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Mark David Goss  
Chairman

Teresa J. Hill  
Vice Chairman

Gregory Coker  
Commissioner

June 27, 2006

**PARTIES OF RECORD:**

RE: Case No. 2006-00129

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, JANUARY 31, 2006, AND FOR THE TWO-YEAR BILLING PERIODS ENDING JULY 31, 2004

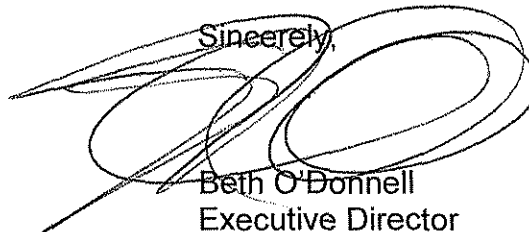
AND

Case No. 2006-00130

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIRONMENTAL SURCHARGE MECHANISM OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR THE SIX-MONTH BILLING PERIODS ENDING OCTOBER 31, 2003, APRIL 30, 2004, OCTOBER 31, 2004, OCTOBER 31, 2005, AND APRIL 30, 2006, AND FOR THE TWO-YEAR BILLING PERIOD ENDING APRIL 30, 2005

Enclosed please find a memorandum that has been filed in the record of the above-referenced case. Any comments regarding this memorandum's content should be submitted to the Commission within five days of receipt of this letter. Questions regarding this memorandum should be directed to Robert Cowan as (502) 564-3940, extension 247.

Sincerely,



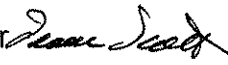
Beth O'Donnell  
Executive Director

Attachment

**INTRA-AGENCY MEMORANDUM**

**KENTUCKY PUBLIC SERVICE COMMISSION**

**TO:** Main Case File – Case No. 2006-00129  
Main Case File – Case No. 2006-00130

**FROM:** Isaac Scott, Team Leader 

**DATE:** June 27, 2006

**SUBJECT:** June 22, 2006 Informal Conference

Pursuant to the June 16, 2006 Orders in these cases, an informal conference was held on June 22, 2006. Attached to this memorandum as Attachment 1 is a list of the participants. The purpose of the conference was to discuss the Kentucky Utilities Company ("KU") and the Louisville Gas and Electric Company ("LG&E") environmental surcharges and their responses to the Staff's First Data Requests.

KU and LG&E provided a handout that presented an overview of their filings and data responses. A copy of the handout is attached to this memorandum as Attachment 2. KU and LG&E discussed the information contained in the handout, with an emphasis on the recommendations they have proposed in their direct testimony.

The Staff asked certain questions about the proposed under-recovery determined by KU and LG&E; the proposed elimination of a credit on operating expenses for LG&E; and how emission allowance inventory is handled in KU's environmental rate base.

Kentucky Industrial Utility Customers, Inc. questioned the financial impact of the scrubbers currently included in the compliance plan and surcharge mechanism and the status of some tax credits for Trimble County Unit 2. The Attorney General had no issues to discuss.

The Staff indicated that an Order scheduling a public hearing would probably be issued in July. The Staff raised the idea that if the Intervenors were satisfied with the information in the record and KU and LG&E were agreeable, the Commission would probably be willing to entertain a motion to submit the case on the record and waive a public hearing. If the parties believed another informal conference would be beneficial, the Staff indicated it would be agreeable to another conference.

Attachments

CASE NO. 2006-00129 and 2006-00130  
 KENTUCKY UTILITIES COMPANY  
 LOUISVILLE GAS & ELECTRIC COMPANY  
 INFORMAL CONFERENCE – June 22, 2006

NAME	WITH
Danae Lewis	PSC - Financial Analysis
Betsy Blackford	OAG
Keriel R. Riggs	SKD for LG&E / KU
KENT BLAKE	LG&E / KU
Carol Foxworthy	LGE / KU
Steve Seelye	LGE / KU
Shannon Charnas	LGE / KU
Robert Conroy	LGE / KU
Mike Kurtz	KIUC
Kurt Boehm	KIUC
ELIE RUSSELL	PSC
Rodd Cowan	PSC
Beth O'Donnell	PSC

**ECR Review**  
**Case Nos. 2006-00129 and**  
**2006-00130**

**Kentucky Utilities Company**  
**Louisville Gas and Electric Company**  
**June 22, 2006**

# Scope of Review Cases

- Kentucky Utilities Company
  - originally for expense months beginning December 2002 through November 2005
  - expanded through February 2006 expense month at KU's request to facilitate joint review
  - Going forward KU and LG&E will follow same 6-month and 2-year review periods
- Louisville Gas & Electric Company
  - Expense months beginning March 2003 through February 2006
- Both cases include a “roll-in” of ECR costs and revenues for the period ending February 2005

# Operation of the ECR -- KU

- Under-collection of \$254,652 determined by:
  - Updating overall rates of return for the 1994 Plan (cost of pollution control debt) and the Post-1994 Plan (overall rate of return including return on equity)
  - Recalculating every month's Net Retail E(m), including revisions to:
    - ECR rate base,
    - Monthly depreciation expense
    - Monthly property tax and other O&M expense
    - Revising the monthly over/under true-up to reflect **actual** ECR revenues in base rates
  - Removing ALL emission allowances not held in coal-fired units inventory accounts from ECR rate base

# Operation of the ECR -- LG&E

- Under-collection of \$2,649,068 determined by:
  - Updating overall rates of return for the 1995 Plan (cost of pollution control debt) and the Post-1995 Plan (overall rate of return including return on equity)
  - Recalculating every month's Net Retail E(m), including revisions to:
    - ECR rate base
    - Monthly depreciation expense
    - Monthly property tax and other O&M expense
    - Revising the monthly over/under true-up to reflect **actual** ECR revenues in base rates
  - Eliminating the reduction for O&M expenses associated with the 2003 Compliance Plan for all expense months following the Commission's order establishing LG&E's new base rates

# Rate of Return Going Forward

- Propose continued use of a 10.50% return on equity as reasonable, and perhaps conservative based on:
  - Recent (past 12 months) increases in 10- and 20-year Treasury bonds, utility bonds and Corporate bonds with ratings equal to the Companies
  - Increases in long-term interest rates are expected to continue over the near term
  - Average rates of return on common equity during 2006 are 10.4% for electric utilities and 10.6% for gas utilities
- The overall rate of return established based on Capitalization for the month ending February 2006
  - 11.23% for LG&E
  - 11.52% for KU



# ECR Roll-In

- Roll-in of ECR costs and revenues into base rates based on February 2005 ECR rate base and 12-months operating expenses
  - KU proposes to roll in \$23,731,313
  - LG&E proposes to roll in \$8,669,729
- Roll-in will not impact either Company's environmental revenue requirement (Net Retail E(m)), but will impact both Companies' final monthly billing factor to be applied to customer bills
- Base Environmental Surcharge Factor (BESF), representing the amount rolled into base rates, will be determined using the most recent 12-month revenues following the Commission's order in these proceedings
  - Based on 12-month revenue ending February 2006,
    - KU's BESF would be 3.21% compared to current 0.30%
    - LG&E's BESF would be 3.36% compared to current 2.38%
  - May require different BESF for each customer class depending upon roll in methodology

# Roll-in Methods

- Two alternatives to implement roll-in:
  - follow past practice and roll in based on base-rate revenues, as an equal percentage increase to all tariffs,
  - recognize existence of rate subsidies between customer classes and mitigate the extent of those subsidies by increasing some tariffs more than others
- Either methodology would be applied to rates in the same manner
  - Applied to demand rates only for customer classes with a demand charge
  - Applied to energy rates for customer classes with no demand charge
  - No increases will be applied to customer charges
- Companies will follow Commission guidance in implementing the roll-in

# Monthly Filing Procedures

- Companies recognize there have been numerous revisions to the monthly filings over the period
- Proactively reviewing monthly filings prior to 6-month and 2-year reviews to ensure filings are correct and to make corrections as close to detection as possible instead of waiting for review
- Process Improvements taking place
  - Review process undertaken to ensure accuracy of filings
  - Process document developed to increase understanding of the ECR mechanism and the monthly filing process
  - Revisions to process incorporated as they are identified
- Extensive review performed on all data included in the responses to the Commission Request for Information
  - Ensure all revised filings were captured properly
  - Additional data revisions identified during review

# Monthly Filing Procedures

- Process improvements made:
  - Companies have developed an automated spreadsheet model to track depreciation, accumulated depreciation, and accumulated deferred tax balances by Company project and summing to ECR-approved project totals
  - Internal controls identify Company-project numbers and approved ECR projects incorporating all Company project numbers; appropriate Company project numbers are tracked through new system
- Catch-up depreciation may continue to require ECR refilings after in-service to accurately reflect book and tax depreciation impacts
  - In-service dates are monitored monthly for timely inclusion in ECR filings
  - New ECR process to accrue full project cost at time of in-service

# Recommendations

- Kentucky Utilities Company
  - Approve collection of \$254,652 over four month period following the Commission's Order
  - Find environmental surcharge amount for the billing period ending April 2005 just and reasonable
  - Approve roll-in amount of \$23,731,313
  - Decide as a matter of policy the methodology for accomplishing the roll-in
  - Reset BESF using most recent 12-month period available following the Commission's Order
  - Establish an overall rate of return of 11.52%, inclusive of the currently approved 10.50% return on equity

# Recommendations

- Louisville Gas and Electric Company
  - Approve collection of \$2,649,068 over four month period following the Commission's Order
  - Find environmental surcharge amount for the billing period ending April 2005 just and reasonable
  - Find that LG&E should eliminate the expense reduction ordered in Case No. 2002-00147 beginning with the expense month of July 1, 2004
  - Approve roll-in amount of \$8,669,729
  - Decide as a matter of policy the methodology for accomplishing the roll-in
  - Reset BESF using most recent 12-month period available following the Commission's Order
  - Establish an overall rate of return of 11.23%, inclusive of the currently approved 10.50% return on equity