COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF THE UNION LIGHT, HEAT AND POWER COMPANY	)))	CASE NO. 2005-00042

REBUTTAL TESTIMONY OF

JAMES A. RIDDLE

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

APPENDIX

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James A. Riddle.

Q. ARE YOU THE SAME JAMES A. RIDDLE WHO PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. The purpose of my rebuttal testimony is to address the testimony of David H. Brown Kinloch on behalf of The Office of the Attorney General for the Commonwealth of Kentucky regarding weather normalization and volumes

bias that has occurred over the last five years when comparing the NOAA based estimate of normal heating degree days to the actual degree days. Clearly, the chart demonstrates that the magnitude of the difference between actual and normal heating degree days is significantly greater when the actual is below the NOAA normal level. The second chart shows that the same bias exists when comparing Mr. Kinloch's estimate of normal degree days to the actual degree days. These two charts which use the NOAA and Mr. Kinloch's 30-year normals demonstrate the bias that exists because these normals are inclined to be above the actual weather experienced over the last five years. The third chart in the exhibit shows that the 10-year normal of 4950 heating degree days does not exhibit this same bias when compared to actual heating degree days .

I calculated MPE for the years 2000 through 2004 using the actual degree days as reported by Mr. Kinloch in Exhibit DHBK – 4. The results show that the MPE for HDD=4950 is (-0.15)%, that is, the actual level of heating degree days have on average been 16 degree days below the normal of 4950. The MPE for HDD=5148 is 3.84% or high by an average of 182 degree days, and the MPE for HDD=5133 is 3.54% which is high by an average of 167 degree days, both of which are ten times higher than the measured error of HDD=4950.

The MPE calculations indicate that the NOAA normal of 5148 and Mr. Kinloch's 30-year normal of 5133 are both biased high by over 3.5% or more than 166 degree days and did not predict the actual weather for 2000 through 2004 as well as the 10-year normal of 4950, which was only different by an average of 16

1988-1997	HDD=5093	MPE=2.73%	Avg. Difference=127
1989-1998	HDD=4984	MPE=0.53%	Avg. Difference=18
1991-2000	HDD=5029	MPE=1.44%	Avg. Difference=63
1992-2001	HDD=5038	MPE=1.62%	Avg. Difference=72
1993-2002	HDD=5042	MPE=1.70%	Avg. Difference=76
1994-2003	HDD=5028	MPE=1.42%	Avg. Difference=62
1995-2004	HDD=5018	MPE=1.22%	Avg. Difference=52

These results indicate that the average degree days based on the eight other ten-year time periods are all biased high and did not predict the actual weather for 2000 through 2004 as well as the 10-year normal of 4950, although all of the 10-year averages above did do better than using the NOAA or Mr. Kinloch's 30-year normals. The 10-year normal the Company has been using was chosen as a more

ULH&P is a more accurate representation of reasonable weather for gas load forecasting and that Mr. Kinloch's testimony does nothing to refute that conclusion.

III. FORECAST OF FIRM TRANSPORTATION SALES

Q. WHAT CONCLUSIONS DID MR. KINLOCH REACH IN HIS TESTIMONY ABOUT ULH&P'S FORECAST OF TEST YEAR FIRM TRANSPORTATION SALES?

A. Mr. Kinloch concludes that the test year sales for Firm Transportation are too low and should grow at an annual rate of 9.08%.

Q. WHAT WAS THE BASIS FOR MR. KINLOCH'S CONCLUSION?

A. Mr. Kinloch reached this conclusion by calculating the percent change in actual

A. No. To understand why, I believe it is important that the parties to this case have a more complete picture of how the gas forecast is prepared. Especially since it is clear that Mr. Kinloch does not understand how the Company prepares the gas forecast.

In Mr. Kinloch's response to ULH&P-DR-01-042, he states that he used a single growth rate to project FT sales to be consistent the Company's methodology. He refers to the Company's response to AG-DR-01-130, Attachment, page 1 of 2 as evidence of the Company's methodology and the use of a single growth rate. Mr. Kinloch completely misinterpreted the calculations in this attachment. The calculation of the change in industrial FT sales between 2001 and 2002 simply served to indicate that FT sales have shown a large

econometric models that have been estimated using several years of historical data.

The national economic forecast provides information on the prospective growth of the national economy. This involves projections for future levels of numerous national economic and demographic concepts such as population, employment, industrial production, inflation, wage rates, and income. The national economic forecast is obtained from Economy.com, a national economic consulting firm.

In conjunction with the forecast of the national economy ULH&P also obtains a forecast of the service area economy from Economy.com. In turn, the service area economic forecast is used along with the energy econometric models

disbursements, governmental transfer payments, property income, proprietors' income, and personal contributions for social insurance. The forecasts of these components are summed to produce the forecast of total income.

Forecasts of employment are developed for the commercial, industrial, and governmental sectors. Within the industrial sector, employment and industrial production is forecast by major industry as defined by the North American Industry Classification Systems (NAICS).

Population projections for the service area are also provided for each five-year age cohort.

Gas Price

Historical gas price data is obtained from the tariff sheets of the Company as

are not only physically located together but their service areas are clearly integrated on an economic and weather basis. Gas transported through our system for customers has been included in the amount of billed gas deliveries. Preparing the forecast in this manner provides an indication of the total gas usage and hence the available market for gas.

The forecast models are developed by customer class, residential, commercial, industrial and governmental/other public authority (OPA). Further, firm gas sales and interruptible transportation sales are modeled separately for the commercial and industrial classes. Firm gas sales (firm and firm transportation) are modeled in the aggregate for the residential, commercial and industrial classes. OPA sales are modeled in the aggregate (firm, firm transportation and

residential customer. The forecast of total residential sales is the product of the residential customer forecast and the use per customer forecast. That is:

Residential Sales =
Number of Residential Customers x
Use per Residential Customer.

The forecast of residential natural gas customers is calculated using a forecast of the saturation of gas space heat. The forecast of customers is created by multiplying the total number of customers in the service area by the projected saturation. It is assumed here that all new residential gas customers will use

In the use per customer model specified above, the estimated coefficient for the Real Marginal Price of Gas represents an estimate of the price elasticity.

In general, natural gas consumption by residential customers is dependent upon usage for space heating, water heating, cooking, and, to a lesser extent, clothes drying. If a customer has obtained gas service, the usage of gas tends to exhibit a regular pattern that follows weather conditions, though it has experienced some downward pressure due to conservation that is driven by increasing equipment efficiencies. In fact, this phenomenon is evidenced by the historical downward trend in base gas usage per customer.

This equation is estimated using monthly data. From the estimated equation, a forecast of use per customer gas usage can be developed.

Commercial Total Firm Gas Deliveries =

f(Commercial Employment,

Real Marginal Price of Firm Gas

Billing Heating Degree Days,

Billing Cooling Degree Days).

This equation is estimated using monthly data. From the estimated equation, a forecast of total firm commercial gas usage can be developed.

Interruptible Transportation – Commercial

Data has been collected on commercial interruptible transportation gas

Industrial

There are two components to the industrial sector forecast: industrial total firm and industrial interruptible transportation. The distinction between total firm and interruptible transportation usage is required due to the differences in supply conditions and gas prices. The forecast is prepared for total firm industrial deliveries and interruptible transportation industrial deliveries. Total industrial gas usage is computed as the sum of firm and interruptible deliveries.

Total Firm – Industrial

An econometric equation is developed to project total firm industrial gas usage. Firm gas deliveries are found to be dependent upon the level of manufacturing employment, the price of gas relative to the price of oil, and the

Interruptible Transportation – Industrial

Data has been collected on industrial interruptible transportation gas usage. Interruptible deliveries have been found to be weather sensitive as were the firm deliveries. Using the data, an equation can be developed to forecast industrial interruptible transportation deliveries relying upon the following general equation structure:

Industrial Interruptible Transportation Deliveries =

f(Industrial Production,

Price of Interruptible Transportation Gas Relative to the Wage Rate,

Price of Interruptible Transportation Gas Relative to the Price of Oil,

and interruptible transportation components because the Company could not develop a statistically sound econometric equation for OPA interruptible transportation sales. The apportioning between firm and interruptible gas usage is based upon historical percentages.

Deliveries to OPA customers are related to governmental employment, heating degree days, and the real marginal gas price. This relationship is represented as follows:

OPA Total Deliveries =

f(Governmental Employment,

Real Marginal Total Gas Price,

Q. PLEASE SUMMARIZE THE STRUCTURE OF THE GAS LOAD FORECAST AS DETAILED ABOVE.

A. As stated above, I prepare a forecast of billed gas sales by customer class for CG&E and Subsidiary Companies. The customer classes are residential, commercial, industrial, OPA/governmental, and street lighting. Further, for the commercial and industrial classes, separate forecasts are prepared for total firm and interruptible transportation using separate econometric models. For OPA, the forecast of total gas sales is disaggregated between firm, FT, and interruptible using a historical percentage. Likewise, for the commercial and industrial classes, the forecast of total firm is disaggregated to firm and FT using a historical percentage. All of this is done at the consolidated level, i.e., CG&E and

Q. HAVING REVIEWED MR. KINLOCH'S TESTIMONY ABOUT FT VOLUMES, DO YOU HAVE ANY CONCERNS?

A. Yes. I have a concern with his weather normalization of historic test year sales. I have concerns about his method of forecasting test year FT volumes and his use of a 9.08% growth rate and I have concerns that Mr. Kinloch focuses on FT volumes only, excluding the other portion of total firm sales. As is evidenced by the Company's forecast methodology, I believe it is vitally important that the forecast must look at total firm sales, not just one piece.

Q. DID MR. KINLOCH ATTEMPT TO WEATHER NORMALIZE HISTORICAL TEST YEAR FT VOLUMES?

A. Yes, in Exhibit DHBK – 7.

the industrial firm model in the same way, the increase is only an additional 644 Mcf. This demonstrates that there is a difference in the weather response between the different customer classes.

Second, Mr. Kinloch uses 12-month totals of sales and degree days to calculate MCF / HDD. Again, Mr. Kinloch's method does not allow for the difference in weather response by month. Customer usage responds differently in non-winter months. The methodology used by the Company calculates the difference between actual and normal degree days for each month and adjusts actual sales based on a monthly factor.

Q. DO YOU SEE ANY PROBLEMS WITH THE METHODOLOGY MR. KINLOCH USED TO FORECAST TEST YEAR FT VOLUMES?

Q. DO YOU SEE ANY PROBLEMS WITH MR. KINLOCH'S ASSERTION THAT FT VOLUMES WILL GROW AT AN ANNUAL RATE OF 9.08%?

A. Yes. First, the annual Firm Transportation sales volumes utilized in his analysis includes sales volumes associated with unbilled revenue. For ratemaking purposes, unbilled sales volumes and associated revenues are eliminated from the test year revenue requirements calculations and therefore the inclusion of the unbilled Mcf sales is not an accurate representation of the sales volumes actually billed to customers. In Attachment JAR-Rebuttal-2, a table has been prepared to reflect the actual annual FT billed sales volumes for the five year period of 2000 through and 2004. The annual rate of growth in FT sales for the period of 2000 through 2004 is 2.90%. The change in actual billed sales volumes from 2003 to

date sales through 2004 is (-5.02)%. That is, Total Firm Sales are down over 5%. See Attachment JAR-Rebuttal-3.

Q. WHAT ABOUT MR. KINLOCH'S LACK OF FOCUS ON FIRM SALES?

A. Let's assume just for this example that Mr. Kinloch's methodology of forecasting FT volumes is acceptable. Shouldn't it be just as applicable to other portions of forecasted test year sales. If the Company were to apply Mr. Kinloch's logic not only to FT volumes but also to Retail Sales then the forecasted test year for Retail Sales would be declining at an annual rate of (-5.38)%. See Attachment JAR-Rebuttal-4.

Continuing with Mr. Kinloch's methodology I prepared a calculation of forecasted Retail Sales volumes and the calculation of the revenue impact from

methodology described above. The difference between actual and forecast of total firm sales is (-0.73)%. See Attachment JAR-Rebuttal-7. This is in contrast to Mr. Kinloch's testimony that only looked at one piece of total firm sales, the FT portion. One needs to examine the whole pie, not just one portion.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING MR. KINLOCH'S TESTIMONY CONCERNING FT VOLUMES.

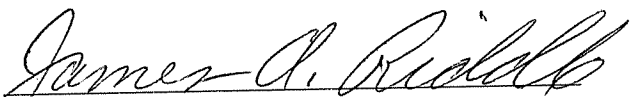
A. Mr. Kinloch's methodology for forecasting FT volumes is too simplistic and ignores all of the components of total firm sales. ULH&P follows accepted utility forecasting practices and its econometric forecasting models are well-founded within economic theory, using several years of historical data to establish how gas usage responds to economic, price and weather variables. The models

VERIFICATION

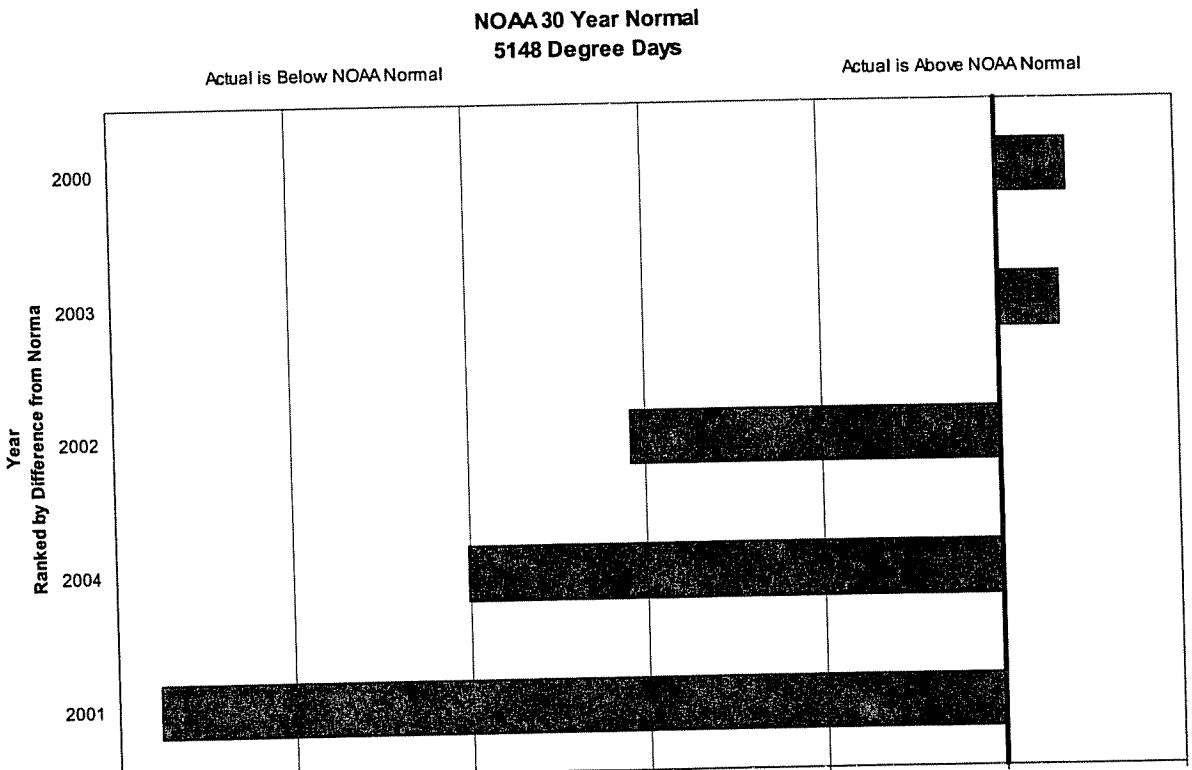
State of Ohio)
)
County of Hamilton)

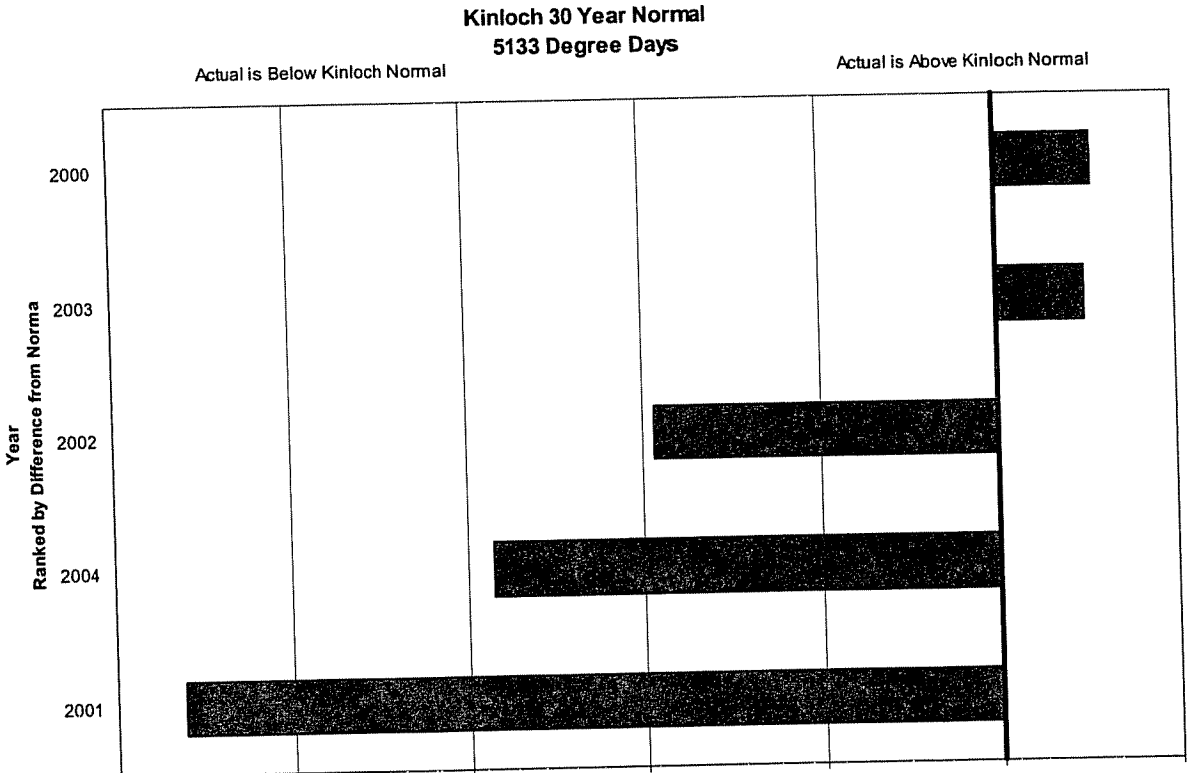
SS:

The undersigned, James A. Riddle, being duly sworn, deposes and says that he is the Manager, Load Forecasting by Cinergy Services, Inc., that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.



James A. Riddle, Affiant


NOAA 30 Year Normal
5148 Degree Days
Actual is Below NOAA Normal
Actual is Above NOAA Normal
Year
Ranked by Difference from Norma
2000
2003
2002
2004
2001


Kinloch 30 Year Normal
5133 Degree Days
Actual is Below Kinloch Normal
Actual is Above Kinloch Normal
Year
Ranked by Difference from Norma
2000
2003
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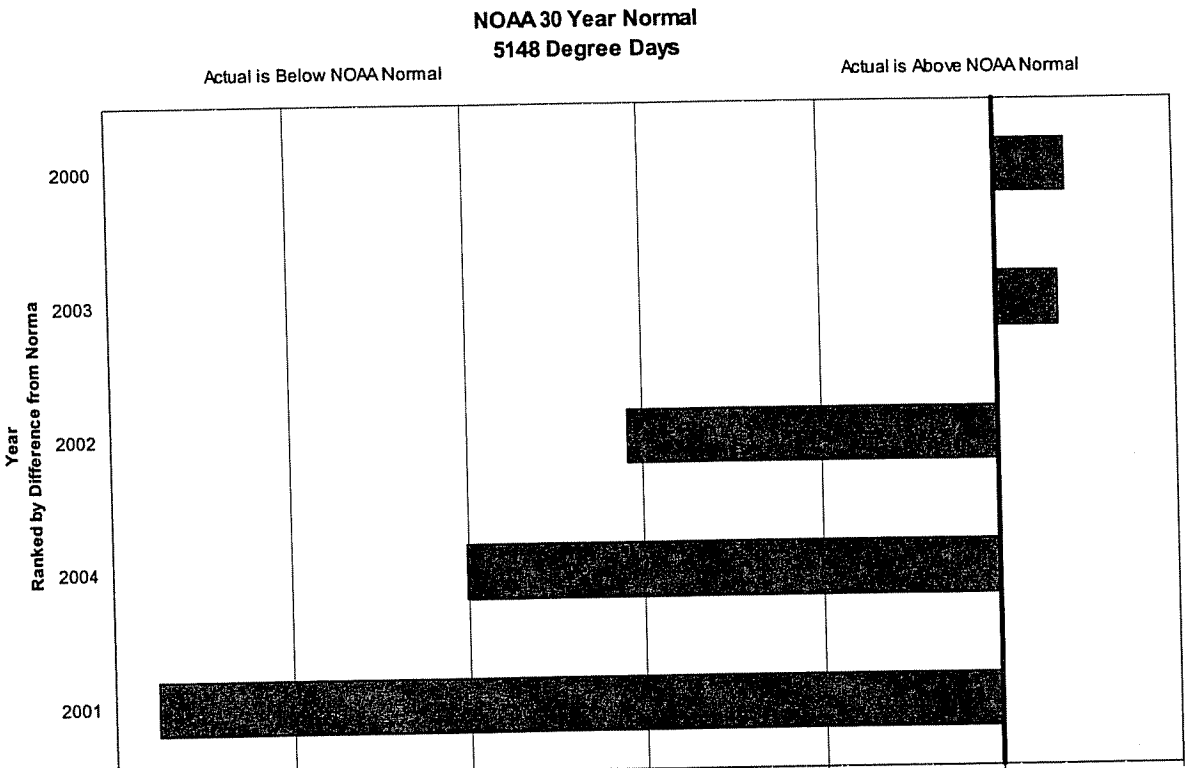
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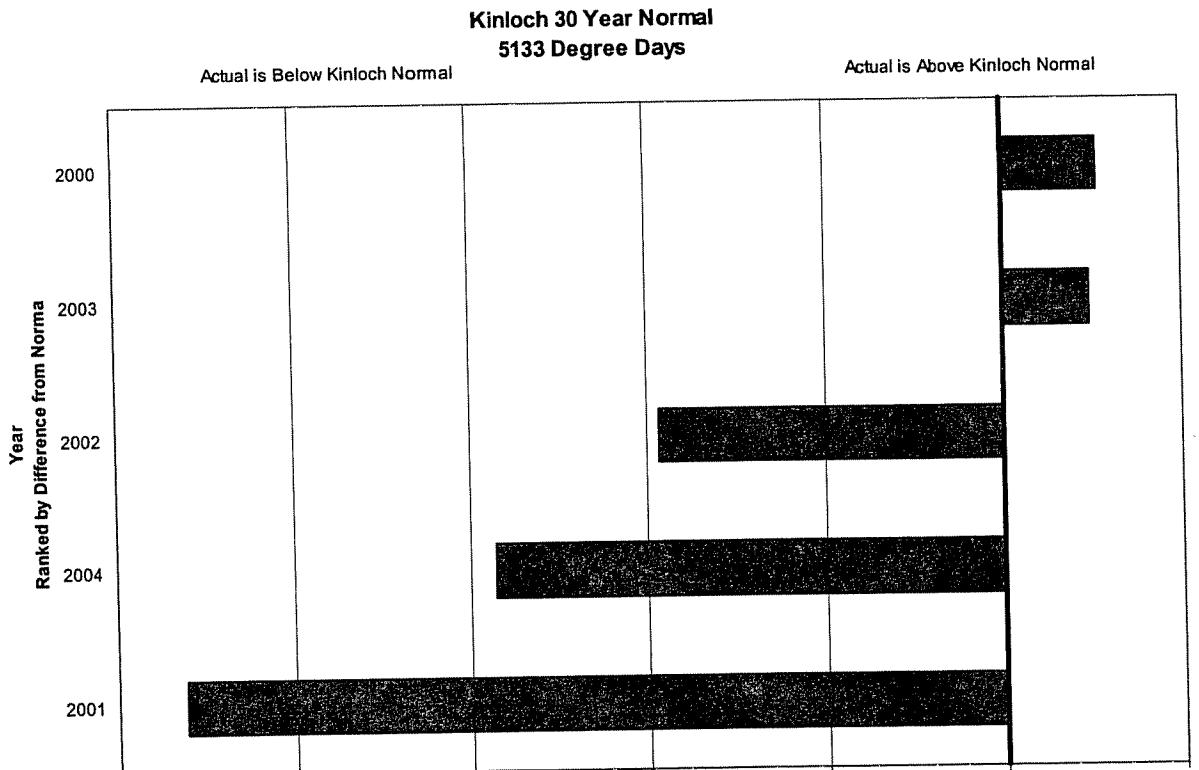
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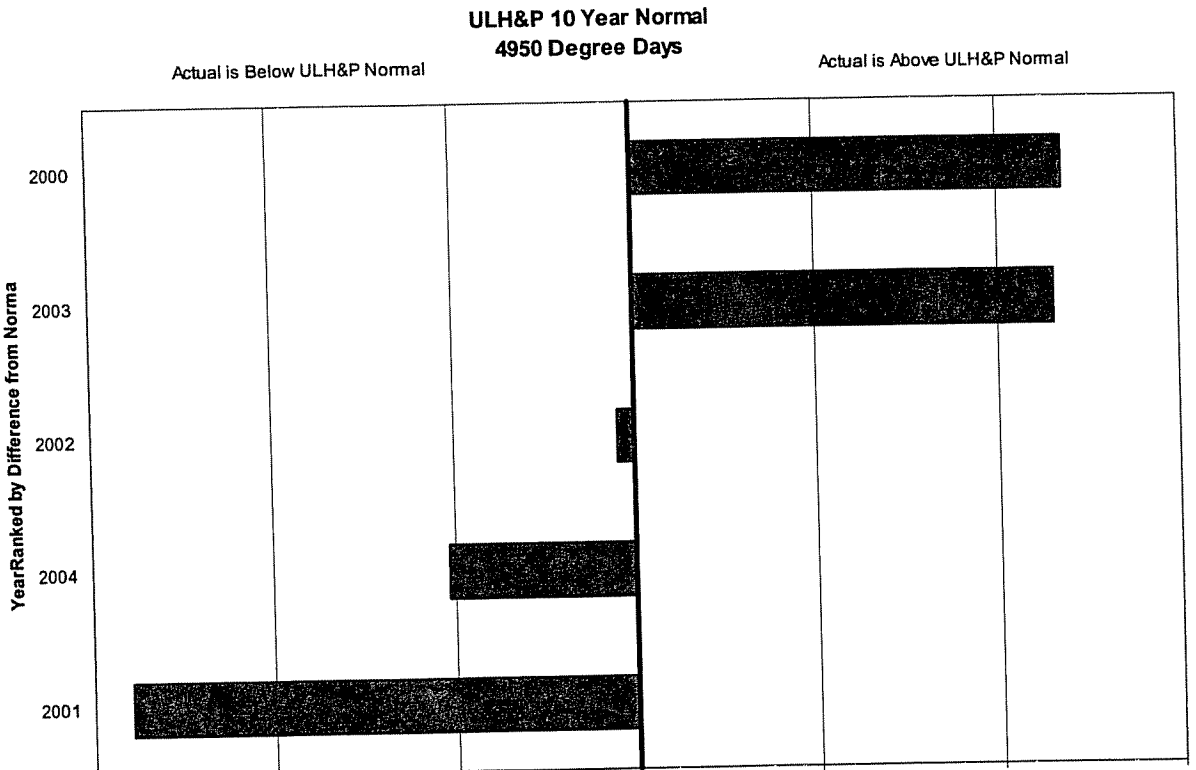

ULH&P 10 Year Normal
4950 Degree Days
Actual is Below ULH&P Normal
Actual is Above ULH&P Normal
YearRanked by Difference from Norma
2000
2003
2002
2004
2001

The Union Light Heat & Power Company
Billed Firm Transportation Sales Volumes
For the Years 2000 through 2004 and 12 months Ended April 2005

Billed Volumes (Mcf)	2000	2001	2002	2003	2004	12 Months Ended April 2005
FT - Commercial	144,637	149,917	157,266	174,709	156,295	173,559
FT - Industrial	909,962	1,005,726	849,796	969,018	1,027,169	1,006,235
FT- Other Public Authority	124,504	119,676	136,969	141,435	138,709	138,582
Total Actual Sales	1,179,103	1,275,319	1,144,031	1,285,162	1,322,173	1,318,376
Year-to-Year Annual Percentage Change in Sales Volumes					2.88%	-0.29%

COMPARISON OF ACTUAL JANUARY THROUGH MAY 2005 BILLED SALES VERSUS ACTUAL JANUARY THROUGH MAY 2004 BILLED SALES

Firm Gas Retail Sales	2004 (Mcf)	2005 (Mcf)	2004-2005 % Change
Residential	4,781,307	4,640,689	
Commercial	2,348,582	2,014,054	
Industrial	286,984	346,770	
Governmental/OPA	376,076	353,750	
Total	7,792,949	7,355,263	-5.62%

Firm Gas Transportation Sales	2004 (Mcf)	2005 (Mcf)	2004-2005 % Change
Residential	0	0	
Commercial	78,325	102,390	
Industrial	508,735	492,640	
Governmental/OPA	85,267	89,791	
Total	672,327	684,821	1.86%

CALCULATION OF FORECASTED RETAIL SALES GROWTH RATE USING THE KINLOCH METHOD

Volumes (1)

	2003	2004	2003-2004 Change	2003-2004 % Change
Retail				
Residential	7,243,135	6,798,673	(444,462)	
Commercial	3,168,151	3,025,865	(142,286)	
Industrial	470,801	450,729	(20,072)	
Other	540,199	532,760	(7,439)	
Total Retail	11,422,286	10,808,027	(614,259)	**(5.38%)**

(1) ULH&P Schedule I-5

CALCULATION OF FORECASTED RETAIL SALES VOLUMES USING THE KINLOCH METHOD

Volumes (1)

	2003	2004	Growth Rate
Retail			
Residential (RS)	7,243,135	6,798,673	-6.14%
Non-Residential (GS)	4,179,151	4,009,354	-4.06%
Total Retail	7,243,135	6,798,673	-5.38%

RS Historic Test Year ending Oct. 31, 2004	7,086,139
GS Historic Test Year ending Oct. 31, 2004	3,843,621
Weather Normalization Adjustment Factor (2)	1.0375
RS WN Historic Test Year	7,351,869
GS WN Historic Test Year	3,987,757
RS Annual Growth Rate	-6.14%
GS Annual Growth Rate	-4.06%

COMPARISON/CALCULATION OF REVENUE IMPACT OF FORECASTED RETAIL SALES VOLUMES USING THE KINLOCH METHOD

Commodity Charge: All Consumption	Sales (1) (Mcf)	Rate ($/Mcf)	Revenue
Residential (RS)	6,486,677	2.334	15,139,904
Non-Residential (GS)	3,677,443	2.049	7,535,080
Total Retail	10,164,120		22,674,984

Commodity Charge: All Consumption	Sales (Mcf)	Rate ($/Mcf)	Revenue
RS Revenues as filed (2)	7,151,018	2.334	16,690,476
GS Revenues as filed (2)	3,913,164	2.049	8,018,074
Total Retail Revenues as filed			24,708,550
			(2,033,566)

COMPARISON OF ULH&P JANUARY THROUGH MAY 2005 ACTUAL BILLED TOTAL FIRM SALES TO FORECAST OF BILLED TOTAL FIRM SALES

Firm Gas Total Sales	Actual 2005 (Mcf)	Forecast 2005 (Mcf)	2004-2005 % Change
Residential	4,640,689	4,674,203	
Commercial	2,116,444	2,121,380	
Industrial	839,410	727,730	
Governmental/OPA	443,541	457,698	
Total	8,040,084	7,981,011	-0.73%

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF THE UNION, LIGHT, HEAT AND POWER COMPANY	)))	CASE NO. 2005-00042

REBUTTAL TESTIMONY OF

JOHN J. SPANOS

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME.

A. My name is John J. Spanos.

Q. ARE YOU THE SAME JOHN J. SPANOS WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony in this statement is to rebut the Direct Testimony of Michael J. Majoros, Jr., submitted on behalf of the Attorney General.

Q. WHAT ARE THE SUBJECTS OF YOUR REBUTTAL TESTIMONY?

II. ATTORNEY GENERAL'S NET SALVAGE POSITION

Q. PLEASE SUMMARIZE THE POSITION OF ATTORNEY GENERAL WITNESS MR. MAJOROS REGARDING THE RATEMAKING TREATMENT OF NET SALVAGE FOR ULH&P.

A. Although it appears that Mr. Majoros has returned to the mainstream by proposing estimates of future net salvage, his estimates are so unreasonable that they represent an effort to effect proposals previously rejected by this Commission through the back door. I base this conclusion on the end result of his net salvage estimates and the extent to which he discusses: (1) the factors that he relied on for his previous proposal to expense net salvage, i.e., Financial Accounting Standard No. 143 and Federal Energy Regulatory

Q. WHAT IS THE END RESULT OF HIS REVISIONS TO YOUR ESTIMATES OF SERVICE LIFE?

A. The end result of Mr. Majoros' revisions to the service life estimates for several accounts is a reduction in annual accrual of $231,312, or about 3.6% of the accrual that I have determined.

Q. WHAT ARE THE BASES FOR HIS PROPOSALS?

A. The bases for the proposals of Mr. Majoros as stated on pages 4 and 5 of his direct testimony are his view that my proposal results in "excessive depreciation," his depreciation study, ULH&P's responses to certain Staff data requests, and ULH&P's actions as a result of recent accounting pronouncements.

views on these subjects and because his end result indicates that he is still attempting to deny the utility an appropriate level of future net salvage recovery.

III. DEPRECIATION CONCEPTS

Q. IN EXHIBIT ___(MJM-4), MR. MAJOROS HAS PROVIDED A DISCUSSION OF DEPRECIATION CONCEPTS. DO YOU HAVE ANY DISAGREEMENTS WITH THE STATEMENTS MADE IN THIS DOCUMENT?

A. Yes, I do. Mr. Majoros' concept of public utility depreciation is not the same as the concept set forth in the Uniform System of Accounts and authoritative texts on the subject. He states on page 1 of Exhibit___(MJM-4) that "public

service value rendered by an asset, i.e., depreciation, must reflect both its original cost and its net salvage.

Q. DOES THE UNIFORM SYSTEM OF ACCOUNTS ALSO ADDRESS THE MANNER IN WHICH DEPRECIATION IS TO BE RECOGNIZED?

A. Yes, it does. The Uniform System of Accounts requires that depreciation be recognized through accrual accounting. That is, the service value of an asset must be accrued during the life of the asset. Since net salvage is a part of the service value, it must be accrued during the life of the related asset in order to comply with the Uniform System of Accounts.

Q. PLEASE CONTINUE WITH YOUR REVIEW OF MR. MAJOROS'

accuracy of this statement would be improved by stating "*Nearly all* utilities, including ULH&P, include net salvage in the depreciation rate calculation."

On page 3, Mr. Majoros states "...but no cash flows out of the company for depreciation expense." This is a true statement, but also may leave an incorrect impression. In order for the company to record depreciation expense, it must have first experienced a cash outflow which is represented by the original cost of the asset.

Mr. Majoros claims on page 5 that the net salvage adjustment in the numerator of the equation for the annual depreciation accrual rate is "equivalent to capitalizing or adding the estimated cost of removal to the original cost of the asset." This is only true mathematically with respect to

salvage costs are incurred, the equality of plant and reserve at the end of an asset's life is restored.

Mr. Majoros continues his assault on net salvage at the top of page 6 by implying that the equality of depreciation expense with company expenditures, original cost and negative net salvage, "will only be achieved if the Company actually spends the additional money at the end of the asset's life. However, unless the Company has a legal liability to remove the asset, it is not required to spend the money." While ULH&P does not have a legal obligation to remove plant, it does have an obligation to provide service. In order to provide service, ULH&P must continually renew its plant by adding new assets and retiring old assets. ULH&P has been spending significant

this unsupported supposition, he concludes "The combination of these two factors, i.e., understated lives and overstated cost of removal ratios, compounds the excessive depreciation rate problem." While that would be a true statement if the supposition were correct, it does not comport with the overwhelming evidence in this proceeding. In my opinion, many of ULH&P's existing depreciation rates contain negative net salvage factors which charge too little for future cost of removal and compound the *inadequate depreciation* rate problem.

IV. EXCESSIVE DEPRECIATION

Q. AT THE BOTTOM OF PAGE 5 OF HIS DIRECT TESTIMONY AND IN EXHIBIT___(MJM-3), MR. MAJOROS REFERS TO THE TERM

> In this instance, the evidence of expert computations of the amounts required for annual allowances does not stand alone. In striking contrast is the proof of the actual condition of the plant as maintained...

The concept of physical depreciation referred to in this sentence is no longer used in the determination of rate base in public utility regulation. Instead, largely as a result of the 1944 decision of the U. S. Supreme Court in *Federal Power Commission et al v. Hope Natural Gas Co.*, net investment has become the primary, if not exclusive, means of determining rate base. In this approach, the Accumulated Provision for Depreciation as recorded on the company's books is deducted from original cost. The Accumulated Provision for Depreciation reflects the past allowances for depreciation whether they

THIS PROCEEDING. DOES FAS NO. 143 HAVE ANYTHING TO DO WITH RATEMAKING IN GENERAL AND THIS PROCEEDING IN PARTICULAR?

A. No, it does not. Although Mr. Majoros assures the Commission that none of his specific recommendations has any impact on ULH&P's depreciation rates, he spends the final 20 pages of his testimony discussing FAS No. 143 and his four "new issues." While the requirements of FAS No. 143 may improve a potential investor's ability to ascertain a company's financial condition, compliance with such standards for ratemaking purposes would violate principles of customer equity and, thus, it has no place in ratemaking or regulatory accounting.

A. In my opinion, it does not. FERC Order No. 631 modified the Uniform System of Accounts to allow utilities to record the entries required for financial reporting by FAS No. 143 on the books maintained for regulatory accounting. FERC specifically stated that the order did not affect existing tariffs. The order simply provides the accounting structure that enables the identification of amounts for use in financial statements and those for use in ratemaking proceedings.

Q. ON PAGE 23, LINES 25 AND 26, MR. MAJOROS STATES THAT THERE IS A "NEED FOR THE KENTUCKY PUBLIC SERVICE COMMISSION TO SPECIFICALLY RECOGNIZE A REGULATORY LIABILITY FOR REGULATORY AND RATE-MAKING

VI. DEREGULATION

Q. ON PAGES 29 THROUGH 35, MR. MAJOROS, REFERRING TO PAST ACCRUALS IN EXCESS OF COSTS, PUTS FORTH THE PROPOSITION THAT "UNLESS THEY ARE EXPLICITY IDENTIFIED AS 'SUBJECT TO REFUND' THEY ARE MERELY HIDDEN POTENTIAL INCOME TO ULH&P." WHAT IS THE GENESIS OF HIS CONCERN?

A. Mr. Majoros concern is based on the financial accounting entries of Cinergy and several other electric utilities related to their deregulated power plants and the financial accounting entries of telecommunications companies also related to deregulated property.

such as the AG would work together to develop an equitable transition from regulation to deregulation.

Q. ON PAGE 34, LINES 19 THROUGH 22, MR. MAJOROS MAKES THE FOLLOWING STATEMENT:*"THEREFORE, AT THE MOMENT, THERE IS NO REGULATORY RECOGNITION OF SUCH A LIABILITY AND THERE IS NO PROVISION FOR A REFUND TO RATEPAYERS IF THE AMOUNTS THEY HAVE PAID ARE NOT SPENT ON COST OF REMOVAL OR DISMANTLEMENT."* IS THIS STATEMENT CORRECT?

A. No, it is not. Although the amount which Mr. Majoros is referring to is recorded as a regulatory liability for financial reporting purposes, for

A. No, there is not. These amounts are separately identified in ULH&P's books and records for Account 108, Accumulated Provision for Depreciation, and used in its determination of rate base and its calculations of remaining life depreciation rates. This treatment has afforded protections to ratepayers for many years and is adequate to do so for many more.

Q. ON PAGE 36, MR. MAJOROS OFFERS THREE ALTERNATIVES FOR DISPOSITION OF THE REGULATORY LIABILITY: (1) A PERMANENT RATE BASE OFFSET; (2) AMORTIZATION BACK TO RATEPAYERS; AND (3) ONGOING REMAINING LIFE COST OF REMOVAL RATE. WHICH DO YOU RECOMMEND?

A. I recommend that the past accruals for future costs of removal be reflected in

with the orders of this Commission and represents amounts paid for service received.

VII. ESTIMATION OF NET SALVAGE

Q. ON PAGE 19 OF HIS TESTIMONY AND IN EXHIBIT ___ (MJM-13), MR. MAJOROS DESCRIBES WHAT HE REFERS TO AS THE TRADITIONAL INFLATED FUTURE COST APPROACH OR "TIFCA." ARE YOU FAMILIAR WITH THE APPROACH BEING DESCRIBED BY MR. MAJOROS?

A. Yes, I am.

Q. HAVE YOU EVER HEARD OR READ OF IT REFERRED TO AS "TIFCA?"

A. The statistical bases for my estimates of net salvage were the historical net salvage costs as a percent of the original cost of the retired assets that produced the gross salvage or required the costs to remove.

Q. DOES THE USE OF THIS STATISTICAL BASIS RESULT IN THE COLLECTION OF FUTURE INFLATED COSTS TO REMOVE FROM CURRENT CUSTOMERS?

A. Yes, to a certain extent. The reliance on historical indications of net salvage as a percent of the original cost retired will result in the collection of net salvage costs at a future price level. However, such reliance also assumes that there will be substantial improvements in technology, comparable or lesser environmental regulations and a significant reduction in inflation.

The average cost of removal percent related to these retirements, made on average at age 29, was negative 34 percent. That is, after 29 years in service, the plant was retired and the cost to remove the plant, as a result of inflation, technological changes and other factors, was 34 percent of the cost to install the same plant.

The future retirements of the total current distribution mains in service will have an average age that actually exceeds the average life. Thus, future retirements will be of plant that has been in service nearly twice as long as the plant retired during the period 1980-2003. For retirements at such ages to experience net salvage that is 20 % of the cost to install, which is my estimate, there will have to be a reduction in the rate of inflation adjusted for

The reuse salvage credits have decreased significantly in recent years as the Company's contractors have found it more economic to use horizontal directional drilling rather than pipe insertions. Therefore, future amounts of gross salvage for mains will be minimal, consistent with the experience during the past three to five years.

Q. WHAT IS THE IMPLICATION OF THE ASSUMPTION THAT THE FUTURE RATE OF INFLATION ADJUSTED FOR TECHNOLOGICAL IMPROVEMENTS WILL BE LESS THAN THE HISTORICAL RATE?

A. The implication of this assumption as reflected in my estimates of net salvage percents is that the resultant net salvage accruals are most likely inadequate to

A. Yes, it is. The future cost to remove an item of plant is part of the service value that it renders to current customers and a ratable portion of such costs should be recovered from these customers. That is the definition of depreciation, i.e., the loss in service value during a specific period. As these future costs are recovered from current customers, they are deducted from rate base. This deduction in the amount on which the utility is entitled to earn a fair return, in effect, represents an amount on which the customer earns a return. That is, as customers provide for the future cost of removal, they receive a return on such amounts. This is fair compensation for making payment prior to the cost incurrence by the utility. Further, as already noted, by charging customers for these costs during the life of the plant; the

Q. IS IT APPROPRIATE FOR ULH&P TO COLLECT AMOUNTS FOR FUTURE NET SALVAGE COSTS THAT ARE GREATER THAN THE AMOUNTS CURRENTLY EXPENDED FOR SUCH COSTS?

A. Yes, it is. Although the amount that I propose to collect from customers for future net salvage costs is greater than the amount currently expended for such costs, the amount that ULH&P spends for plant additions is far greater than the amount that it proposes for the recovery of original cost. If net salvage accruals should be limited to current net salvage expenditures, why shouldn't the portion of depreciation expense related to the recovery of original cost be increased to the current level of plant additions? For example, in the year 2003, ULH&P's total plant additions were $25.3 million.

VIII. THE MAJOROS ALTERNATIVES

Q. ON PAGES 5 THROUGH 7 OF EXHIBIT___(MJM-13), MR. MAJOROS PROVIDES THE COMMISSION WITH FOUR ALTERNATIVES TO THE TRADITIONAL ESTIMATION AND ACCRUAL FOR NET SALVAGE. PLEASE COMMENT ON HIS FIRST APPROACH: "EXPENSING."

A. The first alternative offered by Mr. Majoros is the cash basis or expensing approach. Expensing does not charge the appropriate customers for the cost of retiring an asset and should be rejected. It defers the recovery of cost to customers that are no longer, or never were, served by the asset. Mr. Majoros also suggests that a portion of the cost of retiring assets be charged to the cost

not represent an accrual for the future cost of retiring assets. He states it is similar to the cash basis. It is the cash basis. The only difference is that he has called it depreciation expense and charged it the Accumulated Provision for Depreciation rather than calling it an operating expense. For ratemaking purposes, this is the same approach and should be rejected for all the reasons that I discussed above for expensing.

Q. PLEASE COMMENT ON HIS THIRD APPROACH: "SFAS NO. 143 FAIR VALUE ACCRUAL."

A. The pattern of recovery using this approach would not be appropriate. The pattern of recovery would be a sinking fund, not a straight line. Such a pattern suggests that the service value is being rendered in ever increasing

reject this modification to his net present value approach. I recommend that the Commission reject this alternative as well.

Q. DOES THE USE OF THE NET PRESENT VALUE APPROACH ADDRESS THE CONCERNS EXPRESSED BY THE KPSC IN CASE NO. 2003-00434?

A. No, it does not. The issue discussed by the Commission in Case No. 2003-00434 involving Kentucky Utilities Company related to an inflation adjustment that was made to the historical removal cost percents. The Commission in its order stated:

> Depreciation methods inherently recognize inflationary effects, since the depreciation rates are based upon comparisons of the original cost of the asset to the current cost of removal. This recognition

A. I am not aware of any authoritative texts on the subject of depreciation that support these alternative proposals related to net salvage costs. The two depreciation texts most often cited by depreciation experts as being authoritative support the traditional approach that I have proposed. *Public Utility Depreciation Practices*, published in 1996 by the National Association of Regulatory Utility Commissioners states:

> Closely associated with this reasoning are the accounting principles that revenues be matched with costs and the regulatory principle that utility customers who benefit from the consumption of plant pay for the cost of that plant, no more, no less. The application of the latter principle also requires that the estimated cost of removal of plant be recovered over its life.[1]

Depreciation Systems, another widely accepted text, states the concept

cooperatives that did not maintain detailed records of cost of removal and gross salvage by account. In other Kentucky cases, where the utility maintains detailed records of net salvage as ULH&P does, the traditional methodology that I have used is adopted. The Board of Public Utilities of the State of New Jersey and the Georgia Public Service Commission have also used the expensing or five-year amortization approach.

Q. WHAT IS THE TREATMENT GIVEN TO NEGATIVE NET SALVAGE IN THE DETERMINATION OF THE ANNUAL DEPRECIATION RATES IN THE VAST MAJORITY OF STATE COMMISSIONS?

A. To the best of my knowledge, the 46 state utility commissions not mentioned

A. The Missouri Public Service Commission has been dealing with the issue of net salvage for a number of years. It had originally adopted the expensing approach in a few cases while continuing to adopt the traditional straight line accrual method in another case. Laclede Gas Company appealed its case in which the Commission effectively adopted the expensing approach. The order was remanded to the Commission by the courts. During the remand proceeding the Commission accepted additional evidence on the subject of net salvage. In its final order, the Commission concluded:

> The Commission finds that the fundamental goal of depreciation accounting is to allocate the full cost of an asset, including its net salvage cost, over its economic or service life so that utility customers will be charged for the cost of the asset in proportion to the benefit they receive from its consumption. The Commission further finds that the method

conclude that these costs should be passed on to a future generation of customers. This Commission does not believe that the latter alternative constitutes sound regulatory policy, or is based on sound ratemaking principles. Current customers are receiving service from PSI's generation facilities. A part of the costs of those facilities is dismantlement upon retirement. Therefore, we do not believe it would be appropriate for the Company to backload the dismantlement costs for future ratepayers to pay when the facilities associated with these costs are providing service to current customers. Rather, we find it is appropriate that these costs be shared by all customers that received service from PSI's generation facilities. Accordingly, this Commission finds that dismantlement costs are properly included in determining the depreciation rates approved in this cause.

We believe that there is a sound basis for the traditional approach on this issue that is utilized by a majority of states. Utilizing historical averages as an item to be expensed to current customers means that these customers will be paying for salvage costs at levels that may not be sufficient. That means that the next generation of customers will be paying for salvage costs related to facilities from which they may never

A. The Kentucky Public Service Commission has dealt with the net salvage issue in several recent cases. Traditionally, the Commission has allowed the incorporation of future net salvage in the determination of annual depreciation accrual rates. In two cases involving relatively small electric cooperatives (Jackson Energy Cooperative Corp. and Fleming-Mason Energy Cooperative), the Commission adopted a five-year average of historical net salvage rather than such an allowance. In both of these cases, the utility did not maintain records of net salvage on an account basis and was unable to provide analyses of historical data in support of their account by account estimates of net salvage percents. In the Fleming-

> The AG's (Majoros') claim that KU likely would never incur, or had no legal obligation to incur, the included retirement costs is irrelevant. The real question is whether it is reasonable to capitalize the cost of removal in order to recover those costs over the life of the investment. Capitalizing the cost of removal is a common practice and it has been accepted by this Commission for a number of years. The AG has not presented sufficient evidence in this case to persuade us to change this practice.

I concur with the Commission's conclusion regarding the alternative method that he presented in the Kentucky Utilities case and recommend that not only that method, but also the other three methods discussed by Mr. Majoros, be rejected in this case as well.

X. SPECIFIC SERVICE LIFE AND NET SALVAGE ESTIMATES

Q. WHAT ARE THE SPECIFIC ACCOUNTS FOR WHICH MR.

A. The structures and equipment in these two accounts represent peak shaving facilities. The facilities are located at Erlanger Station and the storage cavern that is 3.1 miles from Erlanger. The structures are pre-fabricated steel buildings initially constructed in 1961. The equipment includes pumps, vaporizers, compressors, boilers, tanks, cooling towers, piping and valves used to transport, vaporize and mix propane for delivery to customers during peak use periods. The equipment also was initially installed in 1961 and has gone through numerous upgrades and replacements, particularly in the past five years.

The statistical analyses of service life for these accounts are indeterminate. Although the assets behave like a mass property, a historical

of lives and Mr. Majoros selected the 59-S1.5 based on statistics. Mr. Majoros' estimates suggest that these structures and equipment could live as long as 120 years. This is patently unreasonable as are the average lives that are well beyond the typical range of estimates for these accounts. These facilities are subject to significant wear and tear with numerous start-ups and shutdowns, deterioration, potential inadequacy, and obsolescence.

Mr. Majoros' estimates for Accounts 2050, Structures and Improvements, and 2110, Liquefied Petroleum Gas Equipment, are unreasonable under the circumstances and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 2741, RIGHTS OF WAY – GENERAL.

average life times maximum age percent of 150 for the R4 type curve) conforms to this maximum life.

Mr. Majoros' estimate of 100 years is at the upper end of the typical range for this account and produces a maximum life that is not consistent with the maximum life of the related mains and should be rejected.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATES FOR ACCOUNTS 2761, MAINS – CAST IRON, COPPER AND ALL VALVES, AND 2801, SERVICES – CAST IRON, COPPER AND VALVES.

A. These accounts are affected by the Company's Accelerated Main Replacement Program ("AMRP"). I have incorporated the impacts of the

offset the concerns that I have expressed regarding inadequate accruals for negative net salvage.

Q. PLEASE DISCUSS THE SERVICE LIFE ESTIMATE FOR ACCOUNT 2763, MAINS – PLASTIC.

A. Plastic mains have been installed on ULH&P's system for 40 years. However, significant amounts of plastic were not installed until 1970, 35 years ago. Although the statistical analyses of retirements is not definitive of life characteristics, the rates of retirement through age 35 for this group are very similar to the rates of retirement through age 35 for Account 2762, Mains – Steel. This is logical. The primary causes of retirement for mains, particularly prior to average life, are the same regardless of the material type.

mains is similar to the estimate for steel mains and projects a more reasonable maximum life. Mr. Majoros' estimate of 70-R1.5 should be rejected.

Q. PLEASE DISCUSS THE NET SALVAGE ESTIMATE FOR ACCOUNT 276, MAINS.

A. I have estimated negative 20 % net salvage for each of the subaccounts of mains as compared to an estimate of negative 5 % made by Mr. Majoros for steel and plastic mains and an estimate of zero percent for cast iron, copper, etc. mains. The historical net salvage data are only available at the account level. This is not really an issue as the costs of retiring mains and gross salvage do not vary with the type material.

Mr. Majoros states that he has based his estimate of negative 5 % on

old mains and a portion of the old main was considered as reuse salvage and capitalized with the new main. The increased use of horizontal directional drilling rather than insertions has eliminated this source of gross salvage. Thus, the average of nearly zero percent as experienced during the most recent five-year period is more representative of the future net salvage.

Mr. Majoros endeavors to support his estimate as being a surrogate for a net present value approach. For all the reasons cited above, the use of net present value is unreasonable and should not be considered as a factor in support of his judgment. Further, Mr. Majoros' use of the overall average is inappropriate when the circumstances underlying the statistics are reviewed and considered. The most recent five-year average of negative 20 % is a

of their service value and should be recovered during their service lives. Second, it is not clear to Mr. Majoros that the net salvage in the historical analyses relates to these types of assets. The underlying data make it clear that the retirements of the mains and services in Accounts 2761 and 2801 are well represented in the historical analyses for the period 1980-2003. Thirty-eight percent of the mains and 25 % of the services retirements for the overall account on a dollar basis represent retirements of the mains and services that are the subject of this program. Finally, Mr. Majoros understates the future cost of retiring simply because the Accumulated Provision for Depreciation for these groups exceeds the calculated or theoretical reserve. This makes no sense at all. The remaining life rate is already reducing the accrual rate to

Mr. Majoros has arbitrarily adjusted the historical indication of negative 35 % as a result of the response of Mr. Gary Hebbeler regarding the current policy of not charging any cost of retiring to services during a replacement project. The cost of retiring abandoned services continues to be recorded as removal cost against services. What Mr. Majoros has chosen to ignore is that the costs previously allocated as the cost of retiring services is now considered the cost of retiring mains.

In contrast, I continued to use the historical indication of negative 35 % for this account. The impact of the new policy on the net salvage percents for mains and services is difficult to quantify at this point. What we know is that the cost of retiring services will decrease and the cost of retiring mains

A. I used the Equal Life Group ("ELG") procedure in this proceeding and also in the last depreciation study that I prepared for ULH&P. It is the basis for ULH&P's currently authorized depreciation rates. I have compared and explained the ELG procedure and the Average Service Life ("ASL" or "ALG") procedure on pages II-29 through II-33 of my depreciation study report. Depreciation expense based on the ELG procedure results is a better match with the loss in service value of assets. It should be retained for ULH&P.

Q. ON PAGES 37 AND 38 OF HIS DIRECT TESTIMONY, MR. MAJOROS RECOMMENDS THE ESTABLISHMENT OF SEPARATE DEPRECIATION RATES FOR THE RECOVERY OF

A. The service life and net salvage proposals of Mr. Majoros should be rejected. Mr. Majoros' attempt to impose his concepts of depreciation as influenced by financial accounting standards through the back door rather than the continuation of this Commission's sound ratemaking policies is unreasonable. Depreciation, including both the original cost and net salvage, should be recognized ratably during the life of the related asset. Expensing net salvage after the related asset is retired conflicts with the regulatory principle of intergenerational equity. The other three alternatives proposed by Mr. Majoros also should be rejected. None of the alternatives provides for both complete capital recovery and intergenerational equity.

The traditional approach to estimating future net salvage used by

arbitrary adjustments of the statistics in yet others. The estimation of service life and net salvage requires judgment that considers appropriate factors as I have described above. Mr. Majoros' estimates do not properly incorporate such factors and should be rejected.

The depreciation rates proposed by ULH&P should be adopted.

Q. DOES THIS CONCLUDE YOUR PRE-FILED REBUTTAL TESTIMONY?

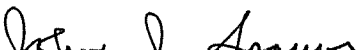
A. Yes.

VERIFICATION

State of Pennsylvania)
)
County of Cumberland)

SS:

The undersigned, John J. Spanos, being duly sworn, deposes and says that he is a Vice President associated with the firm of Gannett Fleming, Inc., and that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.



COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF THE UNION LIGHT, HEAT AND POWER COMPANY	)))	CASE NO. 2005-00042

REBUTTAL TESTIMONY OF

JOHN P. STEFFEN

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

PAGE

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME.

A. John P. Steffen.

Q. ARE YOU THE SAME JOHN P. STEFFEN WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. I rebut David H. Brown Kinloch's testimony relating to whether the Commission should re-approve Rider AMRP. Additionally, I discuss rate design for Rider AMRP.

II. CONTINUATION OF RIDER AMRP

rejected this argument. The Commission's January 31, 2002 Order states at page 75:

> [The Attorney General] contends...the Commission does not have the authority to approve ULH&P's proposal. He states that had the Commission, under its broad authority to set fair, just and reasonable rates, had the authority to participate in 'single issue' ratemaking or consider capital additions outside a general rate case, it would not have been necessary for the General Assembly to enact the statutes permitting a future test-year filing (KRS 278.192) or the environmental surcharge (KRS 278.183). The Commission disagrees. It believes the General Assembly intended prior to 1992 and after 1992 for the Commission to have broad implied and discretionary authority to establish just and reasonable rates.

Q. MR. KINLOCH STATES AT PAGES 22-23 OF HIS DIRECT TESTIMONY THAT THE COMMISSION SHOULD NOT RE-

main replacement program will have on ULH&P over the next 10 years. The Commission believes 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.

Q. DO YOU HAVE AN OPINION AS TO WHETHER THE COMMISSION SHOULD RE-APPROVE RIDER AMRP?

A. Yes, I strongly recommend that the Commission re-approve Rider AMRP. The AMRP produces significant benefits by improving the safety and reliability of ULH&P's gas distribution service, and by reducing ULH&P's operation and maintenance ("O&M") expenses. Rider AMRP allows ULH&P to recover its capital expenditures for the AMRP without undue regulatory lag. This permits ULH&P to maintain its sound

allowed ULH&P to replace significant portions of its cast iron and bare steel mains with safer and more reliable plastic mains. This has significantly reduced ULH&P's O&M expenses, and customers have benefited from this O&M savings through Rider AMRP.

While the AMRP has produced significant benefits to date, the program is far from complete. ULH&P originally proposed the AMRP in 2001 as a ten-year program. In order for ULH&P, its customers and for the general public to reap the full safety and reliability benefits from the AMRP, ULH&P will need to continue the program for seven more years. ULH&P could incur significant financial harm if Rider AMRP is discontinued now. ULH&P requests that the Commission re-approve Rider AMRP to allow ULH&P to finish the AMRP and avoid such

customer classes. This is the same type of charge the Commission originally approved in Case No. 2001-00092 and I see no reason to change this approach. The AMRP costs represent costs for replacing ULH&P's aged cast iron and bare steel mains. These are fixed costs for capital expenditures which benefit all customers on ULH&P's distribution system. It is appropriate for ULH&P to recover these costs through a fixed monthly customer charge rather than a commodity charge.

IV. CONCLUSION

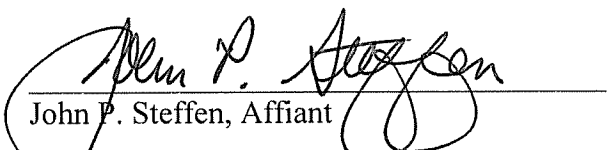
Q. DOES THIS CONCLUDE YOUR PRE-FILED REBUTTAL TESTIMONY?

A. Yes.

VERIFICATION

State of Ohio)
) SS:
County of Hamilton)

The undersigned, John P. Steffen, being duly sworn, deposes and says that he is the Vice President, Rates, for Cinergy Services, Inc. (Services) that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.



John P. Steffen, Affiant

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF THE UNION LIGHT, HEAT AND POWER COMPANY	)))	CASE NO. 2005-00042

REBUTTAL TESTIMONY OF

ALEXANDER J. TOROK

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

APPENDIX

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME.

A. My name is Alexander J. Torok.

Q. ARE YOU THE SAME ALEXANDER J. TOROK WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. I rebut the testimony of Mr. Robert J. Henkes relating to property tax expense and accumulated deferred income taxes ("ADIT").

II. PROPERTY TAX EXPENSE

Q. WHAT DID MR. HENKES RECOMMEND RELATING TO PROPERTY

property tax expense should be reduced because ULH&P will be able to negotiate reductions in the assessed value of these properties below the net book value.

I disagree with Mr. Henkes' recommendation. We recently received the Kentucky Revenue Department's 2005 tentative valuation. A copy of the 2005 valuation is at Attachment AJT-Rebuttal-1. The Kentucky Department of Revenue has increased the 2005 tentative assessment by approximately 36% over the 2004 tentative assessment, and increased the 2005 tentative assessment over the 2004 final assessment in excess of 82%. The Kentucky Department of Revenue has valued ULH&P's property at $543,548,261. A negotiated reduction of the assessed value to the net book value of $374,398,174 would represent a reduction of approximately 31% from the tentative assessment.

By comparison, the Kentucky Department of Revenue's tentative

III. ACCUMULATED DEFERRED INCOME TAXES

Q. MR. HENKES RECOMMENDS ELIMINATING THE ADIT BALANCE RELATED TO UNBILLED REVENUE. HOW DO YOU RESPOND TO HIS RECOMMENDATION?

A. In general, a reasonable approach to the treatment of ADIT for ratemaking purposes, whether an asset or liability, is to treat the ADIT in the same manner that the item that gives rise to the ADIT is treated. Thus, if the underlying income, expense or balance sheet item is excluded from the revenue requirement calculation, it is reasonable to exclude the related ADIT balance. However, this approach may not be appropriate where an ADIT is established while a particular item is included in the revenue requirement calculation and subsequently excluded in a later proceeding. In this case, it may be more appropriate to

rise to this ADIT is excluded from this case, it is not unreasonable to exclude the related ADIT.

IV. FIVE-YEAR AMORTIZATION OF UNPROTECTED DEFERRED TAXES

Q. MR. HENKES HAS PROPOSED THAT UNPROTECTED ADIT BE AMORTIZED OVER FIVE YEARS. DO YOU AGREE WITH THIS PROPOSAL?

A. No, I do not.

Q. WHAT IS THE IMPACT ON THE COMPANY OF THIS PROPOSAL?

A. The ADIT in question is a deferred tax asset. In the Company's response to KY-AG-2-33, the Company did not specifically indicate that the ADIT is an asset. Mr. Henkes appears to have presumed the ADIT to be a liability rather than an

or expense that gives rise to such tax effect. ULH&P has consistently followed this method for its ADIT assets and liabilities in the past, and should continue to do so in the future.

V. CONCLUSION

Q. DOES THIS CONCLUDE YOUR PRE-FILED REBUTTAL TESTIMONY?

A. Yes.

VERIFICATION

State of Ohio)
) **SS:**
County of Hamilton)

The undersigned, Alexander J. Torok, being duly sworn, deposes and says that he is the Vice President of Taxation, that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.

Alexander J. Torok, Affiant

Subscribed and sworn to before me by Alexander J. Torok on this 15th day of July,

61A240 (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 tentative. It will become final on 08/19/2005 , 45 days from the notice date, unless protested. If written protest is not made within the 45 day period, a Notice of Tax Due for state taxes will be issued; no further remedies will be available regarding this assessment per KRS 134.590. DO NOT SEND PAYMENT UNTIL YOU HAVE RECEIVED A NOTICE OF TAX DUE. Local taxes will be billed directly by the local jurisdictions.

Date: 07/05/2005 Tax Year: 2005 TENTATIVE

PROPERTY CLASS	ASSESSMENT
STATE AND LOCAL	
Real Estate @ .131	184,193,967.00

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF AN ADJUSTMENT OF GAS RATES OF THE UNION LIGHT, HEAT AND POWER COMPANY	)))	CASE NO. 2005-00042

REBUTTAL TESTIMONY OF

TIMOTHY J. VERHAGEN

ON BEHALF OF

THE UNION LIGHT, HEAT AND POWER COMPANY

TABLE OF CONTENTS

I. INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME.

A. My name is Timothy J. Verhagen.

Q. ARE YOU THE SAME TIMOTHY J. VERHAGEN WHO PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. I am responding to Mr. Robert J. Henkes' testimony relating to whether ULH&P should be permitted to recover the costs of its incentive compensation plans through its retail gas rates.

important objectives, such as delivering safe, adequate and reliable service. Additionally, these are broad-based pay plans which benefit many employees, which enhance employee performance, and which are necessary for ULH&P to offer competitive compensation plans in order to attract and retain high caliber employees.

ULH&P now proposes, however, to only recover a portion of these incentive compensation costs through its rates. While we continue to believe that all such costs are properly recoverable, we are providing an alternative proposal for the Commission's consideration. This proposal allocates ULH&P's incentive compensation costs between customers and shareholders, such that Cinergy shareholders will bear a fair share of these incentive compensation costs. This proposal recognizes that Cinergy shareholders receive some benefit from the

our proposal reflects a reasonable sharing of the costs between customers and shareholders because both groups benefit from the plans and the nature of the benefits are inextricably intertwined. As discussed in Mr. Wathen's testimony, ULH&P has revised the amount of incentive compensation costs in its revenue requirement calculation, based on the following allocations and assuming the following achievement levels:

Incentive Plan	Incentive Plan Components	Budgeted Achievement Level	Percentage to Shareholders	Percentage to Customers
AIP	corporate goals	2.0	50%	50%
	individual goals	2.0	0%	100%
	RBU operational goals	2.0	0%	100%
LTIP	total shareholder return	at target	50%	50%
		2.0	0%	100%

is reasonable because Cinergy expects to perform at target over the long-term. Cinergy has consistently outperformed its peer group in the last five years, which has resulted in payouts above the original targeted level for the last five cycle payouts.

Q. PLEASE EXPLAIN HOW THE COSTS RELATED TO THE AIP'S CORPORATE PERFORMANCE OBJECTIVE ARE DIVIDED BETWEEN CUSTOMERS AND SHAREHOLDERS.

A. The AIP plan has three separate components: corporate goal, individual goals, and Regulated Businesses Unit ("RBU") operational goals. We propose that the expense attributable to 50% of the corporate performance goal be allocated to customers. The corporate performance goal is currently based on net income. A performance objective based on net income benefits customers in two ways. First, increasing net

employed directly by ULH&P or allocate their time to ULH&P, and they work on ULH&P matters which directly benefit customers. As a result, customers should bear the full cost of this portion of employees' incentive pay.

Finally, the AIP's RBU operational goals for RBU employees 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. Superior performance relating to these goals directly benefits ULH&P customers through safe and reliable service, customer service quality, and low energy costs.

Q. PLEASE EXPLAIN HOW THE COSTS OF THE LTIP ARE DIVIDED BETWEEN CUSTOMERS AND SHAREHOLDERS.

A. The UEIP is an incentive plan for employees not eligible for any of the other incentive compensation plans. Some common examples of employees in the UEIP include field gas employees, customer service personnel and clerical workers. It is appropriate to allocate to customers 100% of costs related to these employees' incentive pay because these individuals are employed directly by ULH&P or allocate their time to ULH&P and they work on ULH&P matters that directly benefit customers. Customers should bear the cost of the employees' incentive pay because incentive pay is necessary to keep the Companies' total compensation competitive.

Q. BASED ON ALL OF THE ABOVE MENTIONED ALLOCATIONS TO CUSTOMERS AND SHAREHOLDERS, HOW MUCH OF ULH&P'S TOTAL INCENTIVE COMPENSATION EXPENSE WOULD BE REFLECTED IN ITS

including the performance objective based on net income. I provided a more thorough explanation of these customer benefits in my response to KyPSC-DR-03-040, which I incorporate herein by reference.

I understand that ULH&P formerly had an incentive plan known as the "Key Employee Annual Incentive Plan," ("KEAIP"), and that the Commission denied rate recovery for the costs related to the KEAIP. ULH&P's current incentive plans, however, are different from the KEAIP as I understand it. Many more employees participate in the current incentive plans, and the performance objectives under the current plans are more detailed and provide clear customer benefits. As a result, the Commission's rejection of rate recovery for the KEAIP should not be used as a basis to deny rate recovery for the costs of the current incentive plans.

incentive compensation plans, the Commission should allow rate recovery of such costs.

I also note that in Case No. 2004-00103, the Commission denied Kentucky-American Water Company's request to recover incentive compensation costs because the company failed to demonstrate why the utility's shareholders should not bear a portion of these costs. With our proposal to allocate incentive compensation costs between shareholders and customers, we have addressed this concern. This is the approach followed by the Indiana Utility Regulatory Commission ("IURC"), and an example is the IURC's rate case order for our affiliated operating company, PSI Energy, Inc., issued on May 18, 2004 in Case No. 42359.

IV. CONCLUSION

VERIFICATION

State of Ohio)
) **SS:**
County of Hamilton)

The undersigned, Timothy J. Verhagen, being duly sworn, deposes and says that he is the Vice President Human Resources for Cinergy Services, Inc. (Cinergy Services), that he has personal knowledge of the matters set forth in the foregoing testimony, and that the answers contained therein are true and correct to the best of his information, knowledge and belief.