cost of service issues and reflect a broad range of allocation methodologies commonly accepted by Public Utility Commissions. Though KIUC is not recommending any specific methodology in this ECR case, it is important to recognize that the results are very similar under a wide variety of methods.

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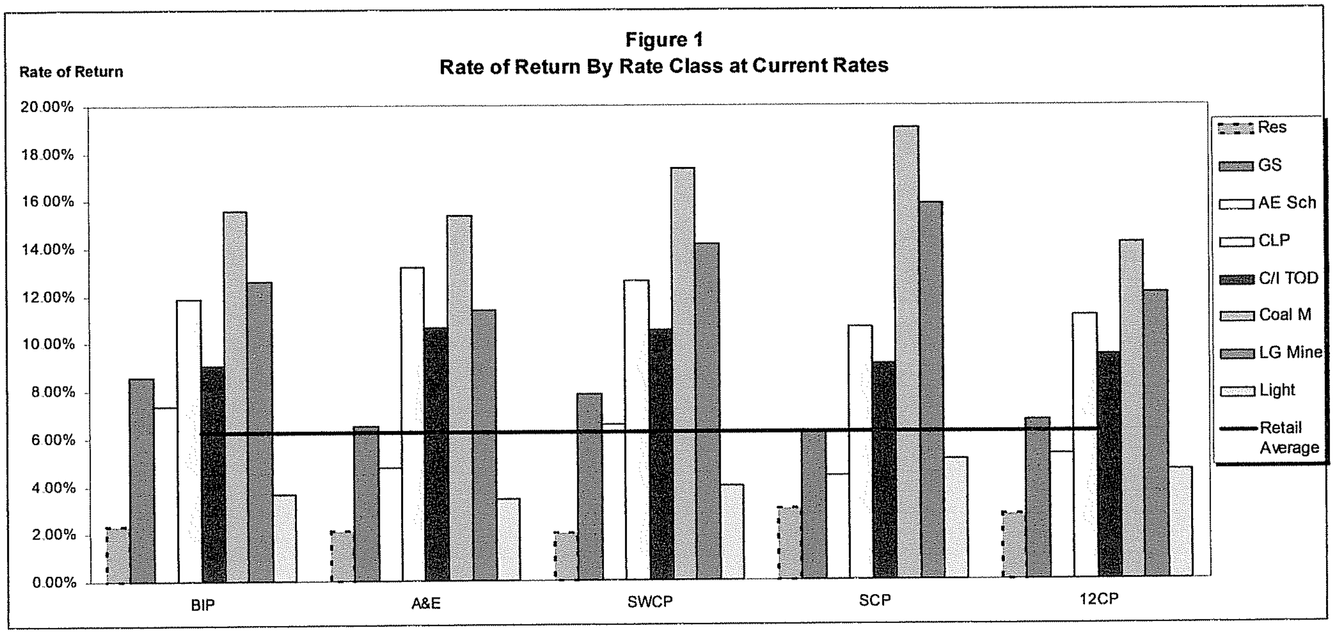
[9] TE at p. 42, lines 14-25.

[10] Figure 1 is derived from Exhibit (SJB-2) are as follows which incorporates the following five cost of service studies: The BIP Method, the Average and Excess Method ("A&E"), the Summer/Winter Average Coincident Peak Method ("S/W CP"), the Summer Coincident Peak Method ("S CP") and the 12 Coincident Peak Methodology ("12 CP").

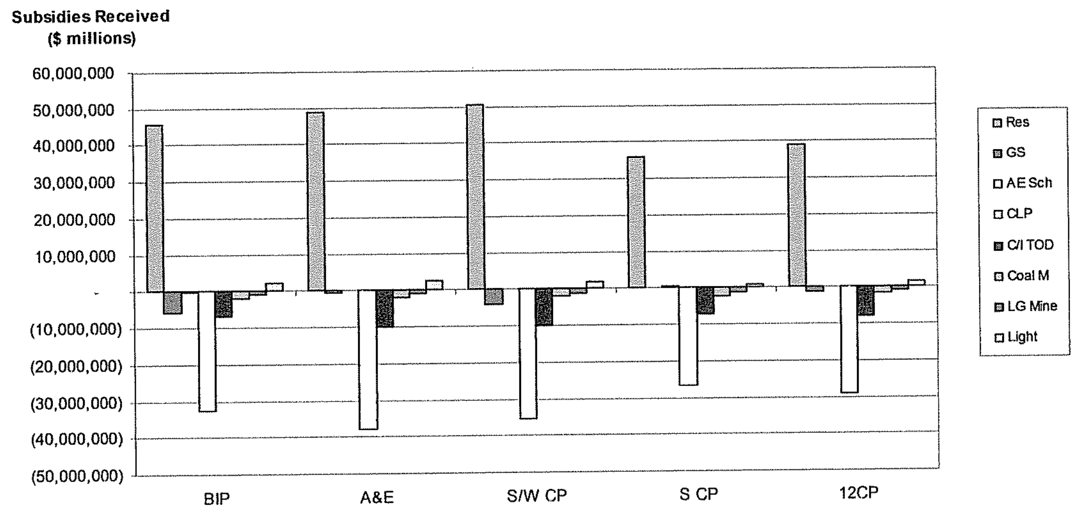


As illustrated in Figure 1, the rate of return for KU's residential customers is in the range of 2% to 3%, compared to the KU retail average rate of return of 6.24%. This means that the residential class is paying a rate of return on its share of the Company's total investment at a rate that is less than half that of the KU retail jurisdiction as a whole. At the same time, industrial customers are paying a rate of return on their share of the Company's total investment in the range of 1.4 to 1.7 times the KU system average.

Figure 2 below shows the dollar subsidies under each of the five cost of service studies examined. These dollar subsidies reflect the amount by which each rate class is paying above or below the cost to actually provide service to these customers.[11] A positive amount means that the rate class is only paying a portion of its cost responsibility. The portion of its share of costs not being paid by customers in that class is being paid by other KU customers in the form of subsidies (illustrated by a negative amount).

[11] Figure 2 is derived from Exhibit (SJB-2).

Figure 2
Subsidies By Rate Class At Current Rates



As is clear from Figure 2, under any of the five cost of service methods evaluated residential customers are receiving subsidies in the range of $40 to $50 million, while all other customers on the KU system (except lighting) are paying rates well in excess of cost.

3. **<u>Setting Industrial Rates Closer To Cost Of Service Is Consistent With Kentucky's Policy To Promote Economic Development And Job Creation.</u>**

The subsidies reflected in the five cost of service studies discussed above are a particularly problematic result for large industrial customers who must compete nationally and internationally for the sales of their products. It is less of a problem for business customers who compete locally.

For local competition, all customers pay the same electric rate and any subsidies built into those rates are competitively neutral. For example, Burger King and Wendy's compete with each other in the same neighborhood and both pay the same electric rates. As long as both pay the same residential subsidy neither is disadvantaged competitively. This is absolutely not the case for industrial manufacturers. Their products are sold nationally and internationally and their competitors are both domestic and foreign.

Moreover, if a Burger King outlet closes there is a Rally's waiting to take its place and there is no net job loss. When an industrial manufacturer closes, those jobs are usually not replaced. At least not easily. Low industrial electric rates are an advantage for Kentucky, but perhaps not to the extent that some believe.

Although Kentucky's residential electric rates are extremely low relative to other states, Kentucky industrial rates are only slightly lower than the rates paid in nearby states. This is due to the enormous subsidies paid to residential customers in Kentucky. For example, Toledo Edison in northern Ohio is known for its very high electric rates. However Toledo Edison's industrial customers do not subsidize residential customers to the same extent as KU's customers. The Toledo Edison residential rate (approximately 9 cents per kWh) is nearly twice the KU residential rate (4.7 cents per kWh). The lack of a significant residential subsidy allows Toledo Edison to provide industrial customers service at rates much closer to cost of service in the range of 3.8 to 4.4 cents per kWh.[12] This is only slightly higher than KU industrial rate. In 2004, KU's industrial rates ranged from a low of 3.0 cents per kWh to a high of 4.3 cents per kWh and averaged 3.4 cents per kWh.[13]

Georgia Power's industrial rates are also competitive with Kentucky due to a lack of a large residential subsidy. Georgia Power's residential customers pay approximately 7.4 cents per kWh (64% higher than KU's residential rates), but Georgia Power's industrial rates range from 3.6 cents to 4.5 cents per kWh.[14] Again, these industrial rates are only slightly higher than KU's industrial rates. The gap will close further as KU's 13% environmental surcharge is phased in through 2009.

Though it is not reasonable for any group of customers on the KU system to pay rates in excess of the cost to serve them, for the reasons explained above, it is a particular problem for industrial customers. Ideally, KU's rates should be adjusted to remove the entirety of all subsidies. But given the magnitude of

[12] TE at p. 207, lines 12-21.
[13] KU FERC Form 1 at p. 304.1.
[14] TE at p. 207 lines 21-25, p. 208 line 1.

the subsidies, this is not a realistic proposal in this ECR case. As should be clear in examining the results in Figure 2, the current rates paid by KU customers are substantially out of alignment with the cost of providing service to them. The Commission should adopt a policy to mitigate these substantial cost disparities. The subsidy charges to large industrial firms are particularly detrimental to the economic well being of Kentucky.

Setting industrial rates closer to cost is also in keeping with Kentucky's stated policy of promoting economic development and job growth. Kentucky has developed a comprehensive economic development system the mission of which is to:

> *"achieve the best quality of life for all Kentuckians through long term strategic planning and implementation that fosters sustainable growth in jobs and incomes and enable communities, businesses, governments and individuals to compete in the global marketplace."* KRS 154.01-020.

To meet this mission, the General Assembly created the Kentucky Economic Development Partnership, a board governing the Cabinet for Economic Development whose purpose is to improve and promote the health and general welfare of the people of the Commonwealth through sustainable economic development. KRS 154.10-010.

The Kentucky Cabinet for Economic Development notes that a number of factors enter the decision of where to locate or expand industrial plants, but "*right up there near the top is always the issue of energy availability and cost.*"[15] It is clear that maintaining low industrial power costs is an ongoing concern of the Commonwealth. On February 7, 2005 Kentucky Governor Fletcher issued Executive Order 2005-121 which initiated Administrative Case No 2005-00090. That Executive Order states "*Kentucky's low-cost advantage in electricity is an important catalyst for economic growth and business development in Kentucky.*"

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[15] Kentucky Cabinet for Economic Development, Whitepaper: Shedding Light on Energy: How Supply and Costs Affect Business Decisions, p. 3

It is important that the Commission aid economic development by allocating costs to the cost causer. The misallocation of a $100.4 million annual rate increase could be economically damaging and contrary to the Commonwealth's stated policy.

4. KIUC's Cost Allocation Proposal Better Allocates Environmental Costs To The Cost Causer.

KIUC's proposal to allocate costs on the basis of "total revenue minus fuel" is just and reasonable because this method properly allocates environmental costs to the cost causer. The environmental costs to be recovered through KU's ECR are predominately fixed costs that bear little or no relationship to fuel consumption.[16] The "total revenue minus fuel" method rightly assigns responsibility to customers on a fixed cost basis.

KU's ECR revenue requirements are predominately fixed costs and should be supported by ratepayers on the basis of non-fuel revenue requirements, as a proxy for what otherwise would be an allocation using predominately demand-based allocators.[17] KIUC witness Stephen Baron explained the connection between KIUC's proposed allocation method and assigning fixed costs to the cost causer:

> "*what we're recommending is that a just and reasonable allocation of ECR revenue requirements... should be done on a non-fuel basis. Non-fuel revenues are more closely related to the types of scrubber costs that are at issue in this case. Fuel costs are recovered through the fuel adjustment clause, and so our recommendation is to use non-fuel revenues*." (TE p. 200 lines 4-11.)

It is undisputed that the cost of the six scrubbers KU is recovering in this case are part of the Brown and Ghent power plants and are thus fixed costs. Because non-fuel base revenues primarily reflect fixed costs that have been allocated to each rate class, it is more reasonable to use these revenues rather than total revenues (that include fuel) to recover ECR costs from ratepayers.

[16] Baron Testimony at p. 18.
[17] Baron Testimony p. 18, lines 17-20.

5. <u>The Allocation Of The Environmental Surcharge On The Basis Of Total Revenues Minus Fuel Can Be Reasonably Implemented.</u>

KIUC proposes an alternative method to recover Commission-approved ECR revenue requirements using non-fuel base revenues "applied to individual rate classes."[18] For purposes of the KIUC proposal, KU's customers have been grouped into eight rate class groups. Each group will have an ECR recovery factor applied to their bill that is derived from non-fuel revenue. Although the "total revenue minus fuel" method can also be employed by applying a uniform surcharge factor to all customer bills less fuel, the use of rate class groupings simplifies the administration of the KIUC proposal. The eight customer classes identified in KIUC's proposal are listed below along with the surcharge recovery factor for 2009 applied to each class under the "total revenue" method and the "total revenue minus fuel" method.

COMPARISON OF ECR RECOVERY FACTORS USING[19]
TOTAL REVENUE VS. NON-FUEL REVENUE
BY CUSTOMER CLASS

Revenue Allocation	Recovery Factors Under Total Revenue	Recovery Factors Under Non-Fuel Allocation
Residential (including all Comb Off-Pk WH)	15.57%	16.47%
General Service (excl Comb Off-Pk WH)	15.57%	17.94%
All Electric Schools	15.57%	15.37%
Combined Lighting & Power	15.57%	14.92%
Combined Time-of-Day/Special Contracts	15.57%	12.38%
Coal Mining Power Service	15.57%	14.87%
Large Mine Power Time-of-day	15.57%	14.30%
Lighting	15.57%	21.09%
TOTAL	15.57%	15.57%

[18] KRS 278.183(2)
[19] KIUC Exhibit__(SJB-3) Revised. The rate increase under KU's 2004 environmental compliance plan is 13.14% by 2009. When added to the existing environmental surcharge, the ECR factor will be 15.57%.

Under the "total revenue minus fuel" method separate ECR recovery factors, are developed for each of the eight class groupings by allocating the ECR revenue requirement to each of these rate classes on the basis of non-fuel base revenues. These revenues are the identical revenues that are used in the Company's uniform ECR recovery factor approach except that the base component of fuel costs and all fuel clause revenues are removed. A rate class specific ECR factor is computed that can then be applied to an individual customer's bill. This is a two step process. The KIUC approach first allocates ECR revenue requirements to rate classes using non-fuel base revenues and then computes an ECR factor for each of the eight rate classes that is applicable to total revenues. In this manner, a unique factor is developed for each rate class grouping. Otherwise, the ECR would operate identically to the way it operates today.[20]

It is not administratively feasible to conduct a cost of service analysis each month to properly allocate ECR revenue requirements. A reasonable compromise is to use ECR recovery factors that produce some mitigation to the subsidy problem Non-fuel base revenue applied to eight individual rate classes is a reasonable alternative.

6. KIUC's Proposal Slightly Reduces Subsidies And Has A Minimal Impact on Residential Rates.

Implementation of KIUC's proposal would have only a small impact on the rate increase to Residentials compared to the "total revenues" method. It is also important to note that KIUC is not proposing to change existing base rates, as the AG has suggested.[21] If the Commission approves KIUC's surcharge allocation base rates will be completely unaffected.

The impact of KIUC's proposed allocation method is relatively small, but it does mitigate the subsidies underlying current KU retail rates. For example, (in 2009) under the "total revenue" method

[20] Baron Testimony p. 17 lines 3-15.
[21] TE at p. 17, lines 1-20.

Residential rates would have an ECR of 15.57% versus 16.47% under a "total revenues minus fuel" allocation.[22] Under the KIUC proposal the Residential class would contribute an extra $2.5 million to the Company's ECR revenue requirement in 2009. Considering that with current rates the Residential class is being subsidized to the tune of $45.7 million, KIUC's proposal represents a small, but important, reduction in the Residential subsidy.[23] Similarly, for large commercial and industrial customers, the current subsidy paid would be reduced by $3.3 million.[24] Despite the relatively low impact to the classes cited in the examples above which are expressed in 2009 rates, the rate impact in 2005 is even smaller. In 2005 residential customers will experience only about 0.2% rate increase and the other rate classes will experience similar small changes using the KIUC allocation.[25] This is because the KIUC proposed environmental surcharge allocation will be phased-in over a 5-year period. This is consistent with the principle of gradualism.

7. **KIUC's Proposed Allocation Does Not Affect The Allocation Of Cost Between Jurisdictional And Non-Jurisdictional Customers.**

KIUC's allocation proposal will not affect the jurisdictional versus non-jurisdictional allocation of the surcharge and will not increase KU's retail revenue requirement. Although KU has stated that if the Commission accepts KIUC's allocation proposal it should apply the same method to its jurisdiction/non-jurisdictional allocation, the Company has provided absolutely no evidence to show that revising the non-jurisdictional allocation is necessary or appropriate.[26] KU's suggestion that the allocation of environmental costs to off-system sales should be changed if KIUC's proposal is adopted was made only in passing. It was half-hearted at best. If KU truly believes there is a problem with the off-system allocation it is always free to present cost of service evidence to back up its claim. The

[22] Exhibit__SJB-3 revised.
[23] Id.
[24] Id.
[25] Baron Testimony at p. 27, lines 15-19.
[26] TE at p. 50, lines 17-22.

exclusion of brokered revenue from the ECR computation of KU, LG&E, and Kentucky Power demonstrates that the Commission can and will alter the jurisdiction/non-jurisdictional allocation when there is a valid reason to do so.

The Commission can easily allocate the surcharge between jurisdictional and non-jurisdictional customers using the "total revenues" method and then use the KIUC's proposed method to distribute costs at the jurisdictional level. It is a common practice to use one method to allocate costs among jurisdictional and non-jurisdictional customers and another to allocate costs among only jurisdictional customers.[27]

There is no reason for the Commission to change the non-jurisdictional allocation if it adopts KIUC's proposed total revenue minus fuel allocation. KU's retail ratepayers will not pay a greater portion of environmental costs as a result of Commission approval of the "total revenues minus fuel" method.

8. Although It Would Be Appropriate To Allocate LG&E's Surcharge On A Similar Non-Fuel Basis The Rate Impact Would Be So Small That Such An Adjustment Is Not Critical.

It would be reasonable to also implement the total revenue less fuel allocation proposal for LG&E, however it is not imperative to do so. The LG&E ECR revenue requirement is much smaller than KU's. Based on the Company's response to PSC Question No. 1(b), LG&E estimates that the 2009 impact of the combined costs associated with the 2001 Plan and the 2004 Plan is 1.25% of revenues. Given the relatively small impact of the LG&E ECR on customer rates, the impact of allocating the LG&E ECR costs on non-fuel base revenues compared to total revenues is very minimal for any of LG&E's rate classes. As a result, KIUC is not recommending implementation of the non-fuel base revenue ECR allocation methodology for LG&E. However, it would not be inappropriate to do so and KIUC would certainly support such a result.

[27] TE at p. 202, lines 10-20.

9. **<u>The Commission Has Discretion To Allocate The Cost Of The Environmental Surcharge Using Any Reasonable Method.</u>**

The AG argues that the Commission lacks jurisdiction to employ any allocation method other than the method which the Commission previously adopted. The AG claims the Commission has tied its own hands. That once the Commission adopts a certain allocation method it can never change its method. The AG's contention is not supported by the environmental surcharge statute, Commission precedent, or the AG's own position in prior environmental surcharge proceedings.

KRS 278.183 does not prescribe a particular allocation method for the environmental surcharge. The only requirement is that the surcharge be reasonable. KRS 278.183(2)(a). By not specifying a particular allocation method in the statute the Legislature left it within the discretion of the Commission to determine the appropriate method.

Commission precedent also shows that the Commission has discretion to use any reasonable allocation method. In the first environmental surcharge proceeding decided in 1994 (Case No. 93-465), KU, the AG and KIUC each proposed different methods for allocating the environmental surcharge among customers. KIUC proposed a method similar to the method recommended here by Mr. Baron which used "*a percentage of revenue approach calculated using non-fuel revenues rather than total revenues,*" but failed to support its proposal with a cost of service study.[28] The AG argued that "*a cost of service study is needed to allocate surcharge revenues between customer classes,*" and that absent such a study customer classes should be assigned different rates based on demand and energy allocators the AG developed for each of KU's construction projects.[29] KU proposed that the Commission apply the "total revenue" method which assigns costs according to the allocations determined in the

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[28] KPSC Case No. 93-465 (Order of July 19, 1994) p. 21.
[29] <u>Id</u>. at p. 20.

Company's most recent rate case.[30] The Commission ultimately chose to use KU's proposed total revenue method because the AG and KIUC did not support their allocation proposals with any cost of service evidence. The Commission stated:

> *"In a limited proceeding such as this, the allocation of costs reflected in existing rates should be maintained absent a compelling argument to the contrary. The intervenors argued for an allocation based on cost-of-service principles but did not present compelling arguments for departing from the existing allocation of costs nor did they file cost-of-service studies to support their positions. The Commission has frequently used a percentage of revenues method to maintain the allocation of costs reflected in existing rates absent a cost-of-service study..."*[31]

The Commission's Order and the record in Case No. 93-465 demonstrates that the Commission has the discretion to employ any reasonable method to allocate the costs associated with an environmental surcharge, but that absent cost of service evidence it will likely allocate environmental surcharge costs on a total revenue basis.

In a 2001 Order approving a Kentucky Power Company environmental surcharge the Commission explained that cost of service principles should not be ignored in ECR proceedings stating that, "[c]*osts properly allocable to wholesale customers cannot, and must not, be reallocated to retail customers merely because such costs are not being recovered from wholesale customers. Reallocating such costs to retail customers violates the principle that costs be allocated to the cost–causer."*[32] In a more recent Kentucky Power environmental surcharge case the Commission stated that it would not abandon the "*bedrock principle*" of allocating environmental surcharge costs based on cost-causation.[33] Finally, The Commission has exercised its discretion to modify the initial basis for allocation by

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[30] Id.
[31] Id. at p. 21.
[32] KPSC Case No. 2000-107, Order of February 8, 2001 at p. 11.
[33] KPSC Case No. 2002-00169, Order of March 31, 2003 at p. 39.

subsequently excluding brokerage revenues from non-jurisdictional and total revenues in the computation of both the LG&E, KU and Kentucky Power monthly ECR factors.

The AG's contention that the Commission does not have discretion to apply any method other than the "total revenue" method has no merit. The Commission's discussion in KU's first environmental surcharge hearing suggests that the "total revenue" method is merely a fallback that should be applied only in the absence of cost of service evidence. ("*The Commission has frequently used a percentage of revenues method to maintain the allocation of costs reflected in existing rates absent a cost-of-service study...*")[34]

KIUC's has submitted five cost of service studies that have not been contested by any party. KIUC respectfully requests that the Commission take advantage of this evidence in order to allocate the environmental surcharge to the cost-causer and bring overall rates closer to cost of service.

10. <u>The Environmental Surcharge Statute Specifically Allows Different Surcharges For Separate Customer Classes.</u>

The AG argues that KRS 278.183 does not give the Commission discretion to employ different surcharges for the separate customer classes. The AG's argument is incorrect. KRS 278.183 specifically provides that the Commission can issue differing surcharges for different customer classes.

The environmental surcharge statute specifically refers to the application of the surcharge to the individual rate classes. The statute states that:

> "*The plan shall include the utility's testimony concerning a reasonable return on compliance-related capital expenditures <u>and a tariff addition containing the terms and conditions of a proposed surcharge as applied to individual rate classes</u>.*" (KRS 278.183(2)) (emphasis added)

[34] KPSC Case No. 93-465 (Order of July 19, 1994) at p. 21.

This sentence in KRS 278.183 clearly deflates the AG's argument that the Commission can only apply a single surcharge factor to the separate rate classes.

Even if the statute did not clearly state that there could be separate surcharges for the individual rate classes the AG's argument would be moot. At its core KIUC's proposed method applies a single surcharge on all customers regardless of customer class. As explained in KIUC witness Stephen Baron's testimony, the "total revenue minus fuel" method is applied by subtracting the cost of fuel from total customer revenues and a single surcharge factor is applied to this "revenue minus fuel" number. This first step is all that is needed in order to allocate and recover ECR revenues under Mr. Baron's "total revenue minus fuel" method.[35] Obviously this does not violate any prohibition against multiple surcharges since each customer would have the identical surcharge factor that would be applied to the customer's non-fuel bill. Although Mr. Baron included a second step in which the data obtained in the first step is used to calculate separate surcharges for eight customer classes that can be expressed as a rate applied to the total revenue on each customer's bill,[36] the second step is unnecessary. The second step was added to Mr. Baron's analysis for administrative convenience and in order to demonstrate that this allocation methodology would result in only a minor impact on residential rates. KIUC's proposed method can be employed just as easily using only step one which applies a single environmental surcharge factor to each customer's total bill less the cost of fuel.[37]

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[35] TE at pp. 197-98.
[36] Baron Testimony at pp. 16-19.
[37] TE at pp. 197-98.

B. Revenue Requirement

1. KIUC And The Companies Agree On How Federal And State Income Tax Reductions Should Be Reflected In The ECR.

KIUC recommends that a 2004 change to §199 of the Internal Revenue Code should be reflected in the Companies' filing. The adoption of this recommendation will reduce the revenue requirement for KU by $1.097 million and for LG&E by approximately $0.282 million once the 2004 Plans are fully implemented.[38]

KIUC's recommendation with respect to this adjustment is supported by the Companies. KU and LG&E both stated that "[f]*or purposes of calculating the gross-up factor, the Company agrees that benefits from the new deduction related to income attributable to domestic production activities should be reflected in the Company's ECR*,"[39] KIUC and the Companies agree on the proper treatment of §199 of the IRS Code,[40] and Kentucky House Bill 272.[41] This is reflected in the Scott Rebuttal Testimony.

2. KU'S Requested Return On ECR Investment Is Unreasonable Because Of An Excessive Common Equity Ratio.

The Commission should limit the common equity ratio in KU's capital structure to no more than the level set in KU's last base rate case for the purpose of establishing a reasonable rate of return pursuant to the requirements of KRS 278.183.[42] Such a cap is necessary because KU has increased its rate of return on ECR investment to an unreasonable level through an excessive common equity ratio. An excessive common equity ratio harms ratepayers, is unnecessary for KU to retain its current bond rating, and is inconsistent with the statutory requirement for a reasonable return given the extremely low

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[38] Kollen Testimony at pp. 8-11.
[39] LG&E's response to KIUC 1-22 and KU's response to KIUC 1-24.
[40] Valerie Scott Rebuttal Testimony at p. 1, lines 18-21.
[41] Id. at p. 2 lines 6-18, p. 3 lines 1-2.
[42] Kollen Testimony at pp. 12-19.

financial risk associated with the ECR cost recovery. The adoption of this proposal will reduce the projected revenue requirement for KU by $4.390 million once the 2004 Plan is fully implemented.

LG&E Energy has steadily driven up the KU common equity ratio from the 51.58% authorized as reasonable by the Commission in its Case No. 2003-434 Order dated June 30, 2004 to 55.09% at December 31, 2004.[43] This occurred despite the fact that total capitalization actually decreased from January 31, 2004 to December 31, 2004. KU accomplished this by retaining earnings and reducing both short-term and long-term debt.[44]

The increase in the KU common equity ratio to 55.09% is excessive and unnecessary for the Company to retain a single A bond rating.[45] It is clear from the history of the Company's common equity ratio and the bond ratings that coincided with the Company's common equity ratio that a significantly lower common equity ratio is sufficient to maintain the Company's single A rating. In its Order in Case No. 2003-434, the Commission approved a common equity ratio of no more than 51.58%. This ratio was sufficient for KU to retain a single A bond rating. Prior to that, the Commission authorized a 50.82% common equity ratio in Case No. 1998-474, before adjustment for pollution control debt directly assigned to the Company's ECR investment. Thus, a common equity ratio of no more than 50.82% also was sufficient for KU to retain a single A bond rating.

Further, a comparison of KU's common equity ratio as of December 31, 2004 to the average common equity ratio of a group of companies with overall characteristics similar to KU reveals that KU's ratio is greatly in excess of the norm. The average common equity ratio of the comparative group used by KIUC witness Richard Baudino to determine the required rate of return on common equity for KU was only 43.13% (actual) for 2003 and 45.59% (projected) for 2004, excluding short term debt. If

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[43] Kollen Testimony p. 12, lines 7-9.
[44] Id. at lines 9-13.
[45] Id. at p. 12, line 21, p. 13, line 1.

KU's short term debt is excluded from its capital structure, consistent with common equity ratio computations for the comparative group, KU's common equity ratio rises to 58.70% at December 31, 2004, or more than 13% in excess of the average for the comparative group.[46]

KU's actual 55.09% common equity ratio was also substantially in excess of LG&E's actual 49.67% common equity ratio at December 31, 2004. KU's common equity ratio, adjusted to include its purchased power liabilities in accordance with the S&P guidelines, still was nearly 2% in excess of LG&E's actual common equity ratio at December 31, 2004.[47]

KU's common equity ratio is also near the high end of the range of the Standard & Poors ("S&P") guidelines for a single A bond rating. The S&P guidelines for an electric utility with the same level of business risk as KU reflect an equity (preferred and common) ratio of 48.0%-55.0%. This range is equivalent to a common equity ratio of 45.77% to 52.77% if the range is properly adjusted downward to remove the KU preferred equity ratio of 2.23% at December 31, 2004.[48]

For bond rating purposes, S&P includes a utility's purchased power obligations as long term debt. If this S&P adjustment is made, the Company's common equity ratio would be 51.48% at December 31, 2004, still some 5.71% above the low end of the range for a single A bond rating.[49]

The return sought by KU is not reasonable as long as it includes an excessive common equity ratio. An excessive common equity ratio increases the overall return because common equity is the most expensive component of the capital structure and also must be grossed-up for income taxes, thus compounding the cost of the most expensive component. KU has requested a return on common equity of 11.00%, compared to the cost of long-term debt of 3.43%, the cost of short-term debt of 2.22%, and

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[46] Id. at p. 13, lines 13-19.
[47] Id. at p. 15, lines 1-5.
[48] Id. at p. 14, lines 4-9.
[49] Id. at lines 11-18.

the cost of preferred at 5.68% at December 31, 2004. The Company's requested 11.00% return on common equity translates to 18.15% after it is grossed-up for income taxes.[50]

Therefore, the Commission should cap the KU common equity ratio for purposes of the ECR to the level last found reasonable in Case No. 2003-434. The effect of KIUC's proposal will be to reduce the KU ECR revenue requirement by $4.390 million, all else equal, based on the December 31, 2004 grossed-up cost of capital provided by the Company in response to Staff Data Request 2-1.

3. **Emission Allowances For Gas Generation Should Not Be Included In ECR Rate Base Investment.**

The Commission should exclude the costs of emission allowance inventories held for use by the Companies' gas generating units.[51] The Companies agree that the related allowance expense is not recoverable through the ECR, but maintain that the allowance inventory may be included in the ECR rate base because FERC accounting rules do not require them to allocate the allowance inventory dollar amounts to specific generating units. That position is inconsistent with KRS 278.183 and with the Commission's interpretation of that statute.

KRS 278.183 allows the recovery of environmental cost associated with the production of energy through the combustion of coal. That Section states:

> "*A utility shall be entitled to the current recovery of its costs of complying with the Federal Clean Air Act as amended and those federal, state, or local environmental requirements which apply to coal combustion wastes and by-products from facilities utilized for production of energy from coal in accordance with the utility's compliance plan...*" (emphasis added)

[50] Kollen Testimony at p. 17 lines 4-11.
[51] Kollen Testimony at pp. 20-21.

The allowances allocated to the KU gas generating units must be excluded from the allowance inventories included in KU's ECR rate base. The environmental surcharge is limited to coal. It does not extend to natural gas, oil, hydroelectric, biomass, or any other source of electric production.

4. **The Nonrecurring O&M Expense For The LG&E Mill Creek Ash Treatment Basin Should Be Deferred And Amortized.**

The Commission should require LG&E to defer and amortize over four years the $6.0 million one-time nonrecurring O&M expense associated with the ash transfer from the Mill Creek ash transfer basin ("ATB") to the landfill.[52] This transfer will extend the life of the facility and the cost should be amortized over a reasonable number of years, with the unamortized deferral amount included in the ECR rate base. The Company has indicated that it will accept this recommendation.

In addition to the capital costs associated with LG&E Project 11, LG&E has included in the scope of this project a one-time nonrecurring $6.0 million O&M expense for ash transfer from the ATB to the landfill. LG&E witness John Malloy asserts in his testimony that "[t]*he transfer will restore and maintain the current useful life of the ATB*."[53] In addition, Mr. Malloy maintains that "[t]*his expense is an inherent and essential component of the capital project to assure that the existing ATB maintains compliance with all associated environmental regulations.*"[54] The Company proposes to reflect this expense as incurred in its monthly ECR filings.

The Company's proposal to reflect this large $6.0 million one-time nonrecurring expense as incurred in its monthly ECR filings is not reasonable. The Company's witnesses acknowledge that the incurrence of this cost will restore and maintain the current useful life of the landfill and that the expense is an inherent and essential component of the capital project. As such, the cost should be deferred and

[52] Kollen Testimony at pp. 22-24.
[53] Mallory Testimony at p. 7 line 9.
[54] Id. at lines 10-11.

amortized over a reasonable number of years because the benefits associated with the incurrence of the cost extend beyond the months in which it will be incurred.

KIUC proposes that the Commission direct the Company to defer the expense as a regulatory asset and amortize it over four years and that the Company be allowed to include the unamortized amount of the regulatory asset in its ECR rate base.[55] The Company acknowledged that this approach would be acceptable in its post-hearing brief in Case No. 2002-147, when it first proposed this project in its 2003 Plan. The Company again has agreed to accept this approach in this proceeding in response to Staff Data Request 1-6.

5. <u>All Expense Reductions Due To Retirement Of Environmental Plant Included In Existing Rates Should Be Reflected In The ECR.</u>

The Commission should affirm the principle it adopted and applied to the ECR in its prior decision in Case No. 2002-147, whereby it required LG&E to credit the ECR revenue requirement for reductions in all expenses caused by the retirement of environmental plant already included in rates, not just the depreciation and property tax expense on that retired plant.[56] The ECR tariffs and schedules proposed by the Companies do not explicitly incorporate this requirement. In addition, the Companies' testimony and their responses to KIUC discovery suggest that they may not reflect such reductions to their ECR expenses, if any.

The Companies have an obligation to reflect all cost reductions due to retirement of environmental plant included in existing rates. In its Case No. 2002-147 Order for LG&E, the Commission stated the general principle that such cost reductions must be reflected in the ECR revenue requirement. That Order states:

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[55] Kollen Testimony at p. 23.
[56] Kollen Testimony at pp. 25-27.

"LG&E is reminded that it has a continuing obligation to review O&M expenses that are already included in existing rates and to the extent those expenses are impacted by the 2003 Plan projects, that impact must be recognized in the surcharge calculations." (February 11, 2003 Order, pp. 16-17)

The Commission reiterated this general principle in its March 24, 2003 Order in the same Matter in response to a KIUC request for rehearing due to LG&E's failure to adhere to this principle and reduce ECR expenses for a reduction in O&M expense. That Order states:

"The Commission finds that if the environmental projects included in LG&E's 2003 Plan cause reductions in expenses already included in base rates, those reductions should be reflected as offsets in the environmental surcharge." (March 24, 2003 Order, p 2.)

Finally, the Commission found that LG&E had failed to comply with this general principle in its Order dated September 4, 2003 in the same docket. The relevant excerpt from that Order follows.

In its response to KIUC's petition for rehearing, LG&E acknowledged that it has a continuing obligation to review O&M expenses that are already included in existing rates and to the extent that those expenses are impacted by the environmental projects in the 2003 Compliance Plan, that impact must be recognized in the surcharge calculations. Yet throughout the rehearing examination, LG&E has argued against a reduction in surcharge O&M expense because of the reassignment of the four employees. LG&E stresses that the four employees in question were not terminated, but reassigned to vacant positions at Mill Creek. Thus, LG&E contends from an overall operations standpoint it did not experience any reduction in operating expenses, and no offset to the surcharge calculations is required.

The Commission is not persuaded by LG&E's arguments. The fact that the environmental employees were actually transferred to existing, vacant non-environmental positions is not relevant to this issue. What is relevant is that the new environmental projects resulted in an O&M savings by eliminating four environmental positions at the Mill Creek scrubber. The O&M expense for those positions was already included in base rates and their elimination must now be reflected in the surcharge calculations.

Therefore, the Commission finds that the O&M labor expenses associated with the elimination of four environmental positions should be recognized as a reduction in operating expenses in LG&E's environmental surcharge

> *calculations. This decision is consistent with the Commission's previous findings in its February 11, 2003 Order regarding LG&E's obligation to recognize in its surcharge calculation the impacts of environmental projects on O&M expenses already included in base rates.* (September 4, 2003, pp. 4-5).

Despite the clear precedent that the Companies must credit ECR expenses for reductions in all environmental compliance expenses, not just depreciation and property tax expense, related to the retirement of plant included in existing rates neither Company has agreed that it would comply with this general principle (See responses to KIUC 1-15 for KU and KIUC 1-14 for LG&E.)

KIUC requests that the Commission state that it will require both Companies to credit ECR expenses for reductions in *all* environmental expenses related to the retirement of plant included in existing rates. The Commission should not allow the Companies to ignore those Orders which do they do not like.

C. <u>Rate of Return on Equity</u>

1. <u>The Settlement Agreement In The Companies' Last Rate Case Is Not Admissible And Does Not Have Any Precedential Value In This Proceeding.</u>

The Partial Settlement Agreement approved in Case Nos. 2003-00433 and 2003-00434 is not admissible, can have no precedential value in this proceeding and cannot be a basis for the Commission's determination of the ROE. It does not constitute substantial evidence.

Section 3.1 of the Settlement Agreement states in part that environmental projects "*shall be based on an 11.0% return on equity until directed by order of the Commission that a different rate of return shall be utilized.*" The 11% ROE specified in the Settlement Agreement is the default rate in effect until the Commission has the opportunity to determine an appropriate ROE for environmental costs. This case is that opportunity. KIUC and the AG have submitted evidence and testimony to aid in the Commission's determination of the ROE and the Commission should base its determination on such evidence.

The 11% ROE contained in the Settlement Agreement is not admissible in this case, has no precedential value, and cannot be a basis for the Commission's determination of the Companies' ROE. Section 4.12 of the Settlement Agreement states:

> "*The signatories hereto, including the AG, agree that <u>neither the Settlement Agreement nor any of the terms shall be admissible in any court or commission</u> except insofar as such court or commission is addressing litigation arising out of the implementation of the terms herein or the approval of this Settlement Agreement. <u>This Settlement Agreement shall not have any precedential value in this or any other jurisdiction.</u>*" (emphasis added)

The ECR ROE specified in the Settlement Agreement was part of "black box" settlement. It was the direct result of give and take in which the signatories may have conceded a point in one area in order to get a concession in another. Of course, because this was a settlement, the give and take was off the record. The signatories opposing the Companies may have agreed to an ECR ROE of 15% or 20% in exchange for a significant concession by the Companies' on another issue. The Commission cannot look at one term of the Settlement Agreement in isolation and give that term any weight in another case because that term was only agreed upon in reference to all of the other terms of the Settlement Agreement. That is the very nature of a "black box" agreement.

At hearing Commission Staff asked each of the ROE witnesses "[w]*hat specifically has occurred since* [the Commission's approval of Settlement Agreement] *that would influence the return on equity*?"[57] The simple answer to the question of what has changed since the parties to the last rate case agreed to a very high ECR ROE as a result of compromises on a myriad of other issues is that (1) the Commission found that the appropriate ROE on base rates for the Companies was 10.5% in Case Nos. 2003-00433 and 2003-00434; and (2) KIUC and the AG have submitted their expert testimony on the appropriate ECR ROE for the Companies.

Commission Orders must be based on substantial evidence. South Cent. Bell v. Public Serv. Com'n, Ky.App.,702 S.W.2d 447, 451 (1985). A "black box" settlement from a prior case which by its very terms is not admissible and which has no precedential value cannot meet the substantial evidence test.

2. The General Economic Trends That Have Affected Utilities In Recent Years And The Structure Of Kentucky's ECR Process Suggest Lower Return On Equity Requirements On The Part Of The Investing Public.

The currently low bond yields, the 2003 decrease on the tax rate on dividends and capital gains, the investment community's current view of the utility industry, and the investment community's opinion of KU and LG&E strongly suggest lower return on equity requirements on the part on the investing public. Additionally, the nature of Kentucky's ECR procedure in which environmental expense recovery is all but assured exposes investors to less risk than the Companies' other investments. Taking all of these factors

[57] TE at p. 184 lines 4-5, See also TE at p. 144 lines 18-19 and TE at p. 121 lines 20-21.

into account, the Commission should approve a ROE significantly lower than that proposed by the Companies. KIUC witness Baudino recommends a ROE of 8.7%.

First, the yields on long-term treasury and utility bonds have declined significantly. Yields have trended downward from 2002 through 2004, with the 20-year bond yield declining from 5.69% to 4.77% at the end of January 2005. The yield on the average public utility bond has also decreased significantly over the last two years, falling from 7.83% in March 2002 to 5.80% in January 2005, a decline of over 200 basis points. Public utility bond yields fell far more than long-term Treasury yields over this two-year period.[58]

Current bond yields are either at or near their lowest levels in recent history. Public utility bond yields are currently at their lowest level since 1995.[59] According to the Mergent *Public Utility Manual* the average public utility bond yields have not been as low as they are now since the 1968 – 1969 time period, almost 35 years ago.[60] Taken as a whole these low bond yields suggest lower return on equity requirements on the part on the investing public.

Next, in 2003 Congress enacted a change in tax policy that lowered the tax rate on dividends and capital gains. Generally, this decrease to tax dividends and capital gains taxes has lowered the investor required returns for utilities.[61] Other things being equal, the dividend tax rate reduction means that investors should require lower pre-tax rates of return for utilities. This is because the after-tax dividend streams have now become more valuable due to the reduction in federal taxation. Thus, for a given stock price investors will discount the future dividend payments at a lower return on equity. [62] The stock prices that KIUC used in its cost of equity analyses fully incorporate the effects of this change in tax

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[58] Baudino Testimony at p. 7, lines 15-19
[59] See KIUC Exhibit____(RAB-2)
[60] Baudino Testimony p. 8, lines 1-3.
[61] Id. at lines 13-19.
[62] Id. at p. 8, lines 18-22

rates and on the expected returns for utilities. This also means that investors require *lower* risk premiums for stocks compared to utility bonds.[63]

Prior to the passage of the 2003 tax bill, dividends were taxed at the normal tax rates, which could be as high as 35%. These same dividends are now being taxed at a much lower 15% rate. What this means is that for a given after-tax rate of return, such as 7% for example, an investor would now require a lower pretax return in order to earn that 7% after-tax return. In the realm of regulation, experts must estimate, and commissions must set, a pretax rate of return on equity that will be applied to a company's rate base. With lower tax rates on dividends, these pretax returns will inevitably decline.[64]

A review of information published by Value Line also reveals that the investment community believes that the electric industry is entering a more stable, less risky environment than it experienced during the last few years. Specifically, investors observe that Companies that focus on core electric operations, such as KU and LG&E, will be lower risk than those with unregulated and/or deregulated operations and investments.[65]

The Value Line Investment Survey reported the following in its October 1, 2004 report on the electric utility industry (central):

> *"The Electric Utility Industry's finances have undergone dramatic changes since the start of the 21st century. Through the 1990s, returns on total capital, share equity, and common equity showed relatively little change. But starting with the year 2000, as retail competition spread, many utilities were confronted with reduced earnings from basic operations. This induced company managements to look for investments elsewhere to shore up profits. Though many of these investments were initially successful, several eventually turned sour. That led to a weakening of finances and a reduction in earnings.*
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[63] Id. at p. 9, lines 2-3.
[64] Id. at p. 35, lines 8-14.
[65] Id. at p. 11, lines 2-5.

The power glut in 2002 resulted in a slowdown in new plant construction the following year. This reduced borrowing needs and lowered interest expense. In turn, it led to a rise in common equity ratios and fixed charge coverages. Company managements initiated additional steps to improve finances by selling unprofitable assets, canceling acquisitions, and focusing on core business operations.

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By the end of the current year, industry finances will probably recover to the level attained at the start of the century. Over the next 3 to 5 years, further progress is likely. Based on our projection of steady profit growth for the industry to 2007 to 2009, we look for solid improvement in free cash flow."

Value Line also noted that available funds could be used by utilities to buy back stock, increase dividend payments, or both.

The March 4, 2005 Value Line profile of the electric utility industry (east) noted the following:

"For a period of several years, beginning in the mid-1990s, many electric utilities eschewed dividend increases in favor of investing in nonregulated operations or M&A activity with another utility ... Many of these nonregulated investments turned sour, or time proved that some of the acquiring utilities in mergers had overpaid. As a result, some companies had little choice but to cut or suspend their common dividends.

Utilities began to take another look at raising the dividend after the federal government cut the tax rate on dividends in 2003. Some were still getting their finances in order as part of their "back to basics" strategies, so noteworthy dividend boosts didn't start to occur until 2004.

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The good news of dividends has continued in early 2005. A few companies that cut or suspended the dividend in the late 1990s or early 2000s have reinstated it, increased it, or stepped up the growth rate."

It appears that investors are taking notice of the increased stability and lower risks associated with public utilities compared to the riskier environment of a few years ago.

In addition to the lower risk that the investment community associates with the utility industry in general, the investment community view KU and LG&E in a positive light. KU carries an A rating from Standard and Poor's and an A1 rating from Moody's. S&P's corporate credit rating for KU is BBB+. In its September 13, 2004 report on KU, Standard and Poor's noted that "*KU's above average business profile is supported by low production costs, a lack of nuclear generating assets, and a favorable regulatory environment. The company's electric operations benefit from environmental cost recovery and cost-of-fuel-adjustment mechanisms. These mechanisms reduce exposure to environmental legislation and potential volatility in natural gas prices, both of which normally concern Standard and Poor's.*" The S&P report noted that a large industrial customer base and coal-fired generation facilities that require large environmental expenditures somewhat temper KU's business profile.[66]

LG&E does not currently have a senior secured bond rating from either Moody's or Standard and Poor's, but does carry the same Standard and Poor's Corporate Credit Rating of BBB+ as KU. In its September 13, 2004 report on KU, Standard and Poor's noted that "*Louisville Gas' above-average business profile is supported by low production costs, lack of nuclear-generating assets, and a favorable regulatory climate. The Company's electric operations benefit from a cost-of-fuel-adjustment mechanism and an environmental cost-recovery mechanism ...*" The S&P report noted that a large industrial customer base and coal-fired generation facilities that require large environmental expenditures somewhat temper LG&E's business profile.[67]

KU's significantly higher than average equity ratio also makes KU less risky. According to Value Line, the average equity ratio of a comparison group similar to KU is 43.1% for 2003 and 45.6% for 2004.[68] KU's equity ratio of 55.09% as of December 2004 is substantially greater than the average equity ratio for

[66] Id. at p. 11, lines 9-18.
[67] Id. at p. 12, lines 1-9.
[68] KIUC Exhibit ____(RAB-8)

the group. From a financial risk perspective, this makes KU less risky than the comparison group.[69]

Finally, in addition to the generally positive trends affecting KU and LG&E which suggest a lower return on equity, the nature of environmental cost recovery in Kentucky also points to the appropriateness of lower returns. Kentucky law authorizes KU and LG&E to collect costs associated with coal related environmental compliance, including a reasonable return on its investments, through a surcharge.[70] Unlike other expenses and rate base investments that are subject to some risk of recovery, the Companies are assured of total recovery of ECR costs on a real time basis even if their overall rates of return are adequate. Thus, investments subject to the ECR are lower risk than the Companies' other investments.

In sum, the confluence of the currently low bond yields, the 2003 decrease on the tax rate on dividends and capital gains, the investment community's current view of the utility industry and of KU and LG&E specifically, and the fact that Kentucky law allows environmental costs to be passed through directly to ratepayers outside of a base rate case suggest that a lower return on equity for KU and LG&E is all that is required by the investing public.

3. KIUC Recommends A Rate Of Return On Equity Of 8.70 Percent In This Proceeding.

In formulating a recommended ROE of 8.70%, KIUC witness Richard Baudino employed a Discounted Cash Flow ("DCF") analysis for a group of comparison electric companies to estimate the cost of equity for KU and LG&E's electric operations as well as two Capital Asset Pricing Model ("CAPM") analyses, although these results were not incorporated in KIUC's recommendation.

Utilizing the DCF model, Mr. Baudino developed cost of equity estimates for a comparison group of electric utility companies. First, using the February 2005 issue of the *C. A. Turner Utility*

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[69] Baudino Testimony p. 37 lines 3-5.
[70] KRS 278.183.

Reports, electric companies that were rated either A/A or A/Baa/BBB by Moody's and Standard and Poor's were selected. From that group companies that had less than 50% of their revenues from electric operations were eliminated. This resulted in a group of electric and/or electric and gas companies that have operational and risk profiles similar to KU and LG&E.[71] From this group, Mr. Baudino then eliminated companies that had recently cut or eliminated dividends, were recently or currently involved in merger or restructuring activities, and had recent experience with significant earnings fluctuations. These criteria are important because utilities that are undergoing those types of changes are not good candidates for the DCF model.[72] The ROE results for the electric company comparison group using the constant-growth DCF model ranged from 7.98% to 9.25%. The ROE results using the CAPM ranged from 8.84% to 11.82%.[73]

KIUC recommends a rate of return on equity for the Companies of 8.70%. This recommendation is based on the average of the four DCF cost of equity estimates, rounded up to the nearest tenth of a percent. Given current market conditions, this value is the most representative of the investor-required return on equity for A-rated companies such as KU and LG&E.[74]

Mr. Baudino based his ROE recommendation on the DCF model because it is likely that his CAPM results, which were higher than his DCF results, are overstated. This is due, in part, to the application of Value Line's beta for the group of .77. Value Line determines its betas based on five years of historical price data. Over the last five years, utility share prices in general have been quite volatile due to restructuring, deregulation, and the increase of unregulated investments that were more risky than core electric operations. Other things being equal, these factors likely increased the historical betas for electric

[71] Id. at p. 19, lines 12-17.
[72] Id. at p. 19, lines 19-21. The resulting group of comparison electric companies used in KIUC's analysis is: CH Energy Group, Cleco Corporation, Consolidation Edison, Empire District Electric, Entergy, Northeast Utilities, NSTAR, PPL Corporation, Progress Energy, Southern Company, Wisconsin Energy
[73]. Id. at p. 33, lines 2-5.
[74] Baudino Testimony at p. 33, lines 9-13.

utilities. It now appears that the industry will be more stable going forward and historical betas are therefore likely to fall from their current level.[75] Additionally, the expected return on the market based on Value Line's most recent forecasts appears to be quite volatile at this time compared to DCF results which have remained fairly stable and are consistent with interest rates trends throughout 2004 and 2005.[76]

KIUC recommends a return on equity of 8.70 percent in this proceeding. KIUC believes this ROE is appropriate regardless of whether the Commission accepts its recommendation to limit KU's equity ratio in this proceeding.

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[75] Id. at p. 33, lines 19-22, p. 34 lines 1-5.
[76] Id. at p. 34, lines 7-15.

IV. CONCLUSION

The five cost of service studies submitted by KIUC, which were undisputed by any party, reveal that the Industrial class is paying far greater than its cost of service. Due in part to economic development considerations KIUC requests that the Commission allocate the ECR on the basis of "total revenues minus fuel" which slightly reduces subsidies in current rates more closely tracks environmental cost-causation. KIUC also recommends several adjustments to the Companies revenue requirements, which would have the effect of lowering the ECR revenue requirement by $14.335 million annually for KU and by $3.532 million annually for LG&E.

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