Kent W. Blake
Director
State Regulation and Rates

LG&E Energy LLC
220 West Main Street
Louisville, Kentucky 40202
_502-627-2573_
502-217-2442 FAX
kent.blake@lgeenergy.com

January 13, 2006

RECEIVED

JAN 13 2006

PUBLIC SERVICE
COMMISSION

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

RE: _**The Plan of Kentucky Utilities Company For The Value Delivery Surcredit Mechanism**_ – **Case No. 2005-00351**

**The Plan of Louisville Gas and Electric Company For The Value Delivery Surcredit Mechanisms** – **Case No. 2005-00352**

Dear Ms. O'Donnell:

Enclosed please find an original and ten (10) copies of Louisville Gas and Electric Company's and Kentucky Utilities Company's Rebuttal Testimony of Kent W. Blake in the above referenced matters.

Should you have any questions concerning the enclosed, please do not hesitate to contact me.

Sincerely,

Kent W Blake

Kent W. Blake

cc: Hon. Elizabeth E. Blackford
Hon. Michael L. Kurtz

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE PLAN OF KENTUCKY UTILITIES COMPANY FOR THE VALUE DELIVERY SURCREDIT MECHANISM	)))	CASE NO. 2005-00351

In the Matter of:

THE PLAN OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR THE VALUE DELIVERY SURCREDIT MECHANISMS	)))	CASE NO. 2005-00352

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JAN 13 2006

PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY OF
KENT W. BLAKE
DIRECTOR, STATE REGULATION AND RATES
E.ON U.S. SERVICES INC.

Dated: January 13, 2006

1 **Q. Please state your name, position and business address.**

2 A. My name is Kent W. Blake. I am Director of State Regulation and Rates for E.ON
3 U.S. Services Inc., which provides services to Louisville Gas and Electric Company
4 ("LG&E") and Kentucky Utilities Company ("KU") (collectively "the Companies").
5 On December 1, 2005, LG&E Energy Services Inc. changed its name to E.ON U.S.
6 Services Inc. My business address is 220 West Main Street, Louisville, Kentucky
7 40202.

8 **Q. Have you previously filed direct testimony with this Commission in these**
9 **proceedings?**

10 A. Yes. I have filed direct testimony in both proceedings on September 30, 2005.

11 **Q. What is the purpose of your testimony?**

12 A. The purpose of my testimony is to address and rebut the arguments advanced by Mr.
13 Robert J. Henkes on behalf of the Office of Rate Intervention for the Attorney
14 General for the Commonwealth of Kentucky ("AG"), and Mr. Lane Kollen on behalf
15 of the Kentucky Industrial Utility Customers, Inc. ("KIUC"). My rebuttal testimony
16 will demonstrate that disregarding important evidence has biased the
17 recommendations of the intervenors and how the Companies are effectively returning
18 100 percent of the Value Delivery Team ("VDT") Savings to customers following the
19 expiration of the five-year term of the VDT surcredit mechanism. My rebuttal
20 testimony will also show why the recommendations of the AG and KIUC to extend
21 the surcredits at the gross level of savings are a violation of the prohibition against
22 single-issue ratemaking. I will also rebut the specific arguments put forth by the AG

1 and KIUC in opposition to the Companies' position to withdraw the Value Delivery
2 Surcredit Riders.

3 **Q. Will you please summarize your testimony?**

4 A. The issue for decision in these proceedings is whether the VDT Surcredit
5 mechanism should be extended beyond its agreed-upon five-year term. The
6 Companies have taken the position that the VDT Surcredit mechanism has served its
7 purpose during its term and should now be allowed to expire. The intervenors
8 recommend the mechanism should not only be extended but that the amount of the
9 surcredits should be increased.

10 In their Plans filed with the Commission in these proceedings, the Companies
11 have proposed detailed steps for customers to receive 100 percent of the savings from
12 the VDT initiative after expiration of the existing VDT Surcredit mechanism. The
13 intervenors take no exception with these steps and do not dispute whether the
14 customers should receive 100 percent of the savings. The Companies have also
15 clearly demonstrated that the expiration of this mechanism will not cause the
16 Companies to earn unreasonable returns and the extension of this rate mechanism will
17 cause financial harm to the Companies during a period of intensive investment in, and
18 construction of, generation and transmission facilities the Commission has
19 determined necessary for the public convenience and necessity.

20 The intervenors, however, recommend the Commission engage in single-issue
21 ratemaking, over the objection of the Companies. By recommending an extension of
22 the VDT Surcredit mechanism beyond its agreed-upon five-year term at the *gross*
23 savings level, the intervenors are asking the Commission to approve a decrease in the

1 Companies' revenues without the traditional ratemaking process of a base rate case.
2 This is the very definition of "single-issue ratemaking". The Commission cannot
3 simply disregard other changes in revenues, expenses and capitalization that the
4 Companies have incurred since their last base rate case and still reach a fair, just and
5 reasonable result.

6 The Companies respectfully submit that the five-year term of the VDT
7 Surcredit mechanism was the result of a unanimous settlement agreement with the
8 very same entities that are parties to this proceeding. That settlement agreement
9 resolved a number of pending issues and, as always exists with any settlement, was
10 the product of extensive negotiations, deliberations and compromises by all parties.
11 Among other things, this settlement put in place a VDT Surcredit mechanism that
12 would only exist for the five-year term during which the associated costs to achieve
13 were being amortized.

14 In making their arguments, the intervenors make two misleading contentions
15 concerning the Companies' former Earnings Sharing Mechanism ("ESM"). First,
16 they contend that the provision in the 2004 base rate case settlement that led to this
17 proceeding was directly related to the termination of the ESM. In reality, the
18 termination of the ESM was the result of a separate settlement agreement, responsive
19 to the intervenors' desire to terminate the ESM and, most importantly, was agreed to
20 in principle well before the revenue requirement issues in the base rate case, including
21 the VDT Surcredit mechanism were even discussed.

22 Second, while the AG correctly notes that the settlement agreement which
23 gave rise to the VDT Surcredit mechanism was entered into at a time when the ESM

1 was in place, his assertion that "[a]fter the expiration of the VDT Surcredit
2 mechanism, the rates charged to the ratepayers under the normal operation of the
3 ESM would have reflected the cessation of the VDT cost amortization and the
4 continuation of all gross VDT savings flowing from the workforce reduction" is
5 misleading. The ESM operated much like the traditional ratemaking environment in
6 which the Companies operate today in that the ESM considered all changes in
7 revenues, expenses and capitalization. To the extent that the Companies' earnings
8 fell within the deadband established under the ESM despite the cessation of the VDT
9 cost amortization and provision of all gross VDT savings to customers, the resulting
10 impact to customers would be exactly what the Companies have proposed in this
11 proceeding. The Companies' financial evidence submitted in this proceeding clearly
12 demonstrates that the Companies' earnings will be at such a reasonable level when
13 the VDT Surcredit mechanism expires. Thus, customers will effectively receive
14 100% of the VDT gross savings upon expiration of the mechanism. However, a
15 change in base rates will not be warranted as such incremental savings have been
16 offset by other changes in the cost of providing service. The net effect of these
17 changes should still allow the Companies to earn the rate of return set by the
18 Commission in the last base rate cases.
19
20 A. <u>The Recommendations of the Intervenors</u>
21 Q. **Do the Companies agree with the recommendations of the intervenor witnesses**
22 **to extend the Value Delivery Surcredit Riders?**
23 A. No. The recommendations of the AG and KIUC overlook the Companies' overall
24 financial condition, inclusive of *all* changes to revenues, expenses and capitalization

1 which cannot be ignored by the Commission in determining a reasonable result.
2 Their recommendations also disregard the express language in Section 2.4 of the
3 October 31, 2001 written and unanimous settlement agreement ("2001 Settlement
4 Agreement") approved by the Commission in its Order of December 3, 2001.[1]
5 Finally, both intervenors based their recommendations on the erroneous premise that
6 the extension of the VDT Surcredit mechanism is necessary because the ESM was
7 terminated.

8 **Q. Are the intervenors' recommendations to extend the VDT Surcredit mechanism**
9 **compatible with the evidence presented by the Companies regarding the**
10 **financial impact of such a recommendation?**

11 A. No. First, the financial analysis presented in my direct testimony and summarized in
12 the following table shows that the expiration of the VDT Surcredit mechanism will
13 not cause the Companies to earn unreasonable returns:

[1] *In the Matter of: Annual Earnings Sharing Mechanism Filing of Louisville Gas and Electric Company*, Case No. 2001-054; *Annual Earnings Sharing Mechanism Filing of Kentucky Utilities Company*, Case No. 2001-055; *Application of Kentucky Utilities Company for an Order Approving Revised Depreciation Rates*, Case No. 2001-140; *Application of Louisville Gas and Electric Company for an Order Approving Revised Depreciation Rates*, Case No. 2001-141; *Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for an Order Approving Proposed Deferred Debits and Declaring the Amortization of the Deferred Debits to be Included in Earnings Sharing Mechanism*, Case No. 2001-169, Commission's Order dated December 3, 2001.

1
2
3

Earned Return on Equity

(Based on Twelve Months Ending June 30, 2005)

	LG&E - Electric[2]	LG&E - Gas[3]	KU[4]
Expiration of Value Delivery Surcredits	10.28%	7.51%	10.07%
Effect of Value Delivery Surcredits with *Net* Level of Savings As Of June 30, 2005	7.36%	3.99%	8.49%

4

5 The intervenors' recommendation to *extend* the VDT Surcredit mechanisms
6 after March 2006, especially at the *gross level of savings,* would cause severe
7 financial harm to the Companies. The schedules in Blake Exhibit Nos. 4 and 5 to my
8 direct testimony have been revised to reflect the impact of the extension of the VDT
9 Surcredit mechanism at both the *net* (Section III) and *gross* (Section IV) levels of
10 savings and are attached collectively as Blake Rebuttal Exhibit 1.
11 The following chart summarizes the financial impact of the intervenors'
12 recommendations to the Companies:

[2] Testimony of Kent W. Blake, Exhibit 5, *In the Matter of: The Plan of Louisville Gas and Electric Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00352 filed September 30, 2005.
[3] Testimony of Kent W. Blake, Exhibit 5, *In the Matter of: The Plan of Louisville Gas and Electric Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00352 filed September 30, 2005.
[4] Testimony of Kent W. Blake, Exhibit 5, *In the Matter of: The Plan of Kentucky Utilities Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00351 filed September 30, 2005.

1
2
3

Earned Return on Equity

(Based on Twelve Months Ending June 30, 2005)

	LG&E - Electric[5]	**LG&E - Gas**[6]	**KU**[7]
Expiration of Value Delivery Surcredits as of April 1, 2006	10.28%	7.51%	10.07%
Extension of Value Delivery Surcredits with Net Level of Savings after March 2006	8.96%	6.04%	9.40%
Extension of Value Delivery Surcredits with Gross Level of Savings after March 2006 (Intervenor position)	7.13%	3.90%	8.44%

4
5 As this table shows, extension of the Value Delivery Surcredits, especially at the
6 gross level of savings, would result in an immediate decrease in revenues and would
7 cause the Companies to be placed immediately in positions of significantly under
8 earning their authorized return on equity. Expiration of the VDT Surcredit
9 mechanism, however, will allow the Companies to earn just within the bottom of the
10 authorized range of return on equity for their electric operations and well below the
11 authorized range of return on equity for the gas operations. The intervenors argue
12 that the Commission should ignore the financial impact of their recommendations on
13 the Companies. This argument conveniently overlooks the significant changes in the
14 cost of providing service that the Companies have incurred since the last base rate
15 change. As discussed below, the Companies submit that all parties should abide by
16 the 2001 Settlement Agreement. Just as the intervenors contend the Companies can

[5] Rebuttal Testimony of Kent W. Blake, Exhibit 1, *In the Matter of: The Plan of Louisville Gas and Electric Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00352.
[6] Rebuttal Testimony of Kent W. Blake, Exhibit 1, *In the Matter of: The Plan of Louisville Gas and Electric Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00352 filed September 30, 2005.
[7] Rebuttal Testimony of Kent W. Blake, Exhibit 1, *In the Matter of: The Plan of Kentucky Utilities Company for the Value Delivery Surcredit Mechanisms*, Case No. 2005-00351 filed September 30, 2005.

1 file rate cases if extension of the VDT Surcredit mechanism cause financial harm to
2 the Companies, comparable traditional ratemaking procedures and remedies are
3 available to all parties if the Companies' base rates were to become unjust and
4 unreasonable following the expiration of the VDT Surcredit mechanism.

5 **Q. Are the intervenors' recommendations to continue the Value Delivery Surcredit**
6 **Riders of KU and LG&E inconsistent with the express language in the 2001**
7 **Settlement Agreement?**

8 A. Yes. The 2001 Settlement Agreement expressly provides on page 6 in Section 2.4
9 that "[t]he surcredit mechanism terminate and be withdrawn from service following
10 the expiration of the sixty month period ending March 31, 2006, subject to any final
11 balancing adjustments." The expiration of the five-year operational term of the VDT
12 Surcredit mechanism allows for the return to traditional ratemaking with respect to
13 the VDT savings once the costs to achieve these savings have been fully amortized.
14 The Companies' Plan clearly demonstrates how the VDT savings and cost
15 amortization will be handled in the Companies' next base rate case. The Plan is,
16 therefore, consistent with the express terms of the 2001 Settlement Agreement. The
17 recommendations of the intervenors to extend the VDT Surcredit mechanism are not.

18

19 **B. Extension of the VDT Surcredit Mechanism,**
20 **Absent the Companies' Consent,**
21 **Constitutes Prohibited Single-Issue Ratemaking**

22 **Q. Do the proposals of the intervenors to extend the surcredit violate the**
23 **prohibition against single-issue ratemaking?**

1 A. Yes. The purpose of the single-issue ratemaking prohibition is to prevent arbitrary
2 and selective exercises in ratemaking which benefit customers or shareholders to the
3 detriment of the other. The intervenors' proposal to increase the surcharge at the
4 gross savings level to reflect the expiration of the amortization of the cost to achieve
5 the Workforce Transition Separation Program ("Workforce Program") in base rates
6 effectively reduces the Companies' total revenues and is simply an exercise in single-
7 issue ratemaking. Although their proposal does maintain the current 60/40 ratio of
8 sharing the savings between shareholders and customers, the fundamental flaw in
9 their proposal is demonstrated by its clear and detrimental financial impact on the
10 Companies' financial health as shown in my direct testimony. This harm cannot be
11 excused by simply asserting that the financial impact is irrelevant for consideration in
12 this case.

13 In its December 22, 2004 Orders in Case No. 2004-00459[8] and Case No.
14 2004-00460[9], the Commission stated:

15 Simply stated, the pending applications appear to be requests
16 for the Commission to engage in single-issue rate-making by
17 focusing exclusively on one or more closely related items of
18 revenue and expense, to the exclusion of all other items of
19 revenue and expense. Although the Commission has, in
20 limited instances, previously engaged in single-issue rate-
21 making, those instances were either specifically authorized by
22 statute or the result of a unanimous agreement by all parties
23 with approval by the Commission. While the General
24 Assembly has authorized single-issue rate-making for recovery
25 of the Commission's annual assessment and the costs of its
26 consultants (KRS 278.130), environmental costs (KRS

[8] In the Matter of: *Application of Louisville Gas and Electric Company for Approval of New Rate Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates*

[9] In the Matter of: *Application of Kentucky Utilities Company for Approval of New Rate Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates*

1 278.183), and demand side management costs (KRS 278.285),
2 there is no provision of law authorizing a rate case focused
3 exclusively on MISO-related revenues and expenses. ...

4 Similarly, there is no statute authorizing the VDT Surcredit mechanism. The
5 mechanism exists solely because of the Commission's approval of the unanimous
6 2001 Settlement Agreement. The Companies cannot consent to the extension of the
7 VDT Surcredit mechanism in these proceedings for the reasons stated in my direct
8 testimony and did not consent to do so by agreeing to file "a plan for the future
9 ratemaking treatment of the VDT surcredits, the shareholder savings, the amortization
10 of the VDT costs and all other VDT-related issues" in connection with Section 3.5 of
11 the May 12, 2004 Partial Settlement Agreement, Stipulation and Recommendation
12 ("2004 Rate Case Settlement Agreement"). This provision simply reserved the
13 resolution of these issues to another proceeding (i.e. these pending cases) at a later
14 time.
15
16 C. The AG's Arguments are Without Merit

17 **Q. The AG's witness argues that because the Earnings Sharing Mechanism**
18 **("ESM") has been discontinued the Value Delivery Surcredits should be**
19 **continued. Do you agree with the AG's contention?**

20 A. No, but before responding to this assertion, the circumstances and context of the
21 adoption and then termination of the ESM must be reviewed. The Companies were
22 offered the ESM in the Commission's Orders of January 7, 2000 in Case No. 98-
23 426[10] and Case No. 98-474.[11] The Companies notified the Commission in early

[10] In the Matter of: *Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of its Rates and Services*

1 February 2000 of their decision to adopt the Commission's optional ESM by filing a
2 tariff. During the course of Case No. 2000-095[12] the Companies committed to
3 propose an extension of the ESM after the three-year period.[13]

4 Beginning in January 2001, LG&E, KU and LG&E Energy Services Inc.
5 employees were offered an opportunity to participate in the Workforce Program. The
6 purpose of this program was to reduce the number of employees through improved
7 management tools and process redesign, including the implementation of world-class
8 best practices and selective outsourcing, while achieving high quality customer
9 service, safety and significant cost savings. In order to reflect the impact of the
10 Workforce Program on the Companies' current and ongoing utility operations, LG&E
11 and KU requested permission from the Commission to capitalize the costs of the
12 Workforce Program in accordance with certain applicable accounting requirements.[14]
13 The Companies filed their application requesting this authority in Case No. 2001-
14 169[15]. The Companies filed their application in an effort to avoid charging all the
15 costs of the Workforce Program in the period they were incurred, thereby unfairly
16 burdening existing customers for the benefit of future customers. The Companies
17 therefore proposed capitalizing the costs and amortizing them over a reasonable
18 period during which the benefits of the Workforce Program would be realized as a

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[11] In the Matter of: *Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of its Rates and Services*

[12] In the Matter of: *Joint Application of PowerGen plc and LG&E Energy Corp., Louisville Gas and Electric Company and Kentucky Utilities Company For Approval of Merger*, Case No. 2000-095

[13] Case No. 2000-095, Order (May 15, 2000) (Commitment No. 17)

[14] Statement of Financial Accounting Standards No. 71, *Accounting for Effects of Certain Types of Regulation* (December 1982) ("FASB No. 71").

[15] In the Matter of: *Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for an Order Approving Proposed Deferred Debits and Declaring the Amortization of the Deferred Debits to be Included in Earnings Sharing Mechanism Calculations*

1 reasonable method of reflecting the impact of this initiative on the Companies'
2 current and ongoing operations.
3 During the course of Case No. 2001-169, the AG and KIUC objected to the
4 Companies' position of sharing the savings through the ESM because of the risk that
5 the savings may not be achieved while the cost to achieve would be recovered. As I
6 explained in my direct testimony, the AG and KIUC and other consumer
7 representatives met with the Commission Staff and the Companies at the
8 Commission's office during the fall of 2001 and reached the unanimous written 2001
9 Settlement Agreement. To address the intervenors' concerns, the parties agreed to
10 use an incentive-type of ratemaking mechanism called the Value Delivery Surcredit.
11 This mechanism guaranteed that customers would receive the savings regardless of
12 whether and when they were achieved. The Companies were able to recover the cost
13 to achieve savings by including the cost to achieve and the amount of the Value
14 Delivery Surcredit in the calculation of the annual ESM. In doing so, the Companies
15 could only recover from customers forty percent of the amount necessary to reach the
16 bottom of the so-called dead band or 10.50 percent.
17 **Q. Is the AG's contention correct that "[i]f the ESM had been continued, the**
18 **ratepayers would have continued to share in the VDT savings after March 31,**
19 **2006, by virtue of the fact that the VDT cost amortization would cease effective**
20 **March 31, 2006 while the continued benefits flowing from the workforce**
21 **reduction would have been reflected through the operation of the ESM."**
22 A. No. Notwithstanding the analysis I previously presented, assuming the intervenors
23 had not objected to the extension of the ESM for another term of operation, and the

1 midpoint was reset at 10.50 percent with another 200 basis point dead band, the
2 evidence presented in this case clearly shows customers would *not* be receiving any
3 direct incremental rate benefits to their current base rates by operation of an ESM
4 under these circumstances. As a matter of fact, the AG's assertion illustrates the
5 validity of the Companies' position-- the Companies' financial returns presented in
6 this case show how the expiration of the VDT Surcredit mechanism effectively
7 provides customers with 100 percent of the VDT savings, but those savings are offset
8 by other changes in revenues, expenses and capitalization of the Companies since the
9 last rate cases.

10 It is also ironic that KIUC now accepts, without question, the estimated
11 savings for the purpose of increasing the surcredits to the gross level when, in the
12 2004 rate cases, KIUC challenged whether the savings in fact were achieved. KIUC
13 reminds the Commission of this inconsistency in its response to the Commission's
14 Request for Information No. 1 where KIUC states: " It should be noted that [KIUC's
15 witness] testified in his Direct Testimony in those proceedings that the actual savings
16 were substantially less than the projected savings assumed in the VDT proceedings
17 and that, as a consequence, the Companies' base revenue requirement was
18 overstated."

19 **Q. Do you agree with the AG's assertion that the discontinuance of the ESM was**
20 **consideration for Section 3.5 in the 2004 Rate Case Settlement Agreement?**

21 A. No. The terms of the written unanimous settlement agreement providing for the
22 billing and recovery of the 2003 ESM Reporting Period and the discontinuance of the
23 ESM ("2004 ESM Settlement Agreement") were reached in principle prior to the

negotiations on the traditional rate base issues of revenue allocation and rate design even began. The express language in both the 2004 ESM Settlement Agreement and the 2004 Rate Case Settlement Agreement clearly demonstrates that they were negotiated separately and independently. The assertion that the two agreements are somehow interrelated and interdependent is simply not supported by the facts.

Q. Does the Commission's approval of the settlement agreement in Case No. 99-149 provide authority for the AG's position in these proceedings?

A. No. The AG's witness makes these arguments at pages 14 through 16 of his testimony. The express language in the settlement agreement in Case No. 99-149, however, states:

> This Agreement shall not constitute nor be cited as precedent or deemed an admission by any Party in any other proceeding except as necessary to enforce its terms before this Commission, or any State Court of competent jurisdiction.

(Effect and Use of Agreement Par. #1 at page 14). The enforcement of the settlement in Case No. 99-149 is not an issue in these proceedings. That settlement agreement like almost all settlement agreements is just that- a compromise and settlement of issues and does not have decisional value, especially on the Companies who were not parties to the agreement in that case. Notwithstanding this important distinction, the language of the Kentucky Power Settlement cited by the AG in support of his recommendation to continue the Value Delivery Surcredits is not the same language in the 2001 Settlement Agreement in these proceedings. The two settlement agreements represent two different transactions for which separate compromises were made and accepted to resolve the controversy.

D. <u>KIUC's Rationale for Rejecting the Companies' Proposal are Without Merit</u>

1 **Q. Does KIUC contend the 2001 Settlement Agreement established a formula for**
2 **determining the disposition of the VDT Surcredit mechanism following the**
3 **expiration of the agreed-upon five-year term of operation?**

4 A. Yes. Mr. Kollen's testimony presents this argument at pages 12 through 15 of his
5 written testimony and offers Exhibit B from the 2001 Settlement Agreement as
6 support for this contention.

7 **Q. Do you agree with the KIUC's assertion the 2001 Settlement Agreement**
8 **established a formula for determining the disposition of the VDT Surcredit**
9 **mechanism following the expiration of the agreed-upon five-year term of**
10 **operation ?**

11 A. No. This argument is advanced by KIUC to suggest the Commission has no choice
12 but to extend the VDT Surcredit mechanism based upon the *gross* savings levels
13 based upon the assertion that the so-called "sharing formula" should be maintained.
14 Their contention is erroneous. The amount of the Value Delivery Surcredits is not
15 based on a "formula". Schedule B identified in Mr. Kollen's testimony as the basis
16 for his assertion is simply a workpaper clearly used in the settlement negotiations and
17 offered as part of the 2001 Settlement Agreement to show how the amortization of the
18 cost to achieve the savings and the "Net Savings to Shareholders" values were
19 calculated for the 2001 Settlement Agreement. The workpaper does not express any
20 formula for determining the disposition of the VDT Surcredit mechanism following
21 the expiration of the agreed-upon five-year term of operation.

1 **Q. Do you agree with KIUC's assertion that "[t]he Companies' proposal is the exact**
2 **opposite of the normal ratemaking process whereby 100% of the savings are**
3 **flowed through to the ratepayers"?**

4 A. No. Mr. Kollen makes this assertion at page 16 of his testimony, but omits the
5 complete description of the Companies' Plans set forth in my direct testimony. As
6 stated in detail in my direct testimony:

> 7 Effective for service rendered on and after April 1, 2006, the Value
> 8 Delivery Surcredits will be allowed to expire subject to the final
> 9 balancing adjustment to be billed in May 2006.
>
> 10 From that point forward, in future base rate cases, LG&E will not
> 11 make a pro-forma adjustment to retain its 60% share of the net savings
> 12 from the VDT initiative. Of course, LG&E's net operating income in
> 13 any future test year will also not include the costs to achieve these
> 14 savings since the amortization period will have expired.
>
> 15 Similarly, revenues will not be reduced by the Value Delivery
> 16 Surcredit in any future test year upon expiration of the Value Delivery
> 17 Surcredit Rider tariff. These future impacts are applied to the twelve
> 18 months ended June 30, 2005, on lines 32 through 35 in Blake Exhibit
> 19 1. These adjustments demonstrate the effect of the Value Delivery
> 20 Surcredit expiration.

21 Thus, contrary to KIUC's assertion, the Companies are proposing to flow back to
22 customers 100 percent of the savings through the traditional ratemaking process.
23 Customers will begin to effectively receive 100 percent of the savings following the
24 expiration of the VDT Surcredit mechanism as shown by the financial evidence of the
25 Companies' returns. Secondly, all aspects of the VDT Surcredit mechanism will be
26 removed directly in the Companies' next base rate cases. Shareholders would only
27 benefit to the detriment of the customers if expiration of the VDT Surcredit
28 mechanism would cause the Companies to earn unreasonable returns. The

1 intervenors have offered no financial analysis to support their contention in this
2 regard.
3 Continuing the VDT Surcredit mechanism past its expiration date until the
4 Companies' next base rate case is single-issue ratemaking and certainly not consistent
5 with the traditional ratemaking process.

6 **Q. Is KIUC's assertion -- that the Commission "previously rejected [the**
7 **Companies' approach in these proceedings]" in its decision in Case No. 97-300 --**
8 **correct?**

9 A. No. In Case No. 97-300, LG&E and KU filed a joint application for the approval of
10 the merger of their parent companies and associated transfer of control over their
11 utility operations. The Commission's reasons for rejecting the claims of the KIUC
12 and the AG to modify the Companies' proposed ratio for sharing merger benefits
13 included:

14 1. The record in that case contained no analysis of the reasonable
15 cost of equity for either LG&E or KU; and
16 2. In the opinion of the Commission no definitive finding of over
17 earning could be made with the limited evidence of record on
18 the Companies' current earnings.

19 Thus, contrary to KIUC's argument, the Commission's Order in Case No. 97-300
20 clearly acknowledges that the Commission did consider the evidence in the record of
21 the financial impact of the transaction on the Companies and shows the Commission
22 exercised its discretionary authority in evaluating the quality and quantity of that
23 evidence. In contrast, the Companies have presented a substantial amount of

1 financial analysis in these proceedings that shows the financial impact of extending
2 the VDT Surcredit mechanism at the gross savings level to be unreasonable and
3 harmful.

4 **Q. Does KIUC's testimony accurately describe the objections of LG&E and KU in**
5 **Case No. 97-300 to the claims of the KIUC and the AG to modify the Companies'**
6 **proposed ratio for sharing merger benefits?**

7 A. No. Contrary to KIUC's assertion that the Companies are "now strenuously arguing
8 the opposite position in this proceeding," the savings at issue in Case No. 97-300 are
9 different than the savings at issue in these proceedings. The merger savings were
10 caused by the premium paid by LG&E Energy Corp. investors for the purchase of KU
11 Energy Corporation stock. But for the investors' willingness to pay the premium,
12 transaction costs and 50 percent of the shareholders' cost to achieve the merger
13 savings, all of which are not recoverable from customers, the merger savings would
14 not have been possible. Thus, the defense of the shareholders' portion of the merger
15 savings in Case No. 97-300 is not comparable to the position taken by the Companies
16 in these proceedings..

17 **Q. Does KIUC's testimony accurately quote the complete language from the**
18 **Commission's September 27, 1997 Order in Case No. 97-300?**

19 A. No. KIUC's testimony selectively quotes from the Commission's Order in Case No.
20 97-300[16]. The complete portion of that Order is attached to my testimony as Blake
21 Rebuttal Exhibit 2. The portions of the Order that are omitted from the KIUC's

[16] In the Matter of: *Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger, Case No. 97-300.*

1 testimony are identified by the underscoring markings on the pages contained in
2 Blake Rebuttal Exhibit 2.

3 **Q. Does the fact, that the Commission does not consider base rate earnings with the**
4 **roll-ins of the fuel adjustment clause or environmental surcharge have any**
5 **application in this case, as KIUC's testimony asserts?**

6 A. No. Neither the Companies nor the intervenors are proposing to "roll-in" the Value
7 Delivery Surcredits into base rates or otherwise adjust base rates.

8 **Q. Is KIUC's rationalization that the Companies can file base rate cases if the**
9 **merger surcredits are extended a valid reason for extending the VDT Surcredit**
10 **mechanism?**

11 A. No. For the reasons I previously discussed, this argument conveniently
12 overlooks the significant changes in the cost of providing service that the Companies
13 have incurred since the last base rate change. Just as the intervenors contend the
14 Companies can file rate cases if extension of the VDT Surcredit mechanism cause
15 financial harm to the Companies, comparable traditional ratemaking procedures and
16 remedies are available to intervenors and the Commission should expiration of the
17 VDT Surcredit mechanism or any other number of factors cause the Companies' base
18 rates to become unjust and unreasonable. The VDT Surcredit mechanism should be
19 allowed to expire so that all parties are afforded the traditional ratemaking procedures
20 and remedies. This would strike the appropriate regulatory balance between the
21 shareholders and customers.

22

23

1 **CONCLUSION**

2 **Q. Do the Companies have a recommendation for the Commission in these**
3 **proceedings?**

4 A. Yes. The Commission should approve the Companies' Plans and issue an order
5 permitting the withdrawal of the three Value Delivery Surcredit Riders from gas and
6 electric service rendered on and after April 1, 2006, subject to final balancing
7 adjustments in the May 2006 billings.

8 **Q. Does this conclude your testimony?**

9 A. Yes.

VERIFICATION

COMMONWEALTH OF KENTUCKY)
) **SS:**
COUNTY OF JEFFERSON)

The undersigned, **Kent W. Blake**, being duly sworn, deposes and says he is the Director of State Regulation and Rates for E.ON U.S. Services Inc., that he has personal knowledge of the matters set forth in the foregoing testimony, and the answers contained therein are true and correct to the best of his information, knowledge and belief.

Kent W. Blake

KENT W. BLAKE

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 13th day of January 2006.

Tammy J. Elzy (SEAL)

Notary Public

My Commission Expires:

TAMMY J. ELZY
NOTARY PUBLIC
STATE AT LARGE
KENTUCKY
My Commission Expires Nov. 9, 2006

Blake Exhibit 4
Sponsoring Witness: Kent Blake

LOUISVILLE GAS AND ELECTRIC COMPANY

Calculation of Overall Revenue Deficiency/(Sufficiency) at June 30, 2005

	ELECTRIC (1)		
	ROE RANGE		
SECTION I - VALUE DELIVERY SURCREDIT EFFECTIVE	10.00%	10.50%	11.00%
1. Adjusted Electric Capitalization (Exhibit 2, Col 6)	$1,544,192,592	$1,544,192,592	$1,544,192,592
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18%	7.45%	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 110,873,028	$ 115,042,348	$ 119,057,249
4. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration	89,499,158	89,499,158	89,499,158
5. Net Operating Income Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 21,373,870	$ 25,543,190	$ 29,558,091
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 35,513,125	$ 42,440,536	$ 49,111,376
SECTION II - VALUE DELIVERY SURCREDIT EXPIRED			
1. Adjusted Electric Capitalization (Exhibit 2, Col 6)	$1,544,192,592	$1,544,192,592	$1,544,192,592
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18%	7.45%	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 110,873,028	$ 115,042,348	$ 119,057,249
4. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit	113,171,617	113,171,617	113,171,617
5. Net Operating Income Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ (2,298,589)	$ 1,870,731	$ 5,885,632
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ (3,819,153)	$ 3,108,258	$ 9,779,099
SECTION III - VALUE DELIVERY SURCREDIT CONTINUED AT NET LEVEL			
1. Adjusted Electric Capitalization (Exhibit 2, Col 6)	$1,544,192,592	$1,544,192,592	$1,544,192,592
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18%	7.45%	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 110,873,028	$ 115,042,348	$ 119,057,249
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level	102,532,417	102,532,417	102,532,417
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 8,340,611	$ 12,509,931	$ 16,524,832
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 13,858,097	$ 20,785,508	$ 27,456,348
SECTION IV - VALUE DELIVERY SURCREDIT CONTINUED AT GROSS LEVEL			
1. Adjusted Electric Capitalization (Exhibit 2, Col 6)	$1,544,192,592	$1,544,192,592	$1,544,192,592
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18%	7.45%	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 110,873,028	$ 115,042,348	$ 119,057,249
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level	87,782,617	87,782,617	87,782,617
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 23,090,411	$ 27,259,731	$ 31,274,632
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 38,365,193	$ 45,292,604	$ 51,963,445

Blake Exhibit 4
Sponsoring Witness: Kent Blake

LOUISVILLE GAS AND ELECTRIC COMPANY

Calculation of Overall Revenue Deficiency/(Sufficiency) at June 30, 2005

	GAS (1)		
	ROE RANGE		
SECTION I - VALUE DELIVERY SURCREDIT EFFECTIVE	10.00% -	10.50% -	11.00%
1. Adjusted Gas Capitalization (Exhibit 2, Col 6)	$ 345,230,511	$ 345,230,511	$ 345,230,511
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18% -	7.45% -	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 24,787,551 -	$ 25,719,673 -	$ 26,617,272
4. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration	13,961,988	13,961,988	13,961,988
5. Net Operating Income Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 10,825,563 -	$ 11,757,685 -	$ 12,655,284
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 17,986,895 -	$ 19,535,636 -	$ 21,027,015
SECTION II - VALUE DELIVERY SURCREDIT EXPIRED			
1. Adjusted Gas Capitalization (Exhibit 2, Col 6)	$ 345,230,511	$ 345,230,511	$ 345,230,511
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18% -	7.45% -	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 24,787,551 -	$ 25,719,673 -	$ 26,617,272
4. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit	20,315,360	20,315,360	20,315,360
5. Net Operating Income Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ 4,472,191 -	$ 5,404,313 -	$ 6,301,912
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ 7,430,637 -	$ 8,979,377 -	$ 10,470,756
SECTION III - VALUE DELIVERY SURCREDIT CONTINUED AT NET LEVEL			
1. Adjusted Gas Capitalization (Exhibit 2, Col 6)	$ 345,230,511	$ 345,230,511	$ 345,230,511
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18% -	7.45% -	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 24,787,551 -	$ 25,719,673 -	$ 26,617,272
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level	17,655,561	17,655,561	17,655,561
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 7,131,990 -	$ 8,064,112 -	$ 8,961,711
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 11,849,948 -	$ 13,398,688 -	$ 14,890,067
SECTION IV - VALUE DELIVERY SURCREDIT CONTINUED AT GROSS LEVEL			
1. Adjusted Gas Capitalization (Exhibit 2, Col 6)	$ 345,230,511	$ 345,230,511	$ 345,230,511
2. Total Cost of Capital (Exhibit 2, Col 9)	7.18% -	7.45% -	7.71%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 24,787,551 -	$ 25,719,673 -	$ 26,617,272
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level	13,786,761	13,786,761	13,786,761
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 11,000,790 -	$ 11,932,912 -	$ 12,830,511
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60185833	0.60185833	0.60185833
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 18,278,039 -	$ 19,826,779 -	$ 21,318,158

LOUISVILLE GAS AND ELECTRIC COMPANY

Electric Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section I - Value Delivery Surcredit Effective

	Adjusted Electric Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$16,732,017	1.08%	3.06%	0.03%
2. Long Term Debt	$662,474,143	42.90%	4.10%	1.76%
3. Preferred Stock	$56,769,782	3.68%	4.30%	0.16%
4. Common Equity	$808,216,650	52.34%	7.36% (a)	3.85% (b)
5.	$1,544,192,592	100.00%		5.80%

6. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration $89,499,158 (c)

7. Net Operating Income / Total Capitalization 5.80% (e)

Section II - Value Delivery Surcredit Expired

	Adjusted Electric Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$16,732,017	1.08%	3.06%	0.03%
2. Long Term Debt	$662,474,143	42.90%	4.10%	1.76%
3. Preferred Stock	$56,769,782	3.68%	4.30%	0.16%
4. Common Equity	$808,216,650	52.34%	10.28% (a)	5.38% (b)
5.	$1,544,192,592	100.00%		7.33%

6. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit $113,171,617 (d)

7. Net Operating Income / Total Capitalization 7.33% (e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Exhibit 1, Line 31, Column 4
(d) - Exhibit 1, Line 38, Column 4
(e) - Column 4, Line 6 divided by Column 1, Line 5

Blake Exhibit 5
Sponsoring Witness: Kent Blake

LOUISVILLE GAS AND ELECTRIC COMPANY

Electric Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section III - Value Delivery Surcredit Continued at Net Level

	Adjusted Electric Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)		Weighted Cost of Capital (Col 2 x Col 3) (4)	
1. Short Term Debt	$16,732,017	1.08%	3.06%		0.03%	
2. Long Term Debt	$662,474,143	42.90%	4.10%		1.76%	
3. Preferred Stock	$56,769,782	3.68%	4.30%		0.16%	
4. Common Equity	$808,216,650	52.34%	8.96%	(a)	4.69%	(b)
5.	$1,544,192,592	100.00%			6.64%	

6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level — $102,532,417 (c)

7. Net Operating Income / Total Capitalization — 6.64% (e)

Section IV - Value Delivery Surcredit Continued at Gross Level

	Adjusted Electric Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)		Weighted Cost of Capital (Col 2 x Col 3) (4)	
1. Short Term Debt	$16,732,017	1.08%	3.06%		0.03%	
2. Long Term Debt	$662,474,143	42.90%	4.10%		1.76%	
3. Preferred Stock	$56,769,782	3.68%	4.30%		0.16%	
4. Common Equity	$808,216,650	52.34%	7.13%	(a)	3.73%	(b)
5.	$1,544,192,592	100.00%			5.68%	

6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level — $87,782,617 (d)

7. Net Operating Income / Total Capitalization — 5.68% (e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Blake Exhibit 4, Electric, Section III, Line 4
(d) - Blake Exhibit 4, Electric, Section IV, Line 4
(e) - Column 4, Line 6 divided by Column 1, Line 5

Blake Exhibit 5
Sponsoring Witness: Kent Blake

LOUISVILLE GAS AND ELECTRIC COMPANY

Gas Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section I - Value Delivery Surcredit Effective

	Adjusted Gas Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$3,740,456	1.08%	3.06%	0.03%
2. Long Term Debt	$148,107,283	42.90%	4.10%	1.76%
3. Preferred Stock	$12,692,129	3.68%	4.30%	0.16%
4. Common Equity	$180,690,643	52.34%	3.99% (a)	2.09% (b)
5.	$345,230,511	100.00%		4.04%

6. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration	$13,961,988	(c)
7. Net Operating Income / Total Capitalization	4.04%	(e)

Section II - Value Delivery Surcredit Expired

	Adjusted Gas Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$3,740,456	1.08%	3.06%	0.03%
2. Long Term Debt	$148,107,283	42.90%	4.10%	1.76%
3. Preferred Stock	$12,692,129	3.68%	4.30%	0.16%
4. Common Equity	$180,690,643	52.34%	7.51% (a)	3.93% (b)
5.	$345,230,511	100.00%		5.88%

6. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit	$20,315,360	(d)
7. Net Operating Income / Total Capitalization	5.88%	(e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Exhibit 1, Line 31, Column 7
(d) - Exhibit 1, Line 38, Column 7
(e) - Column 4, Line 6 divided by Column 1, Line 5

Blake Exhibit 5
Sponsoring Witness: Kent Blake

LOUISVILLE GAS AND ELECTRIC COMPANY

Gas Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section III - Value Delivery Surcredit Continued at Net Level

	Adjusted Gas Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$3,740,456	1.08%	3.06%	0.03%
2. Long Term Debt	$148,107,283	42.90%	4.10%	1.76%
3. Preferred Stock	$12,692,129	3.68%	4.30%	0.16%
4. Common Equity	$180,690,643	52.34%	6.04% (a)	3.16% (b)
5.	$345,230,511	100.00%		5.11%

6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level — $17,655,561 (c)

7. Net Operating Income / Total Capitalization — 5.11% (e)

Section IV - Value Delivery Surcredit Continued at Gross Level

	Adjusted Gas Capitalization (Exhibit 2 Col 6) (1)	Percent of Total (2)	Annual Cost Rate (Exhibit 2 Col 8) (3)	Weighted Cost of Capital (Col 2 x Col 3) (4)
1. Short Term Debt	$3,740,456	1.08%	3.06%	0.03%
2. Long Term Debt	$148,107,283	42.90%	4.10%	1.76%
3. Preferred Stock	$12,692,129	3.68%	4.30%	0.16%
4. Common Equity	$180,690,643	52.34%	3.90% (a)	2.04% (b)
5.	$345,230,511	100.00%		3.99%

6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level — $13,786,761 (d)

7. Net Operating Income / Total Capitalization — 3.99% (e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Blake Exhibit 4, Gas, Section III, Line 4
(d) - Blake Exhibit 4, Gas, Section IV, Line 4
(e) - Column 4, Line 6 divided by Column 1, Line 5

KENTUCKY UTILITIES

Calculation of Overall Revenue Deficiency/(Sufficiency) at June 30, 2005

	(1)				
			ROE RANGE		
SECTION I - VALUE DELIVERY SURCREDIT EFFECTIVE	10.00%	-	10.50%	-	11.00%
1. Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2, Col 13)	$ 1,368,045,946		$ 1,368,045,946		$ 1,368,045,946
2. Total Cost of Capital (Exhibit 2, Col 16)	7.28%	-	7.56%	-	7.83%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 99,593,745	-	$ 103,424,274	-	$ 107,117,998
4. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration	88,222,863		88,222,863		88,222,863
5. Net Operating Income Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 11,370,882	-	$ 15,201,411	-	$ 18,895,135
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60252327		0.60252327		0.60252327
7. Overall Revenue Deficiency/(Sufficiency) prior to Value Delivery Surcredit expiration	$ 18,872,104	-	$ 25,229,582	-	$ 31,360,008
SECTION II - VALUE DELIVERY SURCREDIT EXPIRED					
1. Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2, Col 13)	$ 1,368,045,946		$ 1,368,045,946		$ 1,368,045,946
2. Total Cost of Capital (Exhibit 2, Col 16)	7.28%	-	7.56%	-	7.83%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 99,593,745	-	$ 103,424,274	-	$ 107,117,998
4. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit	100,107,711		100,107,711		100,107,711
5. Net Operating Income Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ (513,966)	-	$ 3,316,563	-	$ 7,010,287
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60252327		0.60252327		0.60252327
7. Overall Revenue Deficiency/(Sufficiency) for expiration of Value Delivery Surcredit	$ (853,023)	-	$ 5,504,456	-	$ 11,634,882
SECTION III - VALUE DELIVERY SURCREDIT CONTINUED AT NET LEVEL					
1. Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2, Col 13)	$ 1,368,045,946		$ 1,368,045,946		$ 1,368,045,946
2. Total Cost of Capital (Exhibit 2, Col 16)	7.28%	-	7.56%	-	7.83%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 99,593,745	-	$ 103,424,274	-	$ 107,117,998
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level	95,029,910		95,029,910		95,029,910
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 4,563,835	-	$ 8,394,364	-	$ 12,088,088
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60252327		0.60252327		0.60252327
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Net Level	$ 7,574,537	-	$ 13,932,016	-	$ 20,062,442
SECTION IV - VALUE DELIVERY SURCREDIT CONTINUED AT GROSS LEVEL					
1. Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2, Col 13)	$ 1,368,045,946		$ 1,368,045,946		$ 1,368,045,946
2. Total Cost of Capital (Exhibit 2, Col 16)	7.28%	-	7.56%	-	7.83%
3. Net Operating Income Found Reasonable (Line 1 x Line 2)	$ 99,593,745	-	$ 103,424,274	-	$ 107,117,998
4. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level	87,775,910		87,775,910		87,775,910
5. Net Operating Income Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 11,817,835	-	$ 15,648,364	-	$ 19,342,088
6. Gross Up Revenue Factor - Blake Exhibit 1, Reference Schedule 1.74	0.60252327		0.60252327		0.60252327
7. Overall Revenue Deficiency/(Sufficiency) for continuation of Value Delivery Surcredit at Gross Level	$ 19,613,906	-	$ 25,971,385	-	$ 32,101,811

Blake Exhibit 5
Sponsoring Witness: Kent Blake

KENTUCKY UTILITIES

Kentucky Jurisdictional Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section I - Value Delivery Surcredit Effective

	Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2 Col 13)	Percent of Total	Annual Cost Rate (Exhibit 2 Col 15)	Weighted Cost of Capital (Col 2 x Col 3)
	(1)	(2)	(3)	(4)
1. Short Term Debt	$71,280,264	5.21%	3.06%	0.16%
2. Long Term Debt	$513,966,267	37.57%	3.96%	1.49%
3. Preferred Stock	$30,410,421	2.22%	5.68%	0.13%
4. Common Equity	$752,388,994	55.00%	8.49% (a)	4.67% (b)
5.	$1,368,045,946	100.00%		6.45%

6. Pro-forma Net Operating Income prior to Value Delivery Surcredit expiration $88,222,863 (c)

7. Net Operating Income / Total Capitalization 6.45% (e)

Section II - Value Delivery Surcredit Expired

	Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2 Col 13)	Percent of Total	Annual Cost Rate (Exhibit 2 Col 15)	Weighted Cost of Capital (Col 2 x Col 3)
	(1)	(2)	(3)	(4)
1. Short Term Debt	$71,280,264	5.21%	3.06%	0.16%
2. Long Term Debt	$513,966,267	37.57%	3.96%	1.49%
3. Preferred Stock	$30,410,421	2.22%	5.68%	0.13%
4. Common Equity	$752,388,994	55.00%	10.07% (a)	5.54% (b)
5.	$1,368,045,946	100.00%		7.32%

6. Pro-forma Net Operating Income for expiration of Value Delivery Surcredit $100,107,711 (d)

7. Net Operating Income / Total Capitalization 7.32% (e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Exhibit 1, Line 30, Column 4
(d) - Exhibit 1, Line 37, Column 4
(e) - Column 4, Line 6 divided by Column 1, Line 5

Blake Exhibit 5
Sponsoring Witness: Kent Blake

KENTUCKY UTILITIES

Kentucky Jurisdictional Rate of Return on Common Equity
For the Twelve Months Ended June 30, 2005

Section III - Value Delivery Surcredit Continued at Net Level

	Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2 Col 13)	Percent of Total	Annual Cost Rate (Exhibit 2 Col 15)		Weighted Cost of Capital (Col 2 x Col 3)	
	(1)	(2)	(3)		(4)	
1. Short Term Debt	$71,280,264	5.21%	3.06%		0.16%	
2. Long Term Debt	$513,966,267	37.57%	3.96%		1.49%	
3. Preferred Stock	$30,410,421	2.22%	5.68%		0.13%	
4. Common Equity	$752,388,994	55.00%	9.40%	(a)	5.17%	(b)
5.	$1,368,045,946	100.00%			6.95%	
6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Net Level					$95,029,910	(c)
7. Net Operating Income / Total Capitalization					6.95%	(e)

Section IV - Value Delivery Surcredit Continued at Gross Level

	Adjusted Kentucky Jurisdictional Capitalization (Exhibit 2 Col 13)	Percent of Total	Annual Cost Rate (Exhibit 2 Col 15)		Weighted Cost of Capital (Col 2 x Col 3)	
	(1)	(2)	(3)		(4)	
1. Short Term Debt	$71,280,264	5.21%	3.06%		0.16%	
2. Long Term Debt	$513,966,267	37.57%	3.96%		1.49%	
3. Preferred Stock	$30,410,421	2.22%	5.68%		0.13%	
4. Common Equity	$752,388,994	55.00%	8.44%	(a)	4.64%	(b)
5.	$1,368,045,946	100.00%			6.42%	
6. Pro-forma Net Operating Income for continuation of Value Delivery Surcredit at Gross Level					$87,775,910	(d)
7. Net Operating Income / Total Capitalization					6.42%	(e)

Notes: (a) - Column 4, Line 4 / Column 2, Line 4
(b) - Column 4, Line 5 - Line 1 - Line 2 - Line 3
(c) - Blake Exhibit 4, Section III, Line 4
(d) - Blake Exhibit 4, Section IV, Line 4
(e) - Column 4, Line 6 divided by Column 1, Line 5

environmental requirements.[13] The existing adjustment clauses for the recovery of environmental costs, Demand Side Management costs, and fuel costs would not be subject to the freeze. During the hearing the Applicants agreed that while they have characterized their no rate adjustment pledge as a freeze, it would in actuality operate as a cap. It would prohibit either utility from requesting an increase absent extraordinary circumstances, but would not prohibit the Commission from initiating a proceeding upon a complaint or on its own motion.[14]

The AG and Metro, POWER, and Shed proposed that the non-fuel merger savings be flowed through to ratepayers by a reduction in base rates, rather than the proposed surcredit mechanism. The Applicants opposed a base rate reduction due to their concerns that the actual level of savings for years 6 through 10 may vary from their projections and, thus, they are unwilling to guarantee the projected levels to ratepayers.

The Intervenors proposed that the identifiable merger savings be shared on a basis that would give a larger portion of the savings to the ratepayers. KIUC proposed a 60/40 sharing, while the Attorney General proposed a 75/25 sharing. They argue that a larger portion of the savings should be shared with the ratepayers due to the Applicants' current earnings. The Applicants, however, claim that their earnings should not be investigated in a merger case. In addition, the Applicants argue that such an investigation in this case would require them to terminate the merger because it is a fully

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13 Transcript of Evidence ("T.E."), Vol. I, August 19, 1997 at 83.

14 Applicants' Response to AG's First Data Request, Item 40.

priced transaction and any reduction in their earnings would result in an unacceptable loss of shareholder value.[15]

The Applicants did, however, acknowledge that the Commission's statutory jurisdiction to regulate utility rates encompassed the authority to investigate and review LG&E's and KU's earnings.[16] The Applicants urge that any review of their earnings take place after consummation of merger due to the volume of work associated with both a merger and an earnings review.[17] The AG agreed that an earnings review should not be a condition of merger,[18] while KIUC acknowledged that an earnings review could be considered separately from the merger.[19] The Commission notes that prior to the Applicants filing this merger case, none of the parties had filed a complaint setting forth a prima facie case that either LG&E's or KU's rates were unreasonable, and the Commission had made no decision to do so on its own motion.

LG&E strenuously maintains that its 1996 earnings are a "high water mark," and that they have already started to drop. All of the parties did agree that taking a snapshot look at earnings, rather than conducting a full rate investigation, was inappropriate for determining whether the Applicants' earnings are reasonable. One factor complicating an earnings analysis is the differing time periods used by the parties. While the AG and

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15 T.E., Vol. I, August 19,1997, at 147.

16 T.E., Vol. I, August 19, 1997, at 33.

17 T.E., Vol. I, August 19, 1997, at 149-152.

18 T.E., Vol. III, August 21, 1997, at 145.

19 T.E., Vol. III, August 21, 1997, at 53.

KIUC have analyzed the Applicants' earnings for the 12 months ending December 31, 1996, the Applicants presented more recent financial information for the 12 months ending June 30, 1997. Another complicating factor is the need to separate LG&E's electric earnings from those of its gas and non-regulated operations. Similarly, KU's Kentucky retail earnings must be separated from its Virginia and wholesale operations. Further complicating such analysis is the absence of the dozens of detailed pro forma adjustments needed to ensure that the test period is representative for rate-making purposes.

In conclusion, the Commission finds that to determine whether a utility is currently overearning requires an economic analysis of two factors: 1) what is a reasonable cost of equity in today's economic conditions; and 2) what is the utility currently earning on its equity. The record in this case contains no analysis of the reasonable cost of equity for either LG&E or KU and, with the limited evidence on current earnings, no definitive finding of overearning can be made. The Commission will continue to monitor LG&E's and KU's financial reports and retains its statutory authority to initiate action which may include an investigation of rates should circumstances warrant.

Thus, the Commission is not persuaded to adjust the Applicants' proposed ratio for sharing merger benefits. Nor do we believe that a reduction in base rates, rather than a billing credit, is necessary or appropriate to ensure an uninterrupted sharing of merger savings with ratepayers. Further, the Commission finds that it is not appropriate in this instance to establish an earnings review as a precondition to the merger. The Applicants' proposed rate credits will provide significant future benefits to ratepayers, and

the parties as well as the Commission retain the ability under KRS 278.260 to review the utilities' earnings.

The Commission does, however, find a serious shortcoming in the Applicants' proposal to reflect the merger savings for only five years, with a vague commitment to thereafter discuss with the Commission the need to continue to reflect such savings. While in their brief the Applicants have changed position and now agree to waive the five-year expiration date on their proposed surcredit tariff, such waiver still comes up short. Beginning in the sixth year of the merger, the annual levels of non-fuel merger savings are projected to increase significantly. Thus, the Commission finds that LG&E and KU should initiate formal proceedings, no later than midway through the fifth year of the merger, to present a plan for sharing with ratepayers the then projected levels of merger savings. This requirement, coupled with the Applicants' waiver of the expiration date on their surcredit tariff, will ensure an uninterrupted sharing of merger savings.

ALLOCATION OF CREDIT TO CUSTOMERS

The Applicants propose to split non-fuel merger savings between utilities on a 50/50 basis. The savings available to KU's ratepayers are then allocated among its Kentucky, Virginia, and FERC jurisdictions based on total revenue. The savings available to KU's Kentucky jurisdictional customers and LG&E's electric customers are then allocated to customer classes based on kilowatt hour usage.

The AG recommends that non-fuel merger savings be allocated among utilities, jurisdictions, and customer classes using shares of non-fuel revenue.[20] Metro, POWER,

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20 Kahal Testimony at 33.