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November 12, 2007

VIA HAND DELIVERY

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40601

RECEIVED

NOV 13 2007

**PUBLIC SERVICE
COMMISSION**

RE: An Examination of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company From November 1, 2004 Through October 31, 2006
KPSC Case No. 2006-00509

An Examination of the Application of the Fuel Adjustment Clause of Louisville Gas and Electric Company From November 1, 2004 Through October 31, 2006
KPSC Case No. 2006-00510

Dear Ms. O'Donnell:

Enclosed please find and accept for filing two originals and ten copies of Kentucky Utilities Company's and Louisville Gas and Electric Company's Joint Response to the Petition for Rehearing of Kentucky Industrial Utility Customers, Inc. in the above-referenced matters. Please confirm your receipt of this filing by placing the stamp of your Office with the date received on the enclosed additional copies and return them to me in the enclosed self-addressed stamped envelope.

Should you have any questions or need any additional information, please contact me at your convenience.

Very truly yours,

W. Duncan Crosby III

WDC/ec
Enclosures
cc: Parties of Record

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NOV 13 2007

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

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

**JOINT RESPONSE OF KENTUCKY UTILITIES COMPANY
AND LOUISVILLE GAS AND ELECTRIC COMPANY
TO THE PETITION FOR REHEARING OF
KENTUCKY INDUSTRIAL UTILITIES CUSTOMERS, INC.**

The Kentucky Industrial Utilities Customers, Inc.’s (“KIUC”) November 2, 2007 Petition for Rehearing uses nothing more than semantics to attempt to convince the Commission that the reasoning of its October 12, 2007 Orders (“Orders”) in these proceedings is faulty because it is “based on arguments that were not made by KIUC.”¹ In fact, the Orders show a full awareness and consideration of the parties’ arguments and summarize them comprehensively. Furthermore, in the Orders the Commission correctly holds that Revenue Sufficiency Guarantee (“RSG”) Make-Whole Payments the Companies received while they were members of the Midwest Independent Transmission System Operator, Inc. (“MISO”) are not fuel-related and are not

¹ *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 2004, through October 31, 2006*, Case No. 2006-00509, and *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Louisville Gas and Electric Company from November 1, 2004, through October 31, 2006*, Case No. 2006-00510, (“Case Nos. 06-509 & 06-510”) Petition for Rehearing of Kentucky Industrial Utilities Customers, Inc. (“Petition”) at 1 (filed Nov. 2, 2007, though dated Nov. 1, 2007). The Attorney General filed a notice on November 9, 2007, stating he supports KIUC’s Petition.

relevant to Fuel Adjustment Clause (“FAC”) proceedings under 807 KAR 5:056.² This holding fatally undermines KIUC’s claim for disallowing certain of Louisville Gas and Electric Company’s (“LG&E”) and Kentucky Utilities Company’s (“KU”) (collectively, the “Companies”) fuel expenses, which the KIUC argues should be disallowed as improper because (1) they are “excessive” and (2) the Companies received RSG Make-Whole Payments to compensate them for those expenses. As the Orders correctly state, based on the record evidence, such payments are not fuel-related – a holding KIUC does not challenge in its Petition – necessarily implying that such payments cannot impact the determination of the propriety of the Companies’ fuel costs. Therefore, the Orders quite logically refuse to disallow as improper any of the Companies’ fuel costs for the period under review when the record shows that RSG Make-Whole Payments are not fuel-related. This logic can only be overturned if it is found to be unreasonable:

KRS 278.430 provides the standard of review of the Commission order by the circuit court. Under that statute the party seeking to set aside any determination by the Commission has the burden of proof to show by clear and convincing evidence that the determination is unreasonable or unlawful.

...

The term unreasonable can be applied to an administrative agency's decision only when it is determined that the evidence presented leaves no room for difference of opinion among reasonable minds.³

KIUC’s Petition does not begin to meet this requirement.

² *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 2004, through October 31, 2006*, Case No. 2006-00509, Order at 2 & 10 (Oct. 12, 2007) (“KU Order”); *In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Louisville Gas and Electric Company from November 1, 2004, through October 31, 2006*, Case No. 2006-00510, Case No. 2006-00510, Order at 2 & 10 (Oct. 12, 2007) (“LG&E Order”) (collectively, the “Orders”).

³ *Energy Regulatory Com. v. Kentucky Power Co.*, 605 S.W.2d 46, 49-50 (Ky. Ct. App. 1980).

The Orders go on to conclude logically that, because RSG Make-Whole Payments are not fuel-related and are therefore irrelevant to FAC proceedings, to take into account such payments when determining the propriety of the Companies' fuel costs would be single-issue rate-making.⁴ KIUC disagrees in its Petition, stating that it objects only to improper fuel costs, not RSG Make-Whole Payments per se.⁵ But the Commission's reasoning holds that such payments are not fuel-related and are therefore irrelevant to FAC proceedings. Accordingly, they have no bearing upon the propriety of fuel costs:

Isolating one of over 30 MISO-related items for inclusion in KU's FAC constitutes single-issue rate-making, which is prohibited by law. While the Commission's FAC regulation establishes a single-issue rate-making mechanism for fuel cost recovery, RSG Make Whole Payments are neither fuel costs nor fuel related and, therefore, are not appropriate for inclusion in the FAC.⁶

Thus, though FAC proceedings are by their very nature single-issue, the single issue appropriate for contemplation therein is the propriety of fuel costs and credits; all other costs and revenues must be examined in other proceedings, and importing a single non-fuel revenue stream into these FAC proceedings, the Orders correctly state, would constitute impermissible single-issue rate-making.⁷

KIUC closes its meritless attack on the Commission's Orders by reciting the standard of review applicable to all Commission orders, the well-known "arbitrary and capricious" standard.⁸ Concerning the standard, KIUC quotes two federal court opinions, which require a "rational connection between the facts found and the choice made," a basis in "a consideration of

⁴ KU Order at 7-8; LG&E Order at 7-8.

⁵ Petition at 5-6.

⁶ KU Order at 7. The LG&E Order contains materially identical language at 7-8.

⁷ *Id.*

⁸ Petition at 6-7.

the relevant factors,” and avoidance of “a clear error of judgment.”⁹ As shown briefly above and at length below, the Commission’s Orders are well-reasoned and based upon the facts presented, making them anything but “arbitrary and capricious.”

I. The Commission’s Orders Provide a Clear and Accurate Understanding of KIUC’s Argument, the Main Premise of Which the Orders Correctly Deny.

Far from setting up and knocking down a straw-man dressed in the guise of KIUC’s argument,¹⁰ the Commission’s Orders accurately portray KIUC’s argument and correctly deny the premise upon which KIUC’s argument logically depends: that RSG Make-Whole Payments are fuel-related. The Commission is under no obligation when evaluating KIUC’s claim or evidence to accept this premise to KIUC’s argument. In fact, the portions of the Order quoted in the Petition to show that the Commission “mischaracterized” KIUC’s argument actually show that the Commission clearly and accurately summarized the argument.¹¹ KU Order plainly states:

KIUC contends, for the hours in which KU received RSG Make Whole Payments, that MISO’s dispatch orders caused KU to incur \$5.6 million in excessive, or improper, fuel costs, which were charged to ratepayers via the FAC. KIUC claims that KU received Make Whole Payments as compensation for over 90 percent of these excess fuel costs, and that KU should be required to refund to its ratepayers the amount it was compensated.¹²

The emphasized portion of the above quotation is the Commission’s most concise statement of KIUC’s argument: the Companies’ fuel costs were improper if (1) they were “excessive” and (2) the Companies received RSG Make-Whole Payments to compensate for the

⁹ *Id.* (quoting *Walker Operating Co. v. FERC*, 874 F.2d 1320, 1337 (10th Cir. 1989), citing *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168, 83 S.Ct. 239, 245-246, 9 L.Ed.2d 207 (1962)).

¹⁰ See Petition at 7 (“Instead, the Commission sets up a straw man with its mischaracterization of KIUC’s argument and then knocks its straw man down.”).

¹¹ KIUC appears to have quoted solely from the Commission’s Order in the KU FAC proceeding, Case No. 2006-00509.

¹² Petition at 2 (quoting Order at 3) (emphasis added).

fuel cost. These quotations, acknowledged in KIUC's Petition, demonstrate that the Commission's fully and correctly assessed the KIUC argument.

KIUC's Brief further illustrates the fact that the Commission properly evaluated KIUC's argument and evidence:

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) [footnote omitted] at 147 MW. The total fuel cost recovered through the FAC was \$10,255.03, [footnote omitted] 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. [Footnote omitted]. 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. [Footnote omitted]. This amount is an improper fuel expense.¹³

The emphasized portion of the above quote shows that KIUC's claim is that the Commission should disallow any fuel cost that (1) exceeded the "market" price of power (i.e., the Locational Marginal Price at that generator's node at the time) and (2) for which fuel cost the Companies received compensation in the form of RSG Make-Whole Payments. The Commission's consideration of this argument is directly reflected in the Orders.¹⁴ The Commission did not, therefore, "fundamental[ly] misinterpret[]" KIUC's Petition.

KIUC's brief presents a definition of "improper fuel cost" that requires both of the elements cited in the Commission's summary of KIUC's argument:

[Element 1:] 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." [Element 2:] For

¹³ Petition at 3-4 (quoting KIUC Brief at 6) (emphases added).

¹⁴ KU Order at 7-8; LG&E Order at 7-8.

\$5,584,489 of the excess fuel costs associated with MISO's out of order 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.¹⁵

Again, KIUC plainly argues that for a fuel cost to be "improper" requires (1) that it exceeds the Locational Marginal Price at the generator node and (2) that the Companies receive a Make-Whole Payment for the fuel cost in question, which precisely tracks the Commission's summary.

The Direct Testimony of KIUC's expert witness, Stephen Baron, is even more straightforward about the necessity of showing both elements if a fuel expense is to be "improper":

My recommendation is to disallow [element 1:] the excess fuel costs charged by each Company, up to the amount of [element 2:] the RSG make whole payments received hourly by each Company. For KU, the disallowance would be \$5,075,553 and for LG&E the disallowance would be \$508,936.

...

The improper level of fuel expenses that should be disallowed is [element 1:] the amount of the actual excess cost charged native load customers [element 2:] for which the Companies were reimbursed by MISO.¹⁶

At least one other piece of KIUC's evidence, certain live testimony from Mr. Baron that is not quoted in the Petition, confirms that KIUC's claim for a disallowance requires both of the above-discussed elements:

[T]he excessive fuel costs are defined as cases in each hour when their cost of generation was greater than market prices but they charged customers the cost of the higher generation and they got

¹⁵ Petition at 4 (quoting KIUC Brief at 5-6) (emphasis added).

¹⁶ Petition at 4-5 (quoting Direct Testimony of Stephen J. Baron at 14 and 55) (emphasis in Petition).

some compensation from MISO in the form of Make-Whole Payments. We're saying, up to the point of the excessive fuel costs, they should use the Make-Whole Payments as an adjustment in the fuel clause.¹⁷

All of these quotations from KIUC's evidence in these proceedings demonstrate that the Commission's characterization of KIUC's argument is completely accurate. KIUC clearly argues that the only costs that should be disallowed in this proceeding are those (1) that are "excessive" and (2) for which the Companies received RSG Make-Whole Payments, which is precisely how the Commission summarized KIUC's argument. KIUC's claim that the Commission's Orders set up a straw-man to knock down in place of KIUC's actual argument is, therefore, simply without any support.¹⁸

Having correctly articulated KIUC's argument, the Orders go on to hold RSG Make-Whole Payments not to be fuel-related and therefore irrelevant to FAC proceedings – a holding KIUC does not challenge in its Petition – leading by force of logic to the reasonable conclusion that none of the Companies' fuel costs are disallowable:

Most significantly, as KU states, RSG Make Whole Payments are not fuel related. They clearly do not conform to the definition of fuel costs included in the Commission's FAC regulation. ... Therefore, it would not be appropriate to require that items unrelated to fuel costs, such as RSG Make Whole Payments, be included in the calculation of KU's FAC.¹⁹

¹⁷ Tr. 97-98 (emphases added).

¹⁸ Indeed, it is KIUC that now misstates its own argument when it states in its Petition, "KIUC did not argue that 'make whole' payments should be credited through the FAC. Instead, KIUC argued that the excessive fuel costs that were incurred when MISO required the companies to dispatch out of economic order should be disallowed as unreasonable." As the above quotes from KIUC's own evidence demonstrate, KIUC consistently states that the only fuel costs the Commission should disallow in this proceeding are those that meet both the test of being "excessive" and the test of having been compensated by MISO RSG Make-Whole Payments.

¹⁹ Petition at 2-3 (quoting KU Order at 7).

Notwithstanding KIUC's claim to the contrary in its Petition,²⁰ KIUC's evidence clearly states KIUC's belief that RSG Make-Whole Payments are indeed supposed to affect FAC calculations: "We're saying, up to the point of the excessive fuel costs, they should use the Make-Whole Payments as an adjustment in the fuel clause."²¹ It is precisely because the Commission holds RSG Make-Whole Payments to be irrelevant to FAC calculations that the Commission was correct not to disallow any of the Companies' fuel costs.

This is the point at which KIUC's Petition introduces semantic games in an attempt to avoid the Commission's clear logic. KIUC protests that it "was very clear that excess fuel costs should be disallowed, not that make-whole payments should be credited."²² Actually, as the evidence recited above shows, KIUC argued that improper fuel expenses should be disallowed.²³ KIUC made clear multiple times in its evidence that for a fuel cost to be improper, and therefore disallowable, it must have been (1) "excessive," defined as exceeding the LMP at the offending generator's node, and (2) compensated for by an RSG Make-Whole Payment.²⁴ But the Commission's Orders are equally clear that RSG Make-Whole Payments are not fuel-related and thus cannot be included in calculating the Companies' appropriate FAC recovery.²⁵ Thus, because KIUC's own definition of an "improper" fuel cost closely links the concepts of impropriety and RSG Make-Whole Payments, and because the Orders unequivocally hold that such payments cannot be used to impact the calculation of the Companies' FAC recovery, KIUC's allegedly "improper fuel costs" cannot be disallowed, as the Orders correctly hold.

²⁰ "The Commission's Order is based on a false reading of KIUC's argument. KIUC never argued that RSG make-whole revenues should be included in the Companies' FAC calculation." Petition at 3.

²¹ Tr. 97-98 (emphasis added).

²² Petition at 3.

²³ See, e.g., Petition at 3-4 (quoting KIUC Brief at 6)

²⁴ See *id.*

²⁵ KU Order at 7-8; LG&E Order at 7-8.

II. The Orders Correctly Hold that Any Impact of RSG Make-Whole Payments on the Calculation of the Companies' FAC Recovery Would Be Impermissible Single-Issue Rate-Making.

The Orders go on to conclude logically that, because RSG Make-Whole Payments are not fuel-related and are therefore irrelevant to FAC proceedings, to take into account such payments when determining the propriety of the Companies' fuel costs would be single-issue rate-making.²⁶ KIUC disagrees in its Petition, stating that because it objects only to improper fuel costs, not RSG Make-Whole Payments per se, its argument that certain of the Companies' fuel costs should be disallowed as improper does not run afoul of the prohibition against single-issue rate-making.²⁷ But the Orders hold that such payments are not fuel-related and are therefore irrelevant to FAC proceedings, meaning they can have no bearing upon the propriety of fuel costs. Thus, though FAC proceedings are by their very nature single-issue, the single issue appropriate for contemplation therein is the propriety of fuel costs and credits; all other costs and revenues must be examined in other proceedings, and importing a single non-fuel revenue stream into these FAC proceedings, the Orders correctly state, would constitute impermissible single-issue rate-making.²⁸

III. The Commission's Orders are Well-Reasoned and Easily Satisfy the "Arbitrary and Capricious" Standard of Review.

KIUC ends its Petition by reciting to the Commission the "arbitrary and capricious" standard of review for administrative agency decisions. Apparently unsatisfied with citing Kentucky courts on this issue, KIUC quotes two federal court opinions, which require a "rational connection between the facts found and the choice made," and hold that administrative agency decisions must be "based on a consideration of the relevant factors" while avoiding "a clear error

²⁶ *Id.*

²⁷ Petition at 5-6.

²⁸ KU Order at 7-8; LG&E Order at 7-8.

of judgment.”²⁹ KIUC then makes the bare and demonstrably false assertion, “The Commission decision was not based on a consideration of the relevant factors and it does not contain a rational connection between the facts found and the choice made.”³⁰ As shown throughout this Response and as is evident from the Commission’s Orders, the Commission clearly understood, and articulated in the Orders, all of the relevant facts in these proceedings and correctly followed the law in holding that RSG Make-Whole Payments are not fuel-related. The Commission then took the only logical step, which was to hold that the Companies’ FAC recovery could not be impacted by such non-fuel-related items without running afoul of the FAC regulation and the prohibition against single-issue rate-making. In short, KIUC’s claim that the Commission’s Orders are “arbitrary and capricious” is utterly devoid of merit.

IV. The Closing Paragraph of KIUC’s Petition Shows the Correctness of the Commission’s Orders.

In relevant part, KIUC closes its Petition as follows:

It is clear from the record that the Companies charged their customers excessive fuel costs at the same time that they were being reimbursed for the same fuel expense from MISO. The Commission should protect ratepayers from providing the Companies with a double recovery of its fuel costs by disallowing these excessive fuel costs in this two-year review case³¹

Apparently, by the end of its Petition KIUC could no longer walk its semantic tight-rope and fell into stating its argument as it truly is: KIUC believes the Companies double-recovered certain fuel costs, once from its customers through FAC recovery, and again through RSG Make-Whole Payments from MISO. But the fundamental and fatal flaw in KIUC’s argument, as the Commission correctly holds in its Orders, is that RSG Make-Whole Payments are not fuel-

²⁹ Petition at 6-7 (quoting *Walker Operating Co. v. FERC*, 874 F.2d 1320, 1337 (10th Cir. 1989), citing *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168, 83 S.Ct. 239, 245-246, 9 L.Ed.2d 207 (1962)).

³⁰ Petition at 7.

³¹ Petition at 7 (emphasis added).

related and cannot be considered in these proceedings – a holding KIUC does not challenge in its Petition. There was, therefore, no double-recovery of fuel costs, only a proper single-recovery through the Companies’ FACs, as the Commission’s Orders hold.³² Thus, at the very end of its Petition, KIUC states the true crux of its argument, and it is against that clear statement of KIUC’s argument that the reasoning of the Commission’s Orders shows itself to be most forceful and correct.

The Commission should, therefore, deny KIUC’s Petition for Rehearing.

Dated: November 12, 2007

Respectfully submitted,



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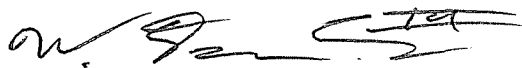
³² KU Order at 7-8; LG&E Order at 7-8.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Joint Response was served on the following persons on the 12th day of November 2007, by first class U.S. mail, postage prepaid:

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