

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE
COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS)
RATES OF THE UNION LIGHT,)
HEAT AND POWER COMPANY)

CASE NO. 2005-00042

ATTORNEY GENERAL'S PETITION FOR REHEARING

On December 22, 2005 the Commission entered its Order on the application of ULH&P for an increase in its rates. Pursuant to KRS 278.400, the Attorney General seeks rehearing.

- 1. The Commission should grant rehearing and reconsider its ruling with reference to incentive compensation.**

The Attorney General sought to exclude all of ULH&P's proposed incentive compensation expense consistent with the Commission's prior rulings pertaining to ULH&P and because the incentive compensation places more weight on shareholder interests than on ratepayer interests. At pages 39 through 40 of the Order dated December 22, 2005, the Commission adopted, in part, ULH&P's alternative proposal for inclusion in rates of a portion of its incentive compensation as put forth in the Company's rebuttal testimony.

The Commission's decision allows in rates \$294,289 of the Company's total test year incentive compensation expenses of \$616,467. The attached exhibit presents a breakout of the specific components of the allowed incentive compensation expenses of \$294,289. First, the Commission ordered that the 50% AIP incentive compensation portion of \$225,558 that is based on corporate financial performance goals (net income of Cinergy) should be shared on a 50/50 basis between ratepayers and shareholders. Second, the Commission ordered that the 25% AIP

incentive compensation portion of \$112,779 that is based on RBU operational goals should be shared on a 50/50 basis between ratepayers and shareholders because 50% of the RBU operational goals consist of corporate financial performance goals. Third, the Commission ordered that 100% of the LTIP incentive compensation expenses of \$125,121 be charged 100% to the shareholders because 100% of this incentive compensation is based on corporate financial performance goals in the form of Cinergy's Total Shareholder Return. Finally, while 50% of the Company's UEIP incentive compensation program is based on corporate financial performance goals and the other 50% is based on RBU operational goals, the Commission ordered that all of these incentive compensation expenses be charged to the ratepayers.

The AG agrees with the Commission's ruling that 100% of the LTIP incentive compensation be charged to the shareholders. This ruling is consistent with past Commission rulings which allocate to the shareholders all incentive compensation expenses that are based on corporate financial performance goals.

However, the AG disagrees with the Commission's ruling that the 50% AIP incentive compensation portion of \$225,558 that is 100% based on corporate financial performance goals be shared on a 50/50 basis between ratepayers and shareholders. The AG therefore asks that the Commission reconsider this issue and allocate the entire \$225,558 expense to the shareholder.

The 50/50 ratepayer/shareholder allocation of AIP incentive compensation that is 100% based on corporate financial performance goals is inconsistent with the prior ruling of the Commission in ULH&P's last gas rate case. It is also internally inconsistent with the Commission's ruling that the AIP incentive compensation portion of \$112,779 that is based on RBU operational goals should be shared on a 50/50 basis between ratepayers and shareholders because 50% of the RBU operational goals consist of corporate financial performance goals. In

other words, the Commission has ruled that the 50% portion, or \$56,389, of the AIP's RBU operational goals incentive compensation that is based on corporate financial performance be fully charged to the shareholder. The Commission did not further allocate this \$56,389 incentive compensation portion on a 50/50 basis between ratepayers and shareholders.

Finally, the 50% ratepayer allocation of incentive compensation that is 100% based on corporate financial performance goals is inconsistent with the Commission's refusal to make ratepayers responsible for the cost of corporate financial performance-based incentive compensation in the last Kentucky American Water Company rate case.¹ ULH&P's claims that net income reflects operational efficiencies that inure to the benefit of customers and creates a healthy balance sheet that results in lower borrowing costs² are just as generic and unsupported by evidence as were Kentucky American's claims that ratepayers gain from a financially healthy company and that incentive compensation motivates employees to put customer service and satisfaction at the forefront of their efforts.

As it did for Kentucky American Water Company's ratepayers, the Commission should refuse to allocate to UH&P's ratepayers the portion of the AIP incentive plan based on corporate financial performance as measured by Cinergy's net income absent specific studies showing the nature and quantity of the benefits ratepayers gain from that component. From a ratepayer perspective, rather than assuming that meeting corporate net income targets demonstrates operational efficiencies that inure to the benefit of customers, a rollicking corporate net income may mean reductions in service consequent to reductions in personnel or in payment center locations, or the entirely too slow replacement of the company's mains under the company's safety replacement CIMOS and BIMOS reviews, which served to create a safety crisis and the

¹ In the Matter of: Adjustments of the Rates of Kentucky-American Water Company, Case No. 2004-001103, 28 February 2005 Order, pp. 47-49.

² Verhagen Rebuttal Testimony, p. 4

need for accelerated mains replacement programs at substantial added expense to the ratepayer. Assumptions about the beneficial effect of achieving corporate financial performance targets cannot be made for ratepayers. ULH&P has provided generic and sweeping statements, but no definite evidence to support its claim of ratepayer benefit.

The AG also disagrees with the Commission's ruling to allocate the entire \$80,460 expense of the UEIP incentive plan to the ratepayers. While 50% of the Company's UEIP incentive compensation program is based on corporate financial performance goals³ and the other 50% is based on RBU operational goals, the Commission ordered that all of these incentive compensation expenses be charged to the ratepayers. It did not share the 50% corporate performance portion of the UEIP on a 50/50 basis between ratepayers and shareholders as it did for the AIP incentive plan corporate performance portion.

Neither did the Commission charge 50% of the RBU operational goals portion of the UEIP to the shareholders as it did for the AIP RBU operational goal portion. Thus, this ruling is internally inconsistent with the Commission's rulings in this case with regard to the Company's AIP incentive compensation plan expenses and is also inconsistent with the Commission's past rulings for ULH&P's incentive compensation expenses.

Further, the Commission's ruling allows the allocation of the corporate financial performance component of incentive compensation cost to ULH&P's ratepayers without specific evidence of the benefit to ratepayers despite correctly requiring such proof as a prerequisite to that allocation on behalf of Kentucky American Water Company's ratepayers. The Commission

³ Verhagen Direct Testimony, page 12, lines 20-23, and page 13, lines 12-13.

should grant rehearing and should allocate 75%⁴ of the total UEIP plan \$80,460 expense that represents corporate performance components to the shareholders.

2. The Commission should grant rehearing and reconsider its ruling with reference to whether a return on equity may be recovered under KRS 278.509.

At page 70 of its Order, the Commission recites the provision of KRS 278.509

and goes on to state:

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

This ruling ignores the fact that KRS 278.509 is a cost recovery statute that must be implemented according to its own terms, terms that do not include the recovery of anything but costs. A return on equity is not a cost. It is profit. That profit is included in rate recovery when those rates are established to be fair, just, and reasonable because the element of profit or a return must be considered to avoid the confiscation of property when establishing rates under the fair, just and reasonable standard. See, *F. P. C. v. Hope Natural Gas Co.*, 320 US 591, 64 SCT 281, 88 Led 333 (1944) discussing the establishment of “just and reasonable rates” under the National Gas Act just and reasonable standard; KRS 278.030. KRS 278.509 is not KRS 278.030 and does not recover all costs recovered under KRS 278.030’s fair, just, and reasonable standard.

Like KRS 278.183 did for electric utilities, KRS 278.509 creates new and substantive rights for gas companies that did not previously exist.⁵ That is the right to cost recovery, not

⁴ All of the UEIP’s 50% incentive plan expenses that are based on corporate financial performance and half of the UEIP’s 50% incentive plan expenses that are based on RBU operational goals should be charged to the shareholder.

⁵ With reference to KRS 278.183, the Supreme Court said:

The legislation involved is substantive and not remedial. The surcharge creates a new right for all electric utilities, that is, the right to recover expenses as well as a return on and a return of capital costs associated with environmental projects without filing a general rate case. The law also requires consumers to pay for the costs of the environmental compliance plan through the

simply an opportunity to recover, the defined costs. This means however, that the concepts of traditional ratemaking arising out of the fair, just and reasonable standard cannot be applied selectively to the benefit of the utility. Instead, the statute must be applied according to its terms. Cf., *Kentucky Indus. Utility Customers, Inc. v. Kentucky Utilities Co.* 983 S.W.2d 493, at 501 (Ky.,1998).

KRS 278.509 holds itself apart from KRS 278.030, under which the utility is entitled to recover fair, just and reasonable rates with the language “notwithstanding any other statute.” It is a statute that creates new and substantive rights. Its purpose is to establish cost recovery for defined costs, not to establish a fair, just and reasonable rate. As a cost recovery statute, it functions differently from fair, just and reasonable rates by insuring that the business does produce net revenues rather than establishing a rate under which it has the opportunity to do so. While KRS 278.509 precludes the recovery of costs that have not been deemed by the commission to be fair, just, and reasonable under that cost recovery mechanism, it does not define a return, the profit, as a cost.

The failure of KRS 278.509 to define profit as a cost stands in contrast to KRS 278.183, also a cost recovery mechanism, which clearly and specifically defines return as a cost saying, “These costs shall include a reasonable return on construction and other capital expenditures...” Because KRS 278.183 makes it clear that when the legislature intends to include a return or profit as a cost for the purposes of a cost recovery mechanism, it does so specifically, the Commission is not free to expand the meaning of cost to include profit when KRS 278.509 does not specifically define return as a cost. *Smith v. Wedding*, 303 S.W.2d 322 (KY 1957).

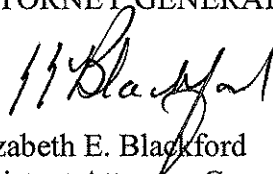
surcharge. These new rights and responsibilities did not exist before the enactment of the surcharge.
Kentucky Indus. Utility Customers, Inc. v. Kentucky Utilities Co. 983 S.W.2d 493, at 500 (Ky.,1998)

If the recovery of the added costs allowed by KRS 278.509 in addition to the base rates established in the general rate cases is insufficient to allow the utility a fair return, the utility retains the statutory right to bring a general rate case under KRS 278.030 to seek recovery of an increase in rates. Cf., *Kentucky Utility Customers Inc. v. Kentucky Utilities Company*, supra., in which the Court found that KRS 278.183 created new and substantive rights that did not previously exist, and that the only costs to be recovered under that statute were those covered by that statute. Other costs remained subject to recovery by way of a general rate case.

Wherefore, the Attorney General seeks rehearing and reconsideration. As a result of that rehearing and reconsideration, the Commission should change the amount and type of incentive compensation to be recovered in rates and should exclude a return on equity from recovery under KRS 278.509.

Respectfully submitted,

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**UNION LIGHT HEAT AND POWER COMPANY
INCENTIVE COMPENSATION ADJUSTMENT**

CASE NO. 2005-00042

				PSC DECISION		
				Test Year Amount	Ratepayer Sharing	Shareholder Sharing
AIP	Corporate Performance goals	50%	\$ 225,558	\$ 112,779	\$ 112,779	
	Individual goals	25%	\$ 112,779	\$ 112,779		
	RBU Operational goals	25%	\$ 112,779	\$ 56,389	\$ 56,389	
			<u>\$ 451,116</u>	<u>\$ 281,947</u>	<u>\$ 169,168</u>	
LTIP	Total Shareholder Return		\$ 125,121		\$ 125,121	
UEIP	Corporate Performance goals	50%	\$ 40,230	\$ 40,230		
	RBU Operational goals	50%	\$ 40,230	\$ 40,230		
			<u>\$ 80,460</u>	<u>\$ 80,460</u>		
Total Test Year Incentive Compensation			<u>\$ 616,467</u>	<u>\$ 322,177</u>	<u>\$ 294,289</u>	

NOTES:

AIP: The overall performance goal for the AIP is divided into three parts: 50% Corporate Performance goal; 25% Individual goals; and 25% RBU Operational goals. The 25% RBU Operational goals also include corporate performance goals. The PSC has ordered that the 50% Corporate Performance goal portion be charged 50% ratepayers/50% shareholders; that the 25% RBU Operational goals portion be charged 50% ratepayers/50% shareholders; and that the 25% Individual goal portion be charged 100% to the ratepayers.

LTIP: All of the LTIP incentive compensation is based on the Total Shareholder Return goal. The PSC has ordered that 100% of this incentive compensation be charged to the shareholders.

UEIP: The overall performance goals for the UEIP is 50% corporate performance goal and 50% RBU operational goals. The 50% RBU Operational goals also include corporate performance goals. The PSC has ordered that 100% of these UEIP incentive compensation expenses be charged to the ratepayers.

Corporate Performance goal = net income of Cinergy Corporation.

NOTICE OF FILING AND CERTIFICATION OF SERVICE

I hereby give notice that I have filed the original and ten true copies of the foregoing Petition for Rehearing with the Executive Director of the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601 this the 13th day of January, 2006, and certify that this same day I have served the parties by mailing a true copy, postage prepaid, to the following:

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