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John J. Finnigan, Jr.
Senior Counsel

VIA HAND DELIVERY

RECEIVED
SEP 2 1 2005
PUBLIC SERVICE COMMISSION

September 21, 2005

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615

Re: In the Matter of an Adjustment of the Gas Rates of The Union Light, Heat and Power Company
Case No. 2005-00042

Dear Ms. O'Donnell:

I have enclosed an original and ten copies of The Union Light, Heat and Power Company's Brief in the above-referenced case. Please date stamp and return the two extra copies in the enclosed, self-addressed envelope.

Additionally, I have enclosed the Kentucky Department of Revenue's revised property tax assessment for ULH&P for 2005. At the hearing on August 15 and 16, 2005, ULH&P was asked to produce this revised assessment when it becomes available. The Department of Revenue issued this revised assessment on September 8, 2005.

Based on this 2005 revised assessment, and based on the plant additions planned for the forecasted test period, ULH&P projects its gas property tax expense for the forecasted test period at $2,189,524. The supporting calculation for this amount is enclosed with this letter.

If you have any questions, please do not hesitate to contact me at (513) 287-3601.

Sincerely,

John Finnigan

John J. Finnigan, Jr.
Senior Counsel

JJF/sew

cc: Hon. Elizabeth Blackford (w/encl.)(via hand delivery)

61A230 (8-04)
Commonwealth of Kentucky
DEPARTMENT OF REVENUE

DEPARTMENT OF REVENUE
OFFICE OF PROPERTY VALUATION
Public Service Branch
200 Fair Oaks Ln, 4th Floor, Station 32
Frankfort, Kentucky 40620
(502) 564-8175

NOTICE OF ASSESSMENT FOR PUBLIC SERVICE COMPANY

UNION LIGHT HEAT & POWER COMPANY
GREGG SCOTT TAX DEPT
1000 E MAIN ST
PLAINFIELD, IN 46168-1765

GNC: 005260
TYPE CO: GEU
TAX ID: 31047308(

This assessment is final. A corresponding Notice of Tax Due is being sent from the Compliance and Accounts Receivable System for the amount shown below. DO NOT SEND PAYMENT UNTIL YOUR NOTICE OF TAX DUE IS RECEIVED.

Local taxes will be billed directly by the local jurisdictions.

Date: 09/08/2005 Tax Year: 2005 FINAL

PROPERTY CLASS	ASSESSMENT
STATE AND LOCAL	
Real Estate @ .131	158,000,000.00
*Tangible Property @ .45	92,000,000.00
Business Inventory @ .05	0.00
STATE TAX ONLY	
Foreign Trade Zone Tangible @ .001	0.00
Recycling Equipment @ .45	0.00
Manufacturing Machinery @ .15	66,008,538.00
Pollution Control Equipment @ .15	0.00
Telephonic Equipment @ .15	0.00
Business Inventory (MM) @ .05	1,991,462.00
Intangibles @ .25	0.00
Intangibles @ .015	0.00
TOTAL ASSESSMENT	$ 318,000,000.00

*Excludes Motor Vehicles $2,915,211.00

A PENALTY OF 0 % WILL BE ASSESSED ON TAXES DUE WHEN FINAL. A 10% penalty is for late filed returns per KRS 132.290(3). A 20% penalty is for omitted property per KRS 132.290(4).

Union Light Heat & Power Company
Estimated 2006 Gas Property Taxes

2005 Final Kentucky Assessment	$318,000,000
Estimated 2005 Taxes	$3,469,214
Estimated 2005 Gas Taxes	$1,793,584
2006 Gas Additions	
Real Estate	$3,732
Tangible Personal Property	$356,749
Manufacturing Property	$414
Underground Gas Storage	$17,109
Estimated 1% increase in tax rates	$17,936
Estimated 2006 Gas	$2,189,524

Prepared by: G. Scott – Manager, Property Tax
09/19/05

i/planning/property tax/ulh&p rate case/union light heat gas rate case.doc

COMMONWEALTH OF KENTUCKY

BEFORE THE 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

BRIEF OF
THE UNION LIGHT, HEAT AND POWER COMPANY

164457

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164457

COMMONWEALTH OF KENTUCKY

BEFORE THE 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**

BRIEF OF
THE UNION LIGHT, HEAT AND POWER COMPANY

I. STATEMENT OF THE CASE

A. HISTORY OF THE PROCEEDINGS

The Union Light, Heat and Power Company ("ULH&P" or "Company") filed a Notice with the Public Service Commission on January 24, 2005, stating that the Company intended to file an application for a general gas rate increase in four weeks or reasonably soon thereafter. This filing complied with the notice requirements of 807 KAR 5:001, Sections 8(1) and 10(2). The Notice stated that the increase would be supported by a fully forecasted test year, as permitted by KRS 278.192 and 807 KAR 5:001, Section 10(1)(b).

The Company filed an Application, Notice and Statement ("Application") and supporting testimony with the Commission on February 25, 2005, in compliance with KRS 278.180. In the Application, ULH&P requested the following relief: (1) an increase in its gas distribution rates of approximately $14 million, based upon a fully forecasted test year reflecting the twelve months ending September 30, 2006, to become effective

April 1, 2005; (2) approval to continue ULH&P's Rider AMRP; and (3) approval of a change to its service regulations to permit ULH&P to assume ownership of the service piping between the curb and the meter at the time such service piping is installed. The following witnesses filed testimony on ULH&P's behalf: Gregory C. Ficke, ULH&P's President; Patricia K. Walker, Vice President of Gas Operations; Gary J. Hebbeler, Manager of Gas Engineering; Peggy A. Laub, Manager of Fixed Asset Accounting; John J. Spanos, of Gannett Fleming, Inc.; James A. Riddle, Manager of Load Forecasting; Timothy J. Verhagen, Vice President of Human Resources; Alexander J. Torok, Vice President of Taxation; Wendy L. Aumiller, Treasurer; Barry F. Blackwell, Director of Management Reporting and Cost Accounting; Steven E. Schrader, Chief Financial Officer for Cinergy Corp.'s Regulated Businesses; Dr. Roger A. Morin, an independent consultant; Paul F. Ochsner, Rates Coordinator; Jeffrey R. Bailey, Manager of Pricing; William Don Wathen, Jr., Manager of Revenue Requirements; and John P. Steffen, Vice President of Rates.

The Commission issued a letter on March 2, 2005, stating that the Application met the Commission's minimum filing requirements. The Company supplemented its filing with additional information on March 7, 2005. On March 21, 2005, the Commission ordered that ULH&P's proposed rates were suspended for six months, from April 1, 2005 through September 30, 2005, and also issued a procedural schedule.

The Attorney General ("AG") filed a motion to intervene on March 4, 2005. The Company did not oppose the AG's motion. The Commission issued an Order on March 9, 2005, granting intervention to the AG. Mr. Walter Nordloh filed a letter raising questions about the case on May 4, 2005, but did not request to intervene. The

Commission responded to Mr. Nordloh's letter on June 16, 2005, and did not grant him intervenor status. No other parties sought to intervene in the case, and the case proceeded with the AG as the sole intervenor.

Commission Staff issued three sets of information requests and the AG issued two sets of information requests. The Company duly responded to all of these information requests. The Commission revised the procedural schedule in an Order dated April 28, 2005. Per the revised schedule, on June 8, 2005, the AG filed testimony of David H. Brown Kinloch, Dr. J. Randall Woolridge, Michael J. Majoros, and Robert J. Henkes. ULH&P and the Commission Staff issued information requests to the AG, to which the AG responded.

ULH&P filed updated information in support of its requested rate increase on July 15, 2005, and also filed rebuttal testimony of Messrs. Hebbeler, Spanos, Riddle, Verhagen, Torok, Ochsner, Bailey, Wathen, Steffen, Ms. Laub and Dr. Morin. Additionally, the Company filed testimony of a new witness, Robert C. Lesuer of Mercer Human Resource Consulting. Commission Staff and the AG issued information requests directed to ULH&P's rebuttal testimony, to which the Company responded.

The case proceeded to hearing on August 15 and 16, 2005.

II. <u>RATE BASE</u>

The Company's Application originally proposed a jurisdictional gas rate base of \$167,499,239.[1] On March 18, 2005, Governor Fletcher signed H.B. 272, which reduced the Kentucky state corporate income tax from 8.25% to 7%, effective January 1, 2005. The Commission required ULH&P to submit revised schedules reflecting this change, which the Company filed on April 29, 2005 ("Supplemental Filing"). In this

Supplemental Filing, the Company reflected a jurisdictional gas rate base of $167,838,698.[2] The Company revised the jurisdictional gas rate base in its rebuttal testimony to $163,788,013.[3] The AG proposed a jurisdictional gas rate base of $162,980,160.[4] The differences between the Company's and the AG's proposed jurisdictional gas rate base arise from different treatment of certain adjustments, discussed in more detail below.

A. <u>JURISDICTIONAL RATE BASE RATIO</u>

1. <u>Change in Kentucky State Income Tax Rate</u>

As discussed above, the Kentucky State Income Tax Rate changed in March 2005, after the Company filed its Application. This impacts the Accumulated Deferred Income Taxes, which is a deduction to rate base. ULH&P accepts this adjustment, and has reflected this adjustment in its proposed adjusted jurisdictional gas rate base.

2. <u>Utility Plant in Service</u>

The slippage factor adjustment reflects the utility's historical trend, over the preceding ten years, of actual versus budgeted capital expenditures.[5] Much information was presented on this subject in the present case, through testimony and responses to data requests. The AG contends that a slippage factor should be calculated using the mathematical average (as opposed to cumulative weighted average) of the prior ten years' capital projects, but that AMRP-related projects should be excluded because "[c]onstruction expenditure decisions made [for Rider AMRP projects] are potentially

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1 Application, Volume V, Schedule B.

2 Supplemental Filing, Schedule B.

3 Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, Page 3 of 25.

4 Henkes Direct Testimony, Schedule RJH-4.

much different than - - and therefore, should not be considered representative of - - the construction decisions made for the Company's non-AMRP projects, the costs of which are recovered in base rates."[6] Using this methodology, the AG initially proposed a slippage factor adjustment of 6.048%.[7] The AG subsequently acknowledged that he made a transposition error in his calculation, and that the correct calculation, using his methodology, is 2.955%.[8]

ULH&P contends that no slippage factor adjustment should be applied. The Company acknowledges that the Commission has typically applied a slippage factor adjustment in forecasted test period cases.[9] The Company contends, however, that a slippage factor is inappropriate here because ULH&P has consistently spent its full capital expenditure budget since the AMRP commenced in 2001, except for an unusual situation which occurred in 2003 and 2004.[10] In those years, ULH&P did not spend its full capital budget because the Kentucky Department of Transportation ("KDOT") notified ULH&P late during ULH&P's planning process that KDOT was delaying some road improvement projects where the Company had planned to do main replacement work.[11] The Company understands that KDOT's budget was cut late in the year due to the Commonwealth of Kentucky's failure to pass a budget for state government.[12] The state government passed a new budget in 2005, so the Company does not expect this

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5 *Id.*
6 Henkes Direct Testimony at 17.
7 *Id.* at 19.
8 AG's Response to ULH&P-DR-01-013.
9 *See, e.g., In the Matter of Adjustment of the Rates of Kentucky-American Water Company,* Case No. 2004-00103 (Order at 3-4) (February 28, 2005).
10 Hebbeler Rebuttal Testimony at 2.
11 *Id.* at 2-3.
12 *Id.*

situation to recur in the foreseeable future.[13] Accordingly, the Company believes that a slippage factor adjustment should not be applied.

If the Commission does, however, apply a slippage factor adjustment, ULH&P disagrees with the AG's proposed methodology because it excludes AMRP-related projects.[14] This methodology is inappropriate because AMRP projects account for approximately 65% of ULH&P's annual capital expenditures, and the AG's methodology skews the calculation by disregarding these projects.[15] ULH&P is not aware of any other forecasted test period case where the Commission excluded a substantial portion of the utility's capital projects from the slippage factor calculation.

ULH&P calculated a slippage factor adjustment of 1.327%, using the mathematic average for the past ten years but excluding 2003 and 2004 due to the unusual circumstances discussed above. ULH&P proposes that this is the appropriate calculation, if the Commission decides to apply a slippage factor adjustment.[16] If the Commission decides to apply a ten-year mathematical average and to include 2003 and 2004 data, then ULH&P agrees with the AG that the appropriate adjustment is 2.955%.[17]

Finally, ULH&P in rebuttal testimony withdrew its proposed adjustment to rate base to reflect implementation of new automated meter reading technology.[18] At the time of the Application, the Company expected this new program to be implemented beginning in 2006, so it included an adjustment in rate base for this item.[19] As of ULH&P's rebuttal filing on July 15, 2005, Company management had not yet approved

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13 *Id.*
14 Henkes Direct Testimony at 19.
15 Hebbeler Rebuttal Testimony at 4.
16 *Id.* at 3-4.
17 *Id.* at 4.
18 Hebbeler Rebuttal Testimony at 4-5.

installation of this technology to begin in 2006, so ULH&P withdrew its request for an adjustment based on this item.[20] Eliminating the thirteen-month average balance of Construction Work in Progress associated with this change reduces rate base by $549,000.[21]

3. **Prepayments**

The parties also disagree as to whether the Prepayments in ULH&P's rate base should be adjusted to remove the PSC Assessment. ULH&P contends that the PSC Assessment is properly included in rate base,[22] while the AG contends that the PSC Assessment should be excluded from rate base.[23]

The AG's sole rationale for excluding the PSC Assessment from rate base is "to reflect PSC policy that such PSC assessment balances are not considered to be prepayments."[24] The Company acknowledges that the Commission excluded the PSC Assessment from rate base in the Company's last general gas rate case, and in three prior ULH&P rate cases.[25] Yet the Commission has expressed a willingness to reconsider this issue because it instructed ULH&P that, in the present case, it should include a narrative explanation of why the PSC Assessment should be treated as a prepayment rather than an accrued liability.[26]

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19 *Id.*

20 *Id.*

21 Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, Schedule B-1.

22 Wathen Direct Testimony at 6-9; Wathen Rebuttal Testimony at 7.

23 Henkes Direct Testimony at 21.

24 *Id.*

25 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 7-10) (January 31, 2002).

26 *Id.* at 9.

In response to the Commission's directive, Mr. Wathen presented an extensive explanation on ULH&P's behalf as to why the PSC Assessment is a prepayment.[27] As Mr. Wathen explains, the PSC Assessment is a prepayment because KRS 278.130 requires ULH&P to pay this charge "on or before July 1 of the amount assessed against it."[28] Although the PSC Assessment is allocated among jurisdictional utilities based on historical revenues, the charge is based on the PSC's projected expenses, and funds the PSC's operations for the following fiscal year, and the Company pays the fee well before the upcoming year covered by the payment, such that this prepayment is reflected as a debit on ULH&P's books at any given point during the year.[29]

The Company's proposed treatment is consistent with the FERC Uniform System of Accounts, which instructs that advance payments for future expenses should be accounted for as prepayments, and the payments should be spread over the future period to which they apply.[30] Kentucky law provides that the Commission's regulation of a gas or electric utility's accounts should "conform as nearly as practicable to the system adopted or approved by the Federal Energy Regulatory Commission."[31] Based on the foregoing, the Commission should properly treat the PSC Assessment as a prepayment.

4. <u>Cash Working Capital</u>

The Attorney General proposed an adjustment to rate base in the amount of $2,282,526 for Cash Working Capital, based on calculating the adjustment using the "1/8th formula" methodology.[32] ULH&P agrees that the "1/8th formula" is the proper

27 Wathen Direct Testimony at 6-9; Wathen Rebuttal Testimony at 6-7.
28 Wathen Direct Testimony at 7.
29 *Id.* at 8.
30 *Id.*
31 KRS 278.220.
32 Henkes Direct Testimony at 22.

methodology to use, but the Company calculated an adjustment of $2,336,716.[33] The difference occurs because the AG has proposed different O&M expenses. The Company and the AG both used a methodology is consistent with Commission precedent. The Company submits that its proposed O&M expense recommendations are proper; therefore, the Company requests that the Commission adopt its Cash Working Capital recommendation.

5. <u>Accumulated Deferred Income Taxes</u>

The Attorney General recommended adjusting ULH&P's rate base for Accumulated Deferred Income Taxes ("ADIT") to reflect: (1) the change in the Kentucky state income tax rate; (2) the impact of ADIT on unbilled gas revenue; and (3) an imputed level of ADIT related to unbilled gas revenue over a five-year period, and to amortize the resulting unprotected excess ADIT over the same five-year period.[34] The AG's recommendations result in gas jurisdictional ADIT of $(36,403,825) and electric jurisdictional ADIT of $(118,258,991).[35]

The Company accepts the AG's first two adjustments to ADIT, but not the third.[36] The Company rejects the third adjustment because it is inconsistent with the matching principle. ULH&P currently treats ADIT by matching the income tax effect to the item of revenue or expense from which the tax effect arises.[37] The AG's proposal not only violates the matching principle, but also is inconsistent with ULH&P's longstanding practice for treating these items.[38] ULH&P therefore submits that the Commission

33 Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, Schedule B-5.1.
34 Henkes Direct Testimony at 22-26.
35 *Id.*, Schedule RJH-7.
36 Wathen Rebuttal Testimony at 8.
37 Torok Direct Testimony at 4-5.
38 *Id.*

should adopt the first two proposed ADIT adjustments discussed above, but reject the third.

After Mr. Henkes filed his testimony proposing the foregoing three ADIT adjustments, the Company discovered that another ADIT adjustment is necessary. The Company learned that, in the Application, it inadvertently failed to eliminate from rate base the ADIT related to purchased gas costs, as required by the Commission's Order from ULH&P's last general gas rate case.[39] Based on all of the foregoing, the Company recommends an ADIT adjustment of $(30,039,766).[40]

III. CAPITALIZATION

The Company and the AG followed the same methodology to derive the adjusted jurisdictional gas capitalization, and this methodology conforms with the methodology used by the Commission in ULH&P's last gas base rate case.[41] Under this methodology, the rate base used to calculate the jurisdictional rate base ratio for computing jurisdictional capitalization is the rate base as of the end of the test period, without reflecting adjustments for ratemaking purposes.[42]

ULH&P's Application proposed a jurisdictional gas capitalization of $165,719,193.[43] Following ULH&P's recommended rate base adjustments, discussed above, ULH&P revised its jurisdictional gas capitalization to $161,960,977.[44] The AG's proposed jurisdictional gas capitalization is $162,296,080, based on the rate base

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39 Wathen Rebuttal Testimony at 8-9.
40 *Id.,* Attachment WDW-Rebuttal-1, Schedule B-6.
41 Henkes Direct Testimony at 11-12.
42 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 5-6) (January 31, 2002).
43 Application, Volume V, Schedule A.
44 Wathen Rebuttal Testimony, Attachment WDW-Rebuttal-1, Schedule A.

adjustments which the AG advocates.[45] The Company requests that the Commission apply ULH&P's revised jurisdictional gas capitalization, and calculate new gas rates by applying ULH&P's weighted average cost of capital to this jurisdictional gas capitalization, consistent with the Commission's normal practice.[46]

IV. REVENUES AND EXPENSES

A. ULH&P'S INITIAL ADJUSTMENTS TO REVENUES AND EXPENSES

ULH&P reported unadjusted net operating income for the base period of $11,382,300.[47] The Company proposes a series of adjustments to its revenues and expenses for the base period and the forecasted period to reflect normalized operating conditions. The purpose of these proposed adjustments is to transform the financial data for the base period into the forecasted period, as required by KAR 5:001, Section 10(8)(a).[48] ULH&P's Application recommended adjustments to net operating income of $(6,066,422) for the base period (Schedules D-2.1 through D-2.14) and $996,818 for the forecasted period (Schedules D-2.15 through D 2.25).[49]

ULH&P proposed adjustments for the following items:

- Schedule D-2.1: adjust base period revenue to the forecasted test period revenue;[50]
- Schedule D-2.2: adjust base period purchased gas costs to the forecasted test period gas costs;[51]

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45 Henkes Direct Testimony, Schedule RJH-3.
46 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 28-29:) (January 31, 2002).
47 Application, Volume V, :Schedule C-2.
48 Wathen Direct Testimony at 11.
49 Application, Volume V, Schedule C-2.
50 Application, Volume V, Schedule D-2.1.
51 Application, Volume V, Schedule D-2.2.

- Schedule D-2.3: adjust base period other production expenses to the forecasted period;[52]
- Schedule D-2.4: adjust base period gas supply expenses to the forecasted period;[53]
- Schedule D-2.5: adjust base period transmission expenses to the forecasted period;[54]
- Schedule D-2.6: adjust base period distribution expenses to the forecasted period;[55]
- Schedule D-2.7: adjust base period customer accounts expenses to the forecasted period;[56]
- Schedule D-2.8: adjust base period customer service and informational expenses to the forecasted period;[57]
- Schedule D-2.9: adjust base period sales expense to the forecasted period;[58]
- Schedule D-2.10: adjust base period administrative and general expenses to the forecasted period;[59]
- Schedule D-2.11: adjust base period other operating expenses to the forecasted period;[60]
- Schedule D-2.12: adjust base period depreciation expense to the forecasted period;[61]

52 Application, Volume V, Schedule D-2.3.
53 Application, Volume V, Schedule D-2.4.
54 Application, Volume V, Schedule D-2.5.
55 Application, Volume V, Schedule D-2.6.
56 Application, Volume V, Schedule D-2.7.
57 Application, Volume V, Schedule D-2.8.
58 Application, Volume V, Schedule D-2.9.
59 Application, Volume V, Schedule D-2.10.
60 Application, Volume V, Schedule D-2.11.
61 Application, Volume V, Schedule D-2.12.

- Schedule D-2.13: adjust base period taxes other than income taxes to the forecasted period;[62]
- Schedule D-2.14: adjust base period income taxes to the forecasted period;[63]
- Schedule D-2.15: adjust forecasted test period injuries and damages expenses to reflect most recent ten-year average amount;[64]
- Schedule D-2.16: adjust forecasted test period expenses to include one-third of the estimated costs of the rate case expense for this proceeding;[65]
- Schedule D-2.17: adjust forecasted test period revenues and expenses to reflect affiliate company rents;[66]
- Schedule D-2.18: adjust forecasted test period expenses to reflect in income tax expenses the interest costs that are deductible for income tax purposes;[67]
- Schedule D-2.19: adjust forecasted test period expenses to eliminate revenues and expenses attributable to other than Kentucky customers;[68]
- Schedule D-2.20: adjust forecasted test period expenses to reflect the calculation of AFUDC on the CWIP balance as of the plant valuation date;[69]
- Schedule D-2.21: adjust forecasted test period expenses to eliminate revenue and expenses related to the DSM Rider;[70]
- Schedule D-2.22: adjust forecasted test period expenses to eliminate miscellaneous expenses;[71]

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62 Application, Volume V, Schedule D-2.13.
63 Application, Volume V, Schedule D-2.14.
64 Application, Volume V, Schedule D-2.15.
65 Application, Volume V, Schedule D-2.16.
66 Application, Volume V, Schedule D-2.17.
67 Application, Volume V, Schedule D-2.18.
68 Application, Volume V, Schedule D-2.19.
69 Application, Volume V, Schedule D-2.20.

- Schedule D-2.23: adjust forecasted test period expenses to annualize depreciation expense for the forecasted test period;[72]
- Schedule D-2.24: adjust forecasted test period expenses to eliminate unbilled revenue and purchased gas costs;[73] and
- Schedule D-2.25: adjust forecasted test period revenue and expenses to include the proposed increase in bad check and reconnection charge revenues.[74]

B. WEATHER NORMALIZATION

The Company and the AG disagreed on whether a 10-year or a 30-year weather estimate of normal weather should be applied in projecting the Company's forecasted gas sales to determine its expected revenues. ULH&P proposed a 10-year weather normalization in its last case, but the Commission rejected this proposal and instead applied a 30-year weather normalization ending in the most recent year.[75] ULH&P used a 10-year weather normalization because the weather during the past ten years is more representative of current weather trends than the weather over the past 30 years.[76] The Company supported its proposed 10-year weather normalization with the following studies:

- testimony from Thomas Karl, the Director of the National Oceanic and Atmospheric Administration's ("NOAA") National Climactic Data Center, to the

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70 Application, Volume V, Schedule D-2.21.
71 Application, Volume V, Schedule D-2.22.
72 Application, Volume V, Schedule D-2.23.
73 Application, Volume V, Schedule D-2.24.
74 Application, Volume V, Schedule D-2.25.
75 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 31-33) (January 31, 2002).
76 Riddle Direct Testimony at 7.

U.S. Senate stating that weather has been warming over the past several years, and that the 1990s was the warmest decade in the past 1,000 years;[77]

- a 1981 study arising from an inquiry by the Illinois Commerce Commission, concluding that weather normals based on a 10-year period were much better predictors of weather than 20-year or 30-year weather normals;[78]
- a 1996 study in the Journal of Climate, concluding that annually updated weather normals over shorter time periods were better predictors of weather than 30-year weather normals;[79] and
- a 2001 white paper by Messrs. Thomas Karl and James Laver of NOAA stating that, based on energy industry complaints to NOAA about the accuracy of 30-year normals, NOAA will develop a web-based tool which will allow for the calculation of new weather normals based on shorter time scales, including annually and ten years.[80]

In addition to this exhaustive research supporting the use of 10-year weather normals, ULH&P analyzed the accuracy of 10-year versus 30-year weather normals using the Mean Percent Error ("MPE"). The MPE indicates whether these normals tend to over-estimate or under-estimate actual weather conditions, with a lower MPE score indicating a more accurate and reliable measurement.[81]

ULH&P's analysis showed that the MPEs for various time periods using 10-year weather normals are consistently more accurate than the MPE for various time periods

77 Riddle Direct Testimony, Attachment JAR-6.
78 Riddle Direct Testimony, Attachment JAR-7.
79 Riddle Direct Testimony, Attachment JAR-8.
80 Riddle Direct Testimony, Attachment JAR-9.
81 Riddle Direct Testimony at 9.

using 30-year weather normals.[82] Additionally, the Company prepares the sales and revenues for its official operating budgets and strategic planning and rating agency forecasts for gas and electric service using 10-year weather normals because the Company is convinced that this measure is more accurate than 30-year weather normals.[83]

The AG advocated using a 30-year weather normalization, primarily because the Commission has approved the use of 30-year weather normals in past cases.[84] The AG did not support his position with any research or studies, and at hearing, the AG did not dispute the accuracy of ULH&P's MPE analysis presented in Mr. Riddle's rebuttal testimony.[85]

Although the Commission has historically endorsed the use of 30-year weather normals to calculate sales, ULH&P's extensive analysis demonstrates that 10-year weather normals produce a more accurate and reliable measurement. The goal of ratemaking should be to establish rates based on the most accurate and reliable data available and to allow the Company an opportunity to earn its authorized rate of return. ULH&P therefore strongly urges the Commission to approve the use of 10-year weather normals to calculate sales, as supported by the testimony of Mr. Riddle.

C. PROJECTED FT SALES

ULH&P's forecast projects a decline in gas sales to firm transportation customers of approximately 26% from October 1, 2004 levels to September 30, 2006, while the AG

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82 Riddle Rebuttal Testimony at 2-4.
83 Hearing Transcript at 61-62 (August 15, 2005).
84 Brown Kinloch Direct Testimony at 6-7.
85 Hearing Transcript at 29-71 (August 15, 2005).

recommends that an increase in sales of 9.08% should be projected.[86] The Company's projection is based on an assumed loss of three customers over this two-year period, and a projected increase in gas prices of 24%.[87]

ULH&P used a sophisticated econometric forecasting model for this projection, which it has used for its official operating budgets and strategic planning and rating agency gas and electric sales forecasts for the past 20 years.[88] The Company's projection is based on several different economic inputs, and uses several years of historical data for its analysis.[89] The program performs a comprehensive forecast of sales for all rate schedules, which is important because all customers' usage of gas is influenced, albeit by varying degrees, by similar economic factors.[90] In addition, the sales to various rate schedules are interrelated in that if an existing retail customer (who receives commodity and transportation service) migrates to become a firm transportation customer (who receives transportation service only), then sales to retail customers would decrease and sales to firm transportation customers would increase, all else equal.[91]

The AG, on the other hand, forecasted an increase in firm transportation sales of 9.08% simply by comparing the amount of sales for firm transportation customers from 2003-2004.[92] The AG offered no justification for only using one year's worth of data and ignoring the other available data. This was a peculiar choice, given the AG's objection to ULH&P's use of only ten years of weather data for its sales forecast The AG did not apply his methodology consistently to all customer classes, because this would have

86 Brown Kinloch Direct Testimony at 8-9.
87 ULH&P Responses to AG-DR-01-130 and AG-DR-02-049.
88 Riddle Rebuttal Testimony at 6-16.
89 *Id.*; Application, Volume V, Schedule I-5.
90 *Id.* at 16.
91 Hearing Transcript at 64-65 (August 15, 2005).

resulted in lower projected sales than that projected by ULH&P.[93] The AG's methodology not only is fundamentally unsound, but also represents brazen cherry-picking. The Company therefore requests that the Commission reject the AG's proposal, and use the Company's projection of firm transportation sales to calculate expected revenues for the forecasted test period.

D. BAD CHECK AND RECONNECTION CHARGE EXPENSES

ULH&P proposed increasing its bad check charge from $11.00 to $20.00, which the AG opposes on the grounds that it is not cost-based.[94] The Company did not perform a specific study to determine the costs to process a bad check.[95] Nevertheless, the proposed charge is reasonable based on observed bad check charges from other service providers.[96] This proposed increase does not result in the Company recovering more than its costs on an overall basis, because this change does not affect the overall revenue requirement.[97] Simply put, the Company should set this fee to deter customers from using bad checks, because this does impose costs on the Company and its customers. The Indiana Utility Regulatory Commission recently imposed a similar increase in the bad check charge for PSI Energy, Inc., ULH&P's affiliate, based on similar logic.[98] The Public Utilities Commission of Ohio Staff has also recommended a similar increase in CG&E's pending electric distribution case. The Company submits that the proposed increase in the bad check charge is reasonable and should be approved.

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92 Brown Kinloch Direct Testimony at 11.
93 Application, Volume V, Schedule I-5.
94 Brown Kinloch Direct Testimony at 20-21.
95 ULH&P Response to AG-DR-02-052.
96 Bailey Rebuttal Testimony at 3-4.
97 *Id.* at 4.
98 *Id.*

The Company proposes an increase in its gas reconnection charge from $15.00 to $25.00, which the AG opposes on the grounds that it violates the gradualism principle.[99] ULH&P submits that the Commission should approve this increase because this charge is mainly labor-based and, as labor costs increase over time, the costs for performing this service will increase. If the Commission adopts the AG's proposal, the gap between the reconnection charge and the actual costs to perform the reconnection would simply widen over time.[100]

E. INJURIES AND DAMAGES EXPENSES

The Company proposed an adjustment to injuries and damages expenses to normalize the forecasted test period injuries and damages expenses by using the 10-year average, then adjusting for inflation.[101] The AG opposed this adjustment, arguing that the appropriate expense is the amount actually budgeted by the Company for the forecasted test period.[102] ULH&P subsequently agreed to withdraw this proposed adjustment.[103]

F. BASE PAYROLL EXPENSES

ULH&P initially proposed to include in its projection of labor expenses an estimated 3.2% increase in the cost of union labor. The labor agreements provide for a 3.0% wage increase based on the maximum rate of each wage level. An employee earning at the minimum rate of a wage level would receive an hourly wage increase of 3.0% of the maximum rate of the wage level. The result is a wage increase greater than 3.0%. The AG argued that this adjustment should be based solely on the 3.0% increase

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99 Brown Kinloch Direct Testimony at 21-22.
100 Bailey Rebuttal Testimony at 4.
101 Wathen Direct Testimony at 16
102 Henkes Direct Testimony at 34-35.
103 Wathen Rebuttal Testimony at 3-4.

actually agreed to in the collective bargaining agreement pay rate.[104] The Company subsequently accepted the AG's recommendation.[105]

G. INCENTIVE COMPENSATION EXPENSES

The AG recommended an adjustment to the Company's operating expenses to eliminate incentive compensation expenses, on the grounds that the performance goals for these incentive compensation plans are weighted more toward the Company's shareholders than customers, and because the Commission excluded these expenses in the Company's last general gas rate case.[106]

In its rebuttal case, ULH&P demonstrated that its incentive plans are within industry standards; that incentive plans have been demonstrated to improve employee productivity; that ULH&P would not be able to hire and retain talented employees if it discontinued such plans; and that customers would also pay higher costs in the form of increased hiring and training expenses.[107]

The Company proposed that it would not fully recover these expenses, but rather would allocate the plans' performance goals between shareholder benefits and customer benefits, and would only recover the portion of this expense related to customer benefits.[108] ULH&P submits that this proposal is reasonable because it provides for customers to pay for these expenses in direct proportion to the customer benefits. For example, the Annual Incentive Plan's ("AIP") corporate performance goal is currently based on net income.[109] This performance objective benefits customers because higher

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104 Henkes Direct Testimony at 35.
105 Wathen Rebuttal Testimony at 4-5.
106 Henkes Direct Testimony at 35-39.
107 Lesuer Rebuttal Testimony at 3-10.
108 Verhagen Rebuttal Testimony at 3.
109 *Id.* at 4.

net income reflects operational efficiencies, which benefits customers by allowing ULH&P to remain a low cost gas provider.[110] Additionally, increased earnings help Cinergy Corp. maintain a healthier balance sheet, which enables ULH&P to obtain financing on reasonable terms, and to delay future requests for rate increases.[111] Based on these interrelated benefits to shareholders and customers, ULH&P proposes to allocate this cost 50% to each group.[112]

An even more compelling example of customer benefits is the AIP's operational performance goals. These performance goals directly benefit customers because the goals are tied to outage frequency, time required to restore service, lost-time accidents, customer satisfaction scores, O&M expense levels and capital expenditures; therefore, a high performance on these goals will directly result in better and more reasonably priced service.[113] Consequently, these performance goals are allocated 100% to customers under ULH&P's proposed cost-sharing mechanism.[114]

The Commission has disallowed rate recovery of incentive compensation expenses in some cases, but allowed recovery in other cases. In fact, Mr. Henkes, the AG's incentive compensation witness in this case, supported rate recovery of incentive compensation costs in the 1997 and 2000 Kentucky-American Water Company rate cases, and the Commission approved recovery.[115] The AG also recommended sharing of incentive compensation costs between shareholders and customers in the 2005 Kentucky-

110 *Id.*
111 *Id.*
112 *Id.* at 3.
113 *Id.* at 5.
114 *Id.* at 3.
115 Hearing Transcript at 169-170 (August 15, 2005).

American Water Company case.[116] ULH&P submits that its cost-sharing proposal is more reasonable than the current all-or-nothing approach, where some companies have been allowed 100% recovery and others receive no recovery of these costs. The Company's proposal is fair, too, in that the Company would only recover the portion of this expense related to customer benefits. ULH&P therefore urges the Commission to adopt this cost-sharing mechanism for recovery of incentive compensation expenses.

H. MISCELLANEOUS EXPENSES

The AG proposed a revision to the Company's adjustment for miscellaneous expenses to remove lobbying expenses, corporate sponsorship expenses, and government affairs expenses. The Company subsequently agreed with the AG's recommendation.[117]

I. DEPRECIATION EXPENSE

The AG recommended a decrease in the Company's depreciation expense adjustment, to reflect different depreciation rates than used by the Company for a few selected items. The Company demonstrated at hearing, however, the AG's proposed service lives for these items were so long as to be beyond common sense. For example, the AG proposed a service life of up to 120-125 years for prefabricated steel buildings, roofs and windows.[118] Similarly, the AG proposed a service life of up to 200 years for the liquefied petroleum equipment, such as valves, pumps, and regulators.[119]

On the other hand, the Company established that the service lives used in its depreciation study were consistent with the depreciation study approved by the Commission in its last general gas rate case; with the depreciation study used in the 2004

116 *Id.* at 168.
117 Wathen Rebuttal Testimony at 4; ULH&P Response to KyPSC-DR-04-002.
118 Hearing Transcript at 45-46 (August 16, 2005).
119 *Id.* at 47-48.

Delta Gas rate case; and with the depreciation study used in the 2004 LG&E rate case.[120] Mr. Majoros, the AG witness, also proposed to arbitrarily extend the service lives of a few selected accounts in the 2004 LG&E rate case, an approach the Commission rejected.[121] Based on the foregoing, ULH&P submits that its adjustment for depreciation expense is much more reasonable than the AG's, and that the Commission should accept the Company's recommendation.

Finally, the AG also recommends that the Commission require ULH&P to establish a regulatory liability for ratemaking purposes for the removal cost portion of depreciation expense for assets which are asset retirement obligations under Financial Accounting Standard ("FAS") No. 143, but for which ULH&P has no legal obligation to remove.[122] ULH&P submits that FAS No. 143 does not apply to ULH&P's actual depreciation expense because ULH&P's depreciation expense is based on actual loss in service value and future removal cost, not on whether it has a legal obligation to remove an asset or not.[123] ULH&P also notes that Mr. Majoros made this exact same recommendation in the 2004 LG&E gas rate case, and that the Commission rejected his recommendation on the grounds that FERC Order No. 631, which adopted the provisions of FAS No. 143, does not require separating out costs of removal from depreciation rates.[124] The Company recommends that the Commission also reject Mr. Majoros' recommendation in this case.

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120 *Id.* at 42-44.

121 *In the Matter of an Adjustment of the Gas and Electric Rates, Terms and Conditions of Louisville Gas and Electric Company,* Case No. 2003-00433 (Order at 33) (June 30, 2004).

122 Majoros Direct Testimony at 21.

123 Spanos Rebuttal Testimony at 10.

124 *In the Matter of an Adjustment of the Gas and Electric Rates, Terms and Conditions of Louisville Gas and Electric Company,* Case No. 2003-00433 (Order at 23) (June 30, 2004).

J. PROPERTY TAXES

The AG recommended increasing the Company's net after-tax operating income to reflect reducing property tax expense to $2,014,755 from the Company's projection of $2,550,000.[125] The Company initially opposed this recommendation on the grounds that the AG's reduction was excessive. The Company recently received its revised property tax assessment from the Kentucky Department of Revenue for 2005. The revised assessment reduced the assessed value of ULH&P's property from $544 million to $318 million. This assessment does not reflect the property tax which will be assessed on new additions to rate base as of the forecasted test period. Based on this revised assessment, and based on the projected additions for the forecasted test period , the Company believes that the proper amount for this adjustment is $2,189,524.[126]

K. INTEREST SYNCHRONIZATION ADJUSTMENT

In the present case, two factors require ULH&P to revise the interest synchronization adjustment it had initially proposed: (1) ULH&P's long-term debt rate of 6.302% used in the Application was subsequently revised to 5.926%;[127] and (2) the Company made an error in the forecasted book interest used in Schedule E-1 of its Application.[128] The AG recommends revising the interest synchronization adjustment to account for these two factors.[129] ULH&P agrees with the AG's recommendation.[130]

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125 Henkes Direct Testimony at 41-44.
126 *See* Letter from John J. Finnigan, Jr. to Elizabeth O'Donnell dated September 21, 2005, filed herein.
127 ULH&P's Response to KyPSC-DR-02-021.
128 Wathen Rebuttal Testimony at 9.
129 Henkes Direct Testimony at 44.
130 Wathen Rebuttal Testimony at 9-10.

L. ITC AMORTIZATION

The AG also recommends that forecasted test period revenue requirements should be revised to reflect ITC amortization.[131] ULH&P accepts the AG's recommendation.[132]

V. RATE OF RETURN

A. CAPITAL STRUCTURE

The Company proposed a capital structure for the forecasted test period of 54.415% common equity; 38.196% long-term debt; and 7.389% short-term debt.[133] The capital structure reflects the transfer of the three generating plants from CG&E to ULH&P.[134] The AG accepts ULH&P's proposed capital structure.[135]

B. COST OF DEBT

The Company used a long-term cost of debt rate of 6.302% for the forecasted test period in its Application.[136] The AG noted that, based on information provided in the Company's responses to data requests, the correct long-term debt rate should be 5.926%.[137] The Company agrees that 5.926% is the proper long-term debt rate.[138] The short-term debt rate for the forecasted test period is 3.875%.[139]

C. RETURN ON EQUITY

Dr. Morin, ULH&P's witness, recommended a return on equity of 11.2% when the Application was filed in February, 2005.[140] At the August, 2005 hearing, he revised

131 Henkes Direct Testimony at 45.
132 Wathen Rebuttal Testimony at 11.
133 Application, Volume V, Schedule J-1, Page 2 of 2.
134 Aumiller Direct Testimony at 8.
135 Woolridge Direct Testimony at 2.
136 Aumiller Direct Testimony at 9.
137 Woolridge Direct Testimony at 9.
138 Wathen Rebuttal Testimony at 10-11.
139 Aumiller Direct Testimony at 8.
140 Morin Direct Testimony at 4.

this estimate to 10.8%.[141] Dr. Morin based his opinion on several methodologies: two Capital Asset Pricing Model ("CAPM") analyses (plain vanilla and empirical CAPM), three Risk Premium analyses (historical Risk Premium analysis on the natural gas distribution industry; historical Risk Premium analysis on the electric utility industry as a proxy for ULH&P's energy delivery business; and a study of allowed Risk Premiums in the natural gas distribution industry), and two Discounted Cash Flow analyses (an analysis of investment-grade natural gas distribution utilities, and an analysis of investment-grade combination gas and electric utilities).[142]

Dr. Woolridge, the AG's witness, recommended a return on equity of 8.7%.[143] He performed a CAPM and DCF analysis, but relied almost exclusively on one methodology, the DCF method, to determine this rate.[144]

Dr. Morin noted two major problems with Dr. Woolridge's proposal. First, it is far below the range of reasonableness; is substantially below the allowed returns in the DCF comparison group used by Dr. Woolridge for his DCF analysis; and would result in the lowest rate of return for a major utility in the United States.[145] Second, it relies solely on Dr. Woolridge's DCF methodology, which is questionable.[146]

Dr. Morin also noted several specific criticisms of Dr. Woolridge's approach:

- **Return Recommendation Far Out of the Mainstream.** Dr. Woolridge's recommended return is completely outside the zone of currently allowed rates of return for major natural gas and electric utilities in the United States and for his own sample of

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141 Hearing Transcript at 60 (August 16, 2005).
142 Morin Direct Testimony at 4.
143 Woolridge Direct Testimony at 1.
144 *Id.* at 15; Morin Rebuttal Testimony at 2.
145 Morin Rebuttal Testimony at 2.
146 *Id.* at 3.

companies.[147]

- **The DCF Model Understates the Cost of Equity.** It is well-known that application of the DCF model to utility stocks understates the investor's expected return when the Market-to-Book ("M/B") ratio exceeds unity.[148]

- **Understated Dividend Yield.** Dr. Woolridge's dividend yield component is understated because it is not consistent with the annual form of the DCF model because it is inappropriate to increase the dividend yield by adding one-half the future growth rate to the spot dividend yield.[149]

- **The Use of an Average Five-Month Stock Price in the DCF Model.** Dr. Woolridge's application of the DCF model violates market efficiency principles and mismatches stock price and expected growth.[150]

- **DCF Dividend Yield and Flotation Costs.** Dr. Woolridge's dividend yield component is understated by 30 basis points because it does not allow for flotation costs, and, as a result, a legitimate expense is left unrecovered.[151]

- **DCF Historical Growth Rates.** Dr. Woolridge improperly relies in part on historical growth despite substantial changes occurring in the energy utility industry.[152]

- **DCF Dividend Growth Rates.** Dr. Woolridge used historical and projected dividend growth for the growth component in his DCF analysis, and earnings growth projections are more appropriate to use.[153]

- **Internal Growth Method.** Dr. Woolridge improperly uses a required ROE in his

147 Morin Rebuttal Testimony at 4.
148 *Id.*
149 *Id.*
150 *Id.*
151 *Id.*
152 *Id.* at 4-5.

calculations that is different from the required ROE he recommends that the Commission adopt.[154]

- **CAPM Risk-Free Rate.** Dr. Woolridge's CAPM results improperly used a 10-year Treasury bond as the proxy rate for his analysis.[155]

- **CAPM Beta Estimates.** There is an inconsistency in Dr. Woolridge's choice of beta estimate in the CAPM analysis. He reports a beta of 0.65 in one portion of his testimony but chooses an estimate of 0.76 in implementing the CAPM.[156]

- **CAPM Market Risk Premium.** Dr. Woolridge's estimate of the market risk premium is too low because he improperly used the geometric means instead of the arithmetic means for his calculations, even though the arithmetic mean is widely-recognized as the proper measure, as attested by the leading textbooks in the field of finance.[157]

- **CAPM and the Empirical CAPM (ECAPM).** The plain vanilla version of the CAPM used by Dr. Woolridge understates the Company's cost of equity for low-beta securities.[158]

- **Higher Projected Long-term Interest Rates.** Dr. Woolridge's recommended ROE is not reflective of the forecast increase in capital costs.[159]

At hearing, Dr. Woolridge was less than persuasive. He did not adjust his recommended return on equity even though five months had elapsed since he filed testimony, and interest rates have started to trend back upward, except for one week

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153 *Id.* at 5.
154 *Id.*
155 *Id.* at 6.
156 *Id.*
157 *Id.*
158 *Id.*

during that period.[160] He used the 10-year Treasury bill yield for his CAPM analysis, even though the Commission has specifically disapproved this practice.[161] He used a market risk premium of 3.7%, even though he admitted at hearing that a well-respected textbook (which his colleague uses to "co-teach" a class with him, and which Dr. Woolridge has quoted with approval in his own book) states that this is far outside the range of reason.[162]

Dr. Woolridge also conceded at hearing that this textbook recommends using the arithmetic mean, rather than the geometric mean he used, to calculate the Risk Premium.[163] He confessed that another textbook used by professors at his university cautions against use of the geometric mean.[164] Although he admitted that these textbooks are respected authorities, Dr. Woolridge concluded with the unconvincing statement: "Well, these are just – these are just books, yes."

Of course these are books, but they're not "just" books. These are well-respected books in the field. They're used at Pennsylvania State University, where he teaches. He quotes these textbooks in his own book. These textbooks are used to teach students the right way to estimate the cost of equity. Yet Dr. Woolridge audaciously violates these basic textbook principles in his own return on equity calculation.

In sum, Dr. Woolridge's recommendation of an 8.7% return on equity is beyond reason. The average allowed return in the 2005 Regulatory Research Associates report is

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159 *Id.*

160 Hearing Transcript at 112-113 (August 16, 2005).

161 *In the Matter of Adjustment of the Rates of Kentucky-American Water Company,* Case No. 2004-00103 (Order at 73) (February 28, 2005).

162 Hearing Transcript at 116-122 (August 16, 2005).

163 *Id.* at 122-123.

164 *Id.* at 125.

10.56%.[165] The Commission has recognized that, while this should not dictate its decision, this report is a reliable indicator of whether a proposed return is reasonable.[166] The average allowed return of several natural gas distribution utilities reported in a recent edition of *Public Utilities Fortnightly* was 10.59%.[167] The Commission's allowed return in the 2004 LG&E rate case, decided when interest rates were lower, was 10.5%.[168] Based on the foregoing, the Commission should reject the AG's proposed return on equity, and accept ULH&P's proposed return on equity of 10.8%.

VI. PRICING AND TARIFF ISSUES

The Company and the AG disagreed on certain cost allocation, revenue distribution and pricing issues, as discussed in the direct and rebuttal testimony of Mr. Ochsner, and in the direct testimony of Mr. Brown Kinloch. The Company submits that its recommended treatment for these items is more consistent with sound ratemaking principles and with the Commission's treatment of these items in the Company's last general gas rate case.

ULH&P requested approval to assume ownership of service lines at the time of installation.[169] The customer has historically owned the portion of the gas service from the curb to the meter line, and has been responsible for installing and maintaining this portion of the gas service, but Kentucky is one of only a handful of states which follows this practice.[170]

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165 *Id.* at 135.
166 *In the Matter of an Adjustment of the Gas and Electric Rates, Terms and Conditions of Louisville Gas and Electric Company,* Case No. 2003-00433 (Order at 66) (June 30, 2004).
167 Hearing Transcript at 142-143 (August 16, 2005).
168 *In the Matter of an Adjustment of the Gas and Electric Rates, Terms and Conditions of Louisville Gas and Electric Company,* Case No. 2003-00433 (Order at 66) (June 30, 2004).
169 Application at 18; Hebbeler Direct Testimony at 13-16.
170 Hebbeler Direct Testimony at 13.+

The Commission previously approved for ULH&P to assume ownership of customer service lines replace during the AMRP, at the time of replacement.[171] Allowing ULH&P to assume ownership of all service lines at the time of installation would improve ULH&P's ability to provide safe and reliable service by giving ULH&P more control over the installation process.[172] This will also allow ULH&P to ensure that its installers are fully qualified under the U.S. Department of Transportation Office of Pipeline Safety's rigorous new safety regulations known as the new Operator Qualification II Rule, which provide new procedures for construction and backfilling service lines during the installation process[173].

The AG did not oppose ULH&P's request to take ownership of service lines at the time of installation. The current practice where the customer owns the line is anachronistic, and only a few states follow this practice. The benefits of this proposal are obvious. ULH&P will be able to exercise better quality control over the installation process and to minimize installation expenses. This will enhance the safety of ULH&P's distribution system for customers and for the general public. Based on the foregoing, ULH&P requests that the Commission approve a deviation from 807 KAR 5:022 Section 9(17)(a)(2), in order to assume ownership of the service line at the time of installation. The Company also requests that the Commission approve the language changes to the service regulations portion of its tariff to reflect this change, as set forth in the proposed new tariffs at Attachment GJH-1 to Mr. Hebbeler's Direct Testimony.

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171 *In The Matter Of: Application Of The Union Light, Heat And Power Company For A Certificate Of Public Convenience And Necessity To Construct Gas Distribution Facilities Within Its Service Territory And For A Deviation From Administrative Regulation 807 Kar 5:022, Section 9(17),* Case No. 2002-00089 (Order) (August 29, 2002).

172 Hebbeler Direct Testimony at 14.

173 *Id.*

VII. CONTINUATION OF RIDER AMRP

A significant issue the Commission must decide is whether to approve continuing Rider AMRP, which allows ULH&P to timely recover the costs related to the AMRP. The AMRP is a program which ULH&P adopted in 2000 to accelerate its replacement rate of cast iron and bare steel mains.[174] The AMRP provides a more safe and reliable natural gas distribution system.[175] Local distribution companies throughout the United States have adopted or are in the process of adopting programs to replace cast iron and bare steel mains on an accelerated basis. Additionally, the new U.S. Department of Transportation distribution Integrity Management rule will address cast iron and bare steel piping, and may well require companies to adopt aggressive replacement programs.

Prior to the AMRP, ULH&P had cast iron pipe in service dating back to 1887 and its bare steel pipe in service dating back to 1906.[176] These types of mains are more prone to leaks than plastic and coated, cathodically protected steel.[177] The U. S. Department of Transportation adopted regulations in 1971 removing cast iron from its list of approved materials for new pipe construction.[178]

ULH&P formerly replaced the cast iron and bare steel mains at a replacement rate that would have taken approximately 50 years to complete.[179] By that time, the mains that ULH&P would have been replacing would have been over 150 years old.[180] In 2000, ULH&P retained Stone & Webster Consultants, Inc., ("Stone & Webster"), an international engineering consulting firm, to review the efficacy of ULH&P's cast iron

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174 Hebbeler Direct Testimony at 2-3.
175 *Id.*
176 *Id.* at 3.
177 *Id.*
178 *Id.*
179 *Id.* at 3-4.

and bare steel main replacement practices.[181] Stone & Webster recommended that ULH&P should replace these mains much more quickly.[182] Under the AMRP, ULH&P will now replace these mains over approximately ten years, which started in 2000.[183]

The AMRP is costly. When ULH&P originally planned the AMRP, it was estimated that the program would cost approximately $112 million over the ten-year period.[184] Recognizing the adverse financial impacts to ULH&P if ULH&P were forced to recover this cost with the regulatory lag under traditional ratemaking principles, the Commission approved Rider AMRP to allow ULH&P to recover these costs on a more timely basis.[185] The Commission approved Rider AMRP for a three-year period, and required ULH&P to file a new general rate case at the end of this three-year period to allow the Commission to review the program, if ULH&P wished to continue Rider AMRP.[186] Significantly, when the Commission initially approved Rider AMRP, it stated

> The Commission finds the replacement of ULH&P's cast iron and bare steel mains within 10 years to be necessary and in the public interest. We also recognize the significant impact the accelerated main replacement program will have on ULH&P over the next 10 years. The Commission believes that we have the statutory authority to establish, and that we should establish, a method of recovery that will help to eliminate any impediment to the success of the program. However, because the AMRP Rider proposal is a case of first impression for the Commission, we believe that it should be established for an initial 3-year period. Having found that the replacement program is in the public interest and having recognized the impact on ULH&P, the Commission finds at this time no reason to believe that the mechanism cannot be continued

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180 *Id.*
181 *Id.* at 4.
182 *Id.*
183 *Id.*
184 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092, Direct Testimony of Paul G. Smith.
185 *Id.* (Order at 71-80) (January 31, 2002).
186 *Id.* at 80.

> for 10 years. However, we believe that establishing the Rider for an initial 3-year period will allow both ULH&P and the Commission an opportunity to review the operation of the mechanism and make a decision on its renewal.[187]

In the present case and in prior annual Rider AMRP filings, ULH&P demonstrated that the AMRP has produced significant customer benefits, such that Rider AMRP should be continued. ULH&P's gas distribution system consists of approximately 1,270 miles of distribution mains.[188] As of December, 2004, ULH&P has replaced approximately 90 miles of cast iron and bare steel mains, leaving 111 remaining miles of cast iron and bare steel mains.[189] As a result, ULH&P has therefore replaced almost one-half of its cast iron and bare steel mains during the first four years of the AMRP.[190] The AMRP's success can be measured by the reduced leak rate for ULH&P's gas distribution system. The incidence of leaks repaired has decreased significantly, from 983 in 1999 to approximately 537 in 2004.[191]

This reduction in leaks has caused ULH&P's Account 887 "Maintenance of Mains" expense to shrink from approximately $1.5 million in 1999 to $846,000 in 2004.[192] The Rider AMRP tracking mechanism reflects these maintenance savings in the revenue requirements, thus promptly returning the savings to customers.[193] Customers also benefit from Rider AMRP because ULH&P has not had a need to file frequent and costly general gas rate cases to recover its capital expenditures for the AMRP.[194] Finally,

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187 *Id.* at 78-79.
188 Hebbeler Direct Testimony at 5.
189 *Id.*
190 *Id.*
191 *Id.*
192 *Id.*
193 *Id.*
194 *Id.*

customers benefit from ULH&P's enhanced ability to access capital markets.[195] During the past three years, the Commission has conducted annual Rider AMRP proceedings, in which ULH&P has complied with all of the requirements established by the Commission.[196]

The AG opposes continuing Rider AMRP for two reasons. First, the rider constitutes single-issue ratemaking. Second, the AG argues that H.B. 440, enacted by the Kentucky Legislature in 2005, does not authorize the Commission to approve the rider. The AG's arguments are completely meritless and should be rejected. The Commission specifically considered the AG's single-issue ratemaking argument in the last case and rejected it.[197] The AG's argument that H.B. 440 does not authorize the Commission to approve Rider AMRP flies in the face of the statute's plain wording:

> Notwithstanding any other provision of law to the contrary, upon application by a regulated utility, the commission may allow recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility. No recovery shall be allowed unless the costs shall have been deemed by the commission to be fair, just, and reasonable.[198]

The AG's witness who argued that H.B. 440 does not authorize the Commission to approve Rider AMRP freely admitted that he was an engineer, not an attorney, and did not offer his opinion as a legal opinion.[199] Clearly the statute authorizes the Commission to approve Rider AMRP. In any event, the Commission decided in the prior case that it had legal authority to approve Rider AMRP under its general ratemaking authority, even

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195 Aumiller Direct Testimony at 4.

196 *Id.*

197 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 74-75) (January 31, 2002).

198 KRS 278.509.

before H.B. 440 was enacted.[200] The new statute simply strengthens the argument that the Commission has authority to approve Rider AMRP.

Significantly, the AG offered no evidence regarding the AMRP's benefits, or on the financial impacts to ULH&P if Rider AMRP is discontinued. On the other hand, ULH&P has extensively documented the customer benefits from the AMRP over the past three years. The Commission acknowledged the financial impacts to ULH&P without Rider AMRP in the prior case.[201] In sum, ULH&P has clearly fulfilled its obligation to demonstrate the ongoing benefits of the AMRP program; therefore, ULH&P respectfully requests that the Commission allow ULH&P to continue implementing Rider AMRP through the anticipated conclusion of the AMRP in 2010.

VIII. CONCLUSION

WHEREFORE, ULH&P respectfully prays that its proposed adjustment of gas rates and changes to existing tariffs and service regulations be approved as requested herein.

Respectfully submitted,

THE UNION LIGHT, HEAT AND POWER COMPANY

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199 Hearing Transcript at 181-182 (August 16, 2005).
200 *In the Matter of Adjustment of Gas Rates of The Union Light, Heat and Power Company,* Case No. 2001-00092 (Order at 71-80) (January 31, 2002).
201 *Id.*

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CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing Brief of The Union Light, Heat and Power Company has been served by hand delivery to the following parties on this 21st day of September, 2005:

Hon. Elizabeth E. Blackford
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