COMMONWEALTH OF KENTUCKY
BEFORE THE 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 2004 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	Case No. 2004-00426

and

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

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.'S
RESPONSE TO THE ATTORNEY GENERAL'S
MOTION TO STRIKE TESTIMONY OF STEPHEN J. BARON

I. INTRODUCTION

On March 23, 2005 the Kentucky Industrial Utility Customers, Inc. filed the testimony of its witness Stephen J. Baron with the Kentucky Public Service Commission ("the Commission") in the above-captioned matter. Mr. Baron's testimony contains, among other things, five cost of service studies and a proposal that the Commission employ the "total revenue minus fuel" methodology which allocates the costs of Kentucky Utilities Company's ("KU") environmental surcharge by applying a single surcharge to the total bill of each customer minus the cost of fuel. The Kentucky Attorney

General ("the AG") did not file rebuttal testimony in response to Mr. Baron's proposal. On May 6, 2005, two business days prior to the scheduled hearing, the AG filed its Motion to Strike Testimony of Stephen J. Baron. The AG contends that the Commission does not have jurisdiction to consider cost allocation on a cost of service basis in an environmental surcharge proceeding and that Mr. Baron's proposal violates KRS 278.183. KIUC submits this Response to the AG's Motion to Strike and respectfully requests that the Commission deny the AG's Motion.

II. ARGUMENT

1. The Commission Has Discretion To Apply Any Reasonable Allocation Method Because The Environmental Surcharge Statute Is Silent With Respect To Cost Allocation.

The AG argues that the Commission lacks the jurisdiction to consider class cost of service when allocating cost responsibilities for the environmental surcharge to the various rate classes. The AG essentially contends that because the Commission has decided to apply the "total revenue" method in past environmental surcharge proceedings it is not within its jurisdiction to apply a different methodology even when the total revenue method produces inequitable results. The AG states that:

"*the entire topic of cost allocation to remedy class cost of service disparities is beyond the subject matter to be considered in connection with an application for cost recovery under KRS 278.183. Therefore, consideration of this issue is both beyond the jurisdiction of the Commission and irrelevant to those determinations the Commission is to make under KRS 278.183.*" (p. 1)

The AG's argument stands in contrast to the language of KRS 278.183, Commission precedent and the AG's own position in prior environmental surcharge proceedings.

The AG's argument that the allocation method proposed in Mr. Baron's testimony violates KRS 278.183 is flawed. KRS 278.183 is silent on the issue of how to allocate an environmental surcharge to ratepayers. By not specifying an allocation method in KRS 278.183 the Legislature left it within the discretion of the Commission to determine the appropriate allocation method. In prior environmental

surcharge proceedings the Commission has applied the "total revenue" including fuel method due in part to the fact that no party had submitted cost of service evidence. Despite the fact that the Commission has used the "total revenue" method in the past the Commission is not, as the AG contends, bound to use this method in every future case. It is clear from past environmental surcharge cases that the Commission will apply the method that it determines will most closely track cost of service principles on a case-by-case basis.

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.[1] 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.[2] KU proposed that the Commission apply the "total revenue" method which assigns costs according to the allocations determined in the Company's most recent rate case.[3] 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-servicestudy... "[4]

[1] KPSC Case No. 93-465 (Order of July 19, 1994) p. 21.
[2] Id. p. 20.
[3] Id.
[4] Id. p. 21.

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 subsequent environmental surcharge proceedings the Commission has also demonstrated that it will deviate from the "total revenue" method and that it will do so in order to track cost of service more closely. The Commission has previously exercised its discretion to modify the initial basis for allocation by subsequently excluding brokerage revenues from non-jurisdictional and total revenues in the computation of both the LG&E and KU monthly ECR factors. Further, in Case No. 2000-107 the Commission rejected Kentucky Power's proposal to allocate a disproportional amount of its environmental surcharge to retail ratepayers in favor of wholesale customers. The Commission stated 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.*"[5] In another 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.[6]

Finally, the Company also apparently shares KIUC's conclusion that the Commission has the discretion to apply any reasonable cost allocation method. In KU witness Kent Blake's discussion of KIUC's allocation proposal, Mr. Blake acknowledges that the "total revenues" method perpetuates class subsidies and testifies that, "[t]*he Commission must determine whether it will apply its discretion in this*

[5] KPSC Case No. 2000-107, Order of February 8, 2001. p. 11.
[6] KPSC Case No. 2002-00169, Order of March 31, 2003 at p. 39.

case to change the methodology for applying ECR charges in order to reduce this discrepancy in the Companies' base rates. This is a basic policy decision."[7]

In this case, KIUC has submitted five cost of service studies through the testimony of Mr. Baron in order to comply with the Commission's specific mandate that cost of service evidence must be submitted in order to support a cost allocation other than total revenue. Instead of attempting to challenge Mr. Baron's cost of service testimony through rebuttal testimony, the AG has moved to strike Mr. Baron's testimony arguing that the Commission lacks the jurisdiction to assign costs by any method other than the total revenue method. The AG has not supported this argument with any statutory language because the statute is silent on an allocation method. The AG has not supported its argument with any language from a Commission Order because the Commission has specifically noted that cost of service evidence is necessary in order for it to approve an allocation method different than the allocation approved in the preceding rate case (i.e. total revenue).

The Commission was given the discretion by the Legislature to allocate the environmental surcharge according to any reasonable method. The Commission has clearly stated that the environmental surcharge allocation should closely track cost of service. The Commission has invited the parties in environmental surcharge proceedings to submit cost of service evidence in support of cost allocations that are different than "total revenue." KIUC has accepted this offer by submitting five cost of service studies in support of its "total revenue minus fuel" proposal. The AG has not made any colorable argument why the Commission should turn its back on the statutory scheme and Commission precedent and strike Mr. Baron's testimony.

[7] Rebuttal testimony of Kent Blake. pp 12-13.

2. **Even If The Commission Agrees With The AG's Contention That KRS 278.183 Requires The Commission To Approve A Single Environmental Surcharge, KIUC's Proposal Does Not Violate This Alleged Statutory Requirement. The "Total Revenue Minus Fuel" Allocation Method Does Not Require Separate Surcharges For The Different Customer Classes.**

The AG argues that the statute's (KRS 278.183) reference to "an environmental surcharge" to "existing rates" precludes Mr. Barons's cost allocation proposal because his testimony adopts "varying or differing surcharges".[8] Even if the Commission were to accept this interpretation of KRS 278.183, the AG is incorrect that KIUC's proposed "total revenue minus fuel" methodology requires different surcharges for the different customer classes.

Mr. Baron's testimony contemplates a two-step process for allocating the environmental surcharge. However, the second step, which is the only step that the AG argues conflicts with the statute, is unnecessary and was only included by Mr. Baron in the interest of administrative convenience. KIUC's proposed "total revenue minus fuel" applies a single surcharge on all customers regardless of customer class.

In Mr. Baron's testimony, the "total revenue minus fuel" method was explained in two steps. In the first step, the cost of fuel is subtracted from total customer revenues and a single surcharge factor is applied to this "revenue minus fuel" number. This differs from the "total revenue" method in only one way. Using the year 2009 as an example, in the "total revenue" method the Company would apply an approximate 15% surcharge to all customer bills in order to pay for KU's environmental compliance costs. In the "total revenue minus fuel method," fuel costs are first subtracted from all customer bills and an approximate 24% surcharge is applied to this lesser amount. This is all that is needed in order to allocate and recover ECR revenues in Mr. Baron's "total revenue minus fuel" method. Obviously this

[8] AG's Motion to Strike, p. 4.

does not violate the AG's alleged prohibition against multiple surcharges, since each customer would have the identical surcharge factor that would be applied to the customer's non-fuel bill. The second step was added to Mr. Baron's analysis for administrative convenience purposes and in order to demonstrate that this allocation methodology would result in only a minor impact on residential rates. In the second step, the data obtained in the first step is used to calculate separate surcharges for each customer class that can be expressed as a rate applied to the total revenue on each customer's bill.[9]

As mentioned above, the second step is unnecessary to the application of the "total revenue minus fuel" method. This 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.

In sum, whether or not the Commission determines that the AG has correctly interpreted the statute, Mr. Baron's "total revenue minus fuel" does not violate KRS 278.183. KIUC's proposed "total revenue minus fuel" effectively applies a single surcharge to each customer's bill and is as easy to administer as the "total revenue" methodology. The only difference between the two allocation methods is that the cost of fuel, an easily ascertainable number, is subtracted from total revenue before the surcharge is factored in.

III. CONCLUSION

The Commission has discretion to apply any reasonable allocation method because the environmental surcharge statute is silent with respect to cost allocation. Further, even if the Commission agrees with the AG's contention that KRS 278.183 requires the Commission to approve a single environmental surcharge, KIUC's proposal does not violate this alleged statutory requirement. The "total revenue minus fuel" allocation method does not require separate surcharges for the different customer classes. The AG's Motion to Strike Testimony of Stephen J. Baron should be denied.

[9] Baron Testimony, p. 16-19.

Respectfully submitted,

Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph: (513) 421-2255
Fax: (513) 421-2764
E-Mail: mkurtz@bkllawfirm.com

COUNSEL FOR KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

May 10, 2005