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AUG 08 2006
PUBLIC SERVICE
COMMISSION

Via Overnight Mail

August 8, 2006

Beth A. O'Donnell, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

Re: Case No. 2006-00129

Dear Ms. O'Donnell:

Please find enclosed the original and twelve (12) copies of the Responses of Kentucky Industrial Utility Customers, Inc. to First Data Request of Commission Staff filed in the above-referenced matter. By copy of this letter, all parties listed on the Certificate of Service have been served.

Please place this document of file.

Very Truly Yours,



Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY

MLKkew
Attachment
cc: Certificate of Service

CERTIFICATE OF SERVICE

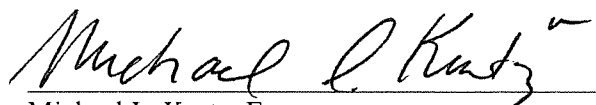
I hereby certify that a copy of the foregoing was served by mailing a true and correct copy, by first-class postage prepaid mail, (unless otherwise noted) to all parties on the 8th of August, 2006.

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A handwritten signature in cursive script that reads "Michael L. Kurtz" with a small flourish at the end.

Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE)
COMMISSION OF THE ENVIRONMENTAL)
SURCHARGE MECHANISM OF KENTUCKY)
UTILITIES COMPANY FOR THE SIX-MONTH)
BILLING PERIODS ENDING JULY 31, 2003,)
JANUARY 31, 2004, JANUARY 31, 2005,)
JULY 31, 2005, AND JANUARY 31, 2006 AND)
FOR THE TWO-YEAR BILLING PERIOD ENDING)
JULY 31, 2004)

CASE NO. 2006-00129

KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
RESPONSE TO
FIRST DATA REQUEST OF COMMISSION STAFF

1. Refer to the Direct Testimony of Stephen J. Baron ("Baron Testimony"), page 9. The current rate design for Kentucky Utilities Company's ("KU") base rates was established in the Commission's June 30, 2004 Order in Case No. 2003-00434.1 In his testimony, Mr. Baron advocates that the environmental surcharge roll-in for KU follow an "alternative" proposal offered by KU that would address rate class subsidies still reflected in the existing base rates.

a. Assume for purposes of this question that there is a roll-in of the environmental surcharge into existing base rates and that KU's alternative proposal has been adopted. Would Mr. Baron agree that after the roll-in, KU's base rates would reflect two rate design approaches: the approach approved in Case No. 2003-00434 and the approach utilized for the roll-in in the current proceeding?

b. Explain why it is reasonable that base rates after the roll-in should reflect two different rate design approaches.

RESPONSE:

a. No, I do not agree. After the roll-in KU's base rates would not reflect two rate design approaches. KU's existing base rates reflect the cumulative changes from all prior base rate decisions of this Commission going back many decades, all prior ECR roll-in cases, all prior fuel adjustment clause roll-in cases, adjustments for the Tax Reform Act of 1986, adjustments from the Earnings Sharing Mechanisms, and more. Now, the cumulative result of all prior ratemaking decisions is a set of rates that bear little

1 Case No. 2003-00434, An Adjustment of the Electric Rates, Terms, and Conditions of Kentucky Utilities Company, final Order dated June 30, 2004.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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SURCHARGE MECHANISM OF KENTUCKY)	
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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

relation to the underlying cost to serve and cost causation. Setting rates is a gradual process. The subsidies and inequities built into the existing rates took many years to create, and will take many years to correct, assuming the Commission and its Staff actually have cost of service as a goal.

Anytime that there is a roll-in, the resulting base rates reflect multiple “approaches.” However, the settlement in the prior base rate case allocated the class rate increases in a manner to reduce subsidies, using the Company’s BIP cost of service study as a guide to subsidy quantification. The alternative approach proposed by the Company in this case also has as its objective a reduction in class subsidies, using the same BIP cost of service method as a guide. As such, the “approaches” are consistent.

- b. See response to part (a). After the roll-in base rates will not reflect only two rate design approaches. Instead, base rates will reflect the rate designs adopted over many decades in many cases. I believe that the most important overriding principle that should govern this case is cost of service. Only the alternative roll-in deals with cost of service. If the Commission chooses to ignore cost of service, then undoubtedly there are many reasons that can be relied on: administrative work load, precedent, etc. But in my opinion none of those reasons are as important as the principle that rates reflect the cost to serve.

COMMONWEALTH OF KENTUCKY

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COMMISSION OF THE ENVIRONMENTAL)	
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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

2. Refer to the Baron Testimony, page 10. Mr. Baron states, "Like a general rate case, an ECR roll-in case is a base rate proceeding and therefore a reasonable venue to address the subsidies in the Companies rate schedules." The 6-month and 2-year environmental surcharge reviews are established in KRS 278.183(3), which states in part:

At six (6) month intervals, the commission shall review past operations of the environmental surcharge of each utility, and after hearing, as ordered, shall, by temporary adjustment in the surcharge, disallow any surcharge amounts found not just and reasonable and reconcile past surcharges with actual costs recoverable pursuant to subsection (1) of this section. Every two (2) years the commission shall review and evaluate past operation of the surcharge, and after hearing, as ordered, shall disallow improper expenses, and to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of each utility.

a. When Mr. Baron was preparing his testimony, was he aware that the main purpose of the current proceeding was the 6-month and 2-year reviews of the operation of KU's environmental surcharge? Explain the response.

COMMONWEALTH OF KENTUCKY

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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

2 (Continued)

b. When Mr. Baron was preparing his testimony, was it his understanding that a roll-in of the environmental surcharge into existing base rates would only occur “to the extent appropriate” as determined by the Commission? Explain the response.

c. Explain in detail how Mr. Baron reached the conclusion that the current environmental surcharge review proceeding was a base rate proceeding. Include citations to KRS 278.183 that support Mr. Baron’s conclusion.

RESPONSE:

a. Yes. It was Mr. Baron’s understanding that the main purpose of the current proceeding was the 6 month and 2 year reviews,. However, another purpose is to reset base rates and evaluate and respond to the Company’s proposed roll-in methodology.

b. Yes. Mr. Baron assumed that only the Commission approved amounts would be rolled-in to base rates.

c. I believe the Staff is reading this portion of my testimony too literally. Of course I understand that this is not a base rate case in the sense of a general rate case and all of the associated filing requirements. But my referenced testimony is based on my belief and understanding that the Company’s base rates would change as a result of the roll-in. The citations to KRS 278.183 that I relied on are the base rate roll-in provision quoted by Staff in this question.

COMMONWEALTH OF KENTUCKY

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SURCHARGE MECHANISM OF KENTUCKY)	
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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

3. Refer to the Baron Testimony, page 12. Mr. Baron includes the following quote from the Commission’s June 20, 2005 Order in Case No. 2004-00426:²

While the Commission appreciates KIUC’s concerns as to the discrepancies between KU’s cost of service and the recovery of costs through its base rates, we are not persuaded that an environmental surcharge proceeding is an appropriate venue to address those discrepancies.

If the Commission in June 2005 found that a proceeding considering the amendment of KU’s environmental compliance plan and surcharge mechanism was not the appropriate venue to address rate design subsidies, explain in detail why Mr. Baron believes the 6-month and 2-year surcharge review cases are an appropriate venue. Include in this response a discussion of the differences between the two proceedings that would make the surcharge review the appropriate forum to consider rate design issues.

Response:

The two cases are entirely different. The initial surcharge application includes a review of the utility’s proposed environmental compliance plan for reasonableness and cost effectiveness. In that proceeding, the Commission is authorized to retain an outside

² Case No. 2004-00426, The Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct Flue Gas Desulfurization Systems and Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge, final Order dated June 20, 2005.

COMMONWEALTH OF KENTUCKY

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**KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
RESPONSE TO
FIRST DATA REQUEST OF COMMISSION STAFF**

expert to evaluate the technical details of the compliance plan. Rate of return is an issue, which can be complex. The allocation of environmental costs to wholesale all requirements customers and off-system sales (excluding brokered sales) can also be complex. In order to address cost of service in the initial setting of the surcharge multiple surcharges are required. As we found out in the prior case that can also be complex and if the Attorney General is correct, multiple surcharges may be illegal.

By contrast, the two year review and base rate roll-in is simpler and more direct. The two year review is primarily an accounting true-up, absent unusual circumstances, since the reasonableness of the projects has already been approved. The mandated roll-in process appears to represent a belief by the legislature that the environmental surcharge should not simply grow and grow, but instead should periodically be reset to zero. When this is done base rates must change. How base rates should change is not defined by statute and instead left to the Commission's discretion.

COMMONWEALTH OF KENTUCKY

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JANUARY 31, 2004, JANUARY 31, 2005,)	
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JULY 31, 2004)	

**KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
RESPONSE TO
FIRST DATA REQUEST OF COMMISSION STAFF**

Right now there are five cost of service studies in the record. All five show that residential customers enjoy substantial subsidies from the business customers. Table 2, from my direct testimony, reproduced below, shows the magnitude of the remaining subsidies in current rates.

Table 2					
KU Class Subsidies Received and (Paid)					
Case No. 2003-00434					
<u>Rate Class</u>	<u>BIP</u>	<u>A&E</u>	<u>SWCP</u>	<u>SCP</u>	<u>12CP</u>
Residential	45,761,527	48,769,677	50,767,041	36,161,694	39,281,116
General Service	(5,663,758)	(727,454)	(4,074,716)	103,660	(1,251,802)
Combined Lt & Pw	(32,593,720)	(38,043,691)	(35,728,215)	(26,987,784)	(29,226,088)
Large Comm/Ind TOD	(4,429,416)	(7,389,406)	(8,039,935)	(6,389,825)	(4,614,040)
Coal Mining Power	(1,879,160)	(1,851,555)	(2,088,627)	(2,265,952)	(1,693,013)
Lg Pw Mine Pw TOD	(988,471)	(846,217)	(1,143,592)	(1,301,892)	(927,972)
All Electric School	(151,542)	237,414	(45,791)	308,732	150,832
Water Pumping	131,413	45,195	160,307	138,764	121,875
Street Lighting	2,334,143	2,577,399	2,007,849	939,543	1,360,077
NAS	(2,521,016)	(2,771,363)	(1,814,319)	(706,939)	(3,200,986)

Given the uncontested record that rates are not currently even close to cost, this roll-in is an ideal opportunity for the Commission to correct this unreasonable situation. But that is a policy the Commission needs to address: should an effort be made to set base rates closer to cost, or should cost of service be disregarded, as irrelevant.

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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

4. Refer to KU’s response to the Commission Staff’s Second Data Request dated June 29, 2006, Item 1(a). In this response KU states, “Based on past practice of implementing a roll-in of the environmental surcharge or the fuel adjustment clause the total bill for a customer has been essentially the same before and after the roll-in.”

- a. Does Mr. Baron agree with this statement by KU? Explain the response.
- b. Describe in detail the change in circumstances that have occurred since KU’s last base rate case that require the Commission to address the inter-class rate subsidy issue in the current environmental surcharge proceeding.

RESPONSE:

a. Yes. Under both the total revenue roll-in and the alternative (cost of service) roll-in the total bill for each customer will essentially be the same. This is verified by the Company Response to Staff Question 3 Set Two. This response shows the total bill as of May 1, 2006 for a typical residential customer as well as three representative business customers with no roll-in, with a roll-in under the total revenue method, and a roll-in under the alternative (cost of service) method. For the typical residential customer and the three business customers the total bill is essentially the same under all the scenarios studied. The total bill is rarely exactly the same after a roll-in, no matter what kind of roll-in. In other words, no matter what roll-in the Commission chooses the total bill will be slightly different. Even under the cost of service roll-in there is little change due to gradualism.

For example, for the typical residential customer the total bill with no roll-in is \$60.32, with a total revenue roll-in \$60.26, and with a cost of service roll-in \$61.05. This demonstrates that

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JANUARY 31, 2004, JANUARY 31, 2005,)	
JULY 31, 2005, AND JANUARY 31, 2006 AND)	
FOR THE TWO-YEAR BILLING PERIOD ENDING)	
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KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
 RESPONSE TO
 FIRST DATA REQUEST OF COMMISSION STAFF

the gradual movement toward cost of service under the alternative method will result in a residential increase of only 73 cents per month, or 1.2%.

b. Mr. Baron, and Mr. Seelye fully discuss this issue in their respective testimonies. First, my testimony is not based primarily on what has changed since the last rate case, but what has stayed the same. Namely, rates to the residential class continue to enjoy a huge subsidy from business customers. The last rate case only chipped away at the subsidy. In addition, the the major changed circumstances since the last rate case are:

1. There are five new cost of service studies in this record. All five new cost of service studies show that residential rates are heavily subsidized by the business customers. These five new cost of service studies are uncontested. There is no evidence in this record to the contrary.
2. Past history suggests that it may be many years before the next full base rate case for the Company, with the result being that some customer classes may be paying substantial subsidies for many years into the future, without the mitigation that will be provided by the Alternative Roll-in proposal.
3. The expected multiple future increases associated with the ECR and subsequent roll-ins creates an opportunity for the Commission to address, and mitigate in a modest way, the disparities between rates and cost of service.
4. The environmental surcharge has become an increasingly large component of rates, and is expected to continue to grow. KU has projected its environmental surcharge revenue requirement over the next 12 months to be \$86.5 million. Response to KIUC Question 5, Set one. Given this magnitude of expense it is no longer reasonable to turn a blind eye to cost of service.