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Via Overnight Mail

June 14, 2007

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

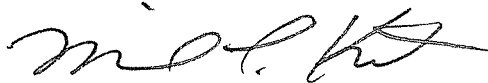
Re: Case No. 2006-00509 and 2006-00510

Dear Ms. O'Donnell:

Please find enclosed the original and twelve (12) copies of the Initial Brief of Kentucky Industrial Utility Customers, Inc. to be filed in the above-referenced matters. 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,



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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 14th day of June, 2007.

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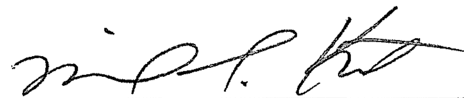

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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

AN EXAMINATION OF THE APPLICATION	)	
THE FUEL ADJUSTMENT CLAUSE OF	)	
LOUISVILLE GAS AND ELECTRIC COMPANY	)	**CASE NO:**
FROM NOVEMBER 1, 2004 TO OCTOBER 31, 2006	)	**2006-00510**

IN THE MATTER OF:

AN EXAMINATION OF THE APPLICATION	)	
THE FUEL ADJUSTMENT CLAUSE OF	)	
KENTUCKY UTILITIES COMPANY	)	**CASE NO:**
FROM NOVEMBER 1, 2004 TO OCTOBER 31, 2006	)	**2006-00509**

INITIAL BRIEF OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

I. INTRODUCTION

By Order dated December 18, 2006 the Kentucky Public Service Commission ("Commission") initiated this consolidated proceeding to examine the fuel adjustment clauses ("FAC") of Louisville Gas & Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively "the Companies"), pursuant to 807 KAR 5:056, Section 1(11) and (12). That Section provides that the Commission shall review a utility's FAC every two years and disallow any improper expenses.

Kentucky Industrial Utility Customers, Inc. ("KIUC") argues that the collection of certain fuel expenses included by the Companies in their respective FACs during the period of April 1, 2005 through

August 31, 2006 when the Companies were associated with the Midwest Independent System Operator's ("MISO") "*Day 2*" operations[1] were improper and should be disallowed. During this 17-month period the Companies were often required by MISO to dispatch high cost generating units when lower cost market power was available. Per MISO protocol, on the occasions in which LG&E and KU were forced to dispatch generating units out of economic order the Companies received compensation from a pool of monies collected from MISO members in the form of Revenue Sufficiency Guarantee Make-Whole Payments (referenced herein as "*RSG make-whole payments*").[2] At the same time LG&E and KU received RSG make-whole payments in compensation for dispatching their generating units out of economic order the Companies charged their native load customers for the higher fuel cost through the FAC. In hours when the Companies were receiving make-whole payments from MISO that were associated with native load, the Companies incurred a total of $5,584,489 in excessive fuel costs, which they recovered from customers in their FAC.[3]

The issue in this case is whether the Companies charged any improper expenses through their FACs. But the sub-issue is who should receive credit for the make-whole payments: the E.ON shareholders who paid none of the excessive fuel costs, or ratepayers who paid all of the excessive fuel costs. KIUC recommends that the Commission disallow the excess fuel costs charged by each Company, up to the amount of the RSG make-whole payments received hourly by each Company. For KU, the disallowance amount is $5,075,553 and for LG&E the disallowance amount is $508,936. In addition, the Commission should apply interest to make ratepayers whole.

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[1] "Day-2 operations" relies on the use of locational marginal pricing to determine the prices charged to load, the prices paid to generators and the cost of congestion. Baron Testimony p. 4.

[2] Baron Testimony p. 4 lines 1-12.

[3] Id. p. 5 lines 1-4.

II. ARGUMENT

1. During The Seventeen-Month Period At Issue KU and LG&E Collected Improper Fuel Costs Through The FAC.

During the period in which the Companies were operating in the MISO Day-2 market, the Companies submitted "*offers*" for each of their generating units that could be dispatched in the day-ahead and real-time MISO markets. MISO then developed a least-cost economic dispatch of all MISO resources, based on scheduled and real-time loads.[4] This process determined the resources that would operate in the day-ahead and real-time markets, as well as locational marginal prices ("LMP") at each price node on the MISO system.[5] The purpose of this model was to insure that, whenever possible, only the lowest cost generating units in the MISO system were running to meet the demands of the customers taking power from the MISO system. Nevertheless, for various reasons primarily related to reliability, MISO often issued instructions to its members, including LG&E and KU, to dispatch generating units whose offer price exceeded the LMP at the generator's node.[6] In these cases, the Companies were required to operate their units at a loss, compared to the prices that they had offered the units to MISO.[7]

When MISO directed the Companies to dispatch their generating units out of economic order the Companies were compensated for their losses in the form of RSG make-whole payments. Make-whole payments were calculated as the difference between the Companies' offering prices and the LMP market price that the generator would otherwise receive.[8] From April 2005 to August 2006, the Companies received $63,265,105 in make-whole payments from MISO.[9] Despite the fact that LG&E and KU were

[4] Id. p. 5 lines 14-17.
[5] Id. p. 5 lines 18-20.
[6] Id. p. 6 lines 1-12.
[7]The "offering costs" were the prices offered for the generation, not necessarily the actual cost of operating the units. Baron Testimony p. 6.
[8] Baron Testimony p. 7 lines 8-12.
[9] Id. p. 7 lines 18-19.

being "*made whole*," the Companies charged native load customers through the FAC for the inflated fuel costs incurred when the Companies operated their generating units out of economic order.[10]

Table 1 below[11] summarizes the number of days and hours in each month in which the Companies operated a generating unit with excessive fuel costs (compared to the market price) and included this cost in their respective FACs. For example, during the Month of August 2006, KU had "*excess cost*" generating units assigned to native load customers on 26 days during that month. KU received $623,302 in make-whole payments from MISO associated with generating units assigned to native load whose fuel cost exceeded market prices just in the month of August 2006.[12]

Table 1
Summary of Days and Hours With Excess Fuel Cost Assigned to Native Load

		KU		LG&E	
	Month	**# Days**	**# Hours**	**# Days**	**# Hours**
2005	April	11	52	3	6
	May	10	66	-	-
	June	26	176	7	27
	July	19	111	18	96
	August	19	103	11	59
	September	17	104	6	32
	October	8	52	1	3
	November	4	13	-	-
	December	16	52	-	-
2006	January	2	5	-	-
	February	14	48	3	5
	March	14	79	2	5
	April	9	33	2	7
	May	7	25	-	-
	June	13	50	4	8
	July	23	114	8	25
	August	26	163	8	37
TOTAL		238	1,246	73	310

[10] Id. p. 8 lines 9-10.
[11] Baron Testimony p. 12.
[12] Baron Exhibit__(SJB-3)

Below is a summary prepared by KIUC witness Stephen Baron of the make-whole revenues received by the Companies and the excess fuel cost associated with these MISO RSG make-whole payments.[13]

ANALYSIS OF LGE-KU MISO MAKE-WHOLE PAYMENTS

		RSG MWP Received by Company	Excess Fuel Cost	RSG MWP Credited
Day Ahead	LGE	$ 954,127	14,875	12,155
	KU	$ 6,713,067	461,112	333,616
	OSS	$ 3,161,387	485,797	357,816
	Total	$10,828,581	$ 961,766	$ 703,587
Real-time	LGE	$ 2,683.996	567,535	496,781
	KU	$19,252,628	5,004,733	4,741,938
	OSS	$30,499,900	13,340,273	12,555,864
	Total	$52,436,524	$18,912,542	$17,794,582
Total	**LGE**	**$ 3,638,123**	**$ 582,392**	**$ 508,936**
	KU	**$25,965,695**	**$ 5,465,846**	**$ 5,075,553**
	OSS	**$33,661,287**	**$13,826,071**	**$12,913,680**
	Total	**$63,265,105**	**$19,874,308**	**$18,498,169**

The first set of data, titled "*RSG MWP Received by the Company*" shows the total amount of make-whole payments received by the Companies during the period. The total amount of make-whole payments (make-whole payments are classified by MISO into two categories: "*Day Ahead*" or "*Real-time*") received by the Companies during this period were $63,265,105. However, only a fraction of this amount was double-recovered through an improper fuel charge in the FAC. Of the total, $33,661,287 was assigned to off-system sales and thus there was no corresponding fuel costs recovered by the Companies from native load customers through the FAC. Only $29,603,818 of the make-whole payments received by the Companies was associated with native load. In hours when the Companies were receiving make-whole compensation payments from MISO associated with native load, the Companies had a total of $6,048,238 in excessive fuel costs, which they included in their respective FACs. These results are shown under the column "*Excess Fuel Cost.*" For $5,584,489 of the excess fuel costs associated with MISO's out of order

[13] Baron Exhibit__(SJB-4)

dispatch instructions, the Companies received a corresponding RSG make-whole payment. This $5,584,489 represents fuel costs that should not have been recovered from ratepayers through the FAC because the Companies were already being compensated for these costs through RSG make-whole payments. This amount is indicated in the column titled "*RSG MWP Credited.*"[14]

When the Companies were required to dispatch their more expensive generating units out of economic order, the Companies were not disadvantaged because MISO reimbursed them for their losses in the form of make-whole payments. However, native load customers were not as fortunate. If the higher cost (compared to available market prices) generating unit was run per MISO instructions the full cost of running this more expensive unit was charged to native load customers in the Companies' FAC. None of the MISO make-whole payments were recognized in the calculation of the Companies fuel adjustment charges.[15]

The Companies' recovery of improper fuel costs during the period at issue in this case is best understood by looking at a single hour in a sample month. KIUC Cross Exam Ex. 1 shows that for the hour ending 12:00 p.m. on August 30, 2006 MISO ordered KU to operate Paddy's Run Unit 13 (a gas fired combustion turbine)[16] at 147 MW. The total fuel cost recovered through the FAC was $10,255.03[17], or $69.76/MWH. During the hour that KU was required to operate an expensive gas peaking unit the same amount of energy was available on the market for $4,232.13, or $28.79/MWH.[18] Had KU bought market power rather than generate with expensive gas, ratepayers would have saved $6,022.90. This is the precise amount for which KU received a make-whole payment.[19] This amount is an improper fuel expense.

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[14] In a few hours, the RSG MWP did not fully cover the excess fuel costs and this shortfall was removed from the KIUC calculation of improper fuel expenses.

[15] In the Response of LG&E and KU to KIUC First Set of Data Requests, Question No. 1, page 2 of 2, the Companies state: "*The fuel cost associated with the resources stacked to native load was recovered through the FAC from retail customers. No MISO Day 2 charges or revenues were included in the calculation of the FAC except for the Locational Marginal Cost ("LMP") for purchases from MISO included in AFB.*"

[16] TE at 25.

[17] TE at 26.

[18] TE at 28.

[19] KIUC Cross Exam Ex. 1

The level of improper fuel expenses should be the amount of the excess fuel costs that was charged to native load customers, up to the amount of RSG make-whole payments received by the Companies. The payments received from MISO each hour during which excess fuel costs were charged to native load customers is $5,584,489. This almost covered the excess fuel costs charged to ratepayers of $6,048,238. KIUC does not seek disallowance of the entire $6,048,238 because the Companies did nothing wrong when they followed the MISO dispatch instructions. But the Companies did act improperly when they kept for the E.ON shareholders the $5,584,489 in make-whole payments when shareholders paid none of the excessive fuel costs.

In addition, the Commission should apply interest to the disallowance. The appropriate interest rate should either be each Company's respective weighted cost of capital or, at a minimum, the short-term cost of debt capital for each Company.[20] Ratepayers were charged excessive fuel costs beginning more than two years ago in April 2005. Without adding interest the Companies would profit from their improper actions. To more fully compensate customers for the loss of the use of their money, the Companies' weighted average cost of capital should be the interest rate used.

2. This Two-Year Review Is The Proper Forum For Reimbursing Ratepayers For The Improper Fuel Costs Collected Through The Companies' FACs.

There has been some discussion between the parties concerning the possibility of addressing make-whole payments in the Companies' next base-rate case. In fact, Kentucky Power Company ("KPC") accounts for its PJM operating reserve credits[21] (which are similar to LG&E and KU's RSG make-whole payments) by including them as a credit to ratepayers in its base rates.[22] Unfortunately, LG&E and KU's ratepayers are not able to receive credit for make-whole payments through a base rate case because; 1) as

[20] Baron Testimony p. 15 lines 1-7.

[21] "*PJM provides generators with operating reserve credits (known as "make-whole" payments) as compensation for instances when they are running per PJM dispatch instruction, but do not receive sufficient revenues from the energy market to cover their costs or for times when they are required to remain on-line for transmission reliability, blackstart capability, etc.*" KPSC Case No. 2006-00507, Kentucky Power Company's Response to First Set of Data Requests of KIUC, Item 1, p. 2 of 2.

[22] KPSC Case No. 2006-00507, Kentucky Power Company's Response to First Set of Data Requests of KIUC, Item 1, p. 2 of 2.

the Companies and all of the intervenors apparently agree, reimbursement through a future base rate case would violate the rule against retroactive ratemaking; and 2) as the Company has noted,[23] any credit for fuel costs that were double recovered along with MISO make-whole payments would be disallowed in a rate case as non-recurring revenues, because, unlike KPC's ongoing association with PJM, LG&E and KU are no longer members of MISO.

The appropriate avenue for addressing these excessive fuel costs is through an adjustment to the FAC in this two-year review case. The Commission's FAC rules require the disallowance of improper fuel expenses during a two-year review case. 807 KAR 5:056 Section 1, (12) states that:

> "*Every two (2) years following the initial effective date of each utility's fuel clause the commission in a public hearing will review and evaluate past operations of the clause, disallow improper expenses and to the extent appropriate reestablish the fuel clause charge in accordance with subsection (2) of this section.*" (Emphasis added)

Disallowing LG&E and KU's improper fuel expenses through an adjustment to the FAC in this two-year review case is in line with the Commission's Order in Case No. 2006-00172 . In that case, Union Light, Heat and Power Company d/b/a Duke Energy Kentucky ("Duke Kentucky"), cognizant of the fact that collecting MISO make-whole payments for out of economic order dispatch while also collecting the inflated FAC revenues that were caused by such an out of order dispatch represented an improper fuel cost, voluntarily submitted a proposal to adjust its FAC in order to exclude such fuel costs. Below is an excerpt from a sample month of a Duke Kentucky FAC schedule that was approved by the Commission. As seen in the schedule below, Duke Kentucky deducts MISO Make-whole Payments directly from the Generation portion of its Fuel Costs Schedule in its FAC:

[23] TE p. 67 lines 11-20.

DUKE ENERGY KENTUCKY[24]
FINAL FUEL COST SCHEDULE

Expense Month: February 2007

A. Company Generation		**Dollars ($)**
Coal Burned	(+)	$6,999,264.16
Oil Burned	(+)	-
Gas Burned	(+)	2,138,227.54
MISO Make-whole Payments	**(-)**	**1,387,050.46**
Fuel (assigned cost during Forced Outage	(+)	4,727.05
Fuel (substitute cost during Forced Outage	(-)	4,628.88
Sub-Total		$7,750,539.41

The Commission approved a Fuel Adjustment Clause tariff for Duke Kentucky in which MISO make-whole payments are deducted from Duke Kentucky's total fuel costs in its FAC,[25] and determined that such an accounting of make-whole payments is in compliance with 807 KAR 5:056.[26] The FACs of KU and LG&E must also comply with 807 KAR 5:056, without deviation. By approving this treatment of Duke Kentucky's make-whole payments, the Commission determined that MISO make-whole payments are related to fuel cost and can be credited to customers through a utility's FAC.

The position of LG&E and KU is inconsistent with the Commission's prior rulings with respect to Duke Kentucky's FAC. If LG&E and KU prevail here, then the Duke Kentucky FAC must also be changed to eliminate the MISO make-whole credit. That would be an extreme and unfortunate result, but one which legal consistency would require. The better result would be to conform the LG&E and KU FACs to the Duke Kentucky precedent.

[24] KIUC Cross Ex. 2 (emphasis in bold added).
[25] KIUC Cross Ex. 2, "Schedule 4."
[26] KPSC Case No. 2006-00172 Order of December 21, 2006.

3. **This Two-Year Review Of The Companies' Fuel Adjustment Clause Concerns The Single Issue Of Fuel Costs.**

The Companies have opposed KIUC's recommendation on the basis that our analysis only looks at fuel costs associated with the Companies' association with MISO without looking at all MISO expenses and revenues. Company witness Robert Conroy states in his Direct Testimony that KIUC's recommendation amounts to "*single issue ratemaking*." Mr. Conroy explains:

> "*KIUC's proposal to take a single kind of revenue and in effect credit it to the Companies' customers is clear violation of the Commission's restriction against single-issue ratemaking and nothing more than selective cherry-picking of revenues without matching costs..., when the Companies proposed a tariff mechanism to account for <u>all</u> the Companies' MISO-related costs and revenues not already included in base rates associated with serving native load, KIUC objected that the prohibition against single-issue ratemaking prohibited the mechanism.*" (Direct Testimony of Robert Conroy p. 11 lines 22-23, p.12 lines 1-6)

The Companies' contention that KIUC's proposal is "*single-issue ratemaking*" is of course correct. Kentucky's Fuel Adjustment Clause is by definition a single issue ratemaking mechanism. This is not a base rate case in which all costs and revenues must be accounted for in determining the Companies' revenue requirement. The only costs that can be at issue here are fuel costs.

The earnings of a utility are not relevant to the FAC. If LG&E and KU's association with MISO had been hugely profitable, then none of those profits could have been used to lower fuel costs that were otherwise reasonable. Indeed, if KIUC ever suggested using "*over-earnings*" to artificially lower fuel costs, then the shouts of protest from the Companies would be deafening. The opposite also applies. Even if the Companies lost money on MISO (and there is no evidence in this record that they did) that loss cannot be used as justification to charge unreasonable fuel costs to consumers through the FAC.

III. CONCLUSION

KIUC has no objection to the way LG&E and KU dispatched their generating units out of economic order per MISO instructions, or the Companies' recovery through their FACs of the higher cost fuel associated with running such units. However, the Companies received RSG make-whole payments from MISO in order to compensate them for the higher costs of this uneconomic dispatch. It was improper for shareholders to keep the make-whole payments since shareholders absorbed none of the excessive fuel costs.

Respectfully submitted,

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June 14, 2007