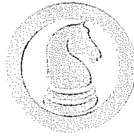

STOLL·KEENON·OGDEN
PLLC

2000 PNC PLAZA
500 WEST JEFFERSON STREET
LOUISVILLE, KENTUCKY 40202-2828
502-333-6000
FAX: 502-333-6099
WWW.SKOFIRM.COM

W. DUNCAN CROSBY III
DIRECT DIAL 502-560-4263
DIRECT FAX 502-627-8754
duncan.crosby@skofirm.com

June 15, 2007

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PUBLIC SERVICE
COMMISSION

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

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 Brief 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

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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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**
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**

JOINT BRIEF OF KENTUCKY UTILITIES COMPANY AND LOUISVILLE GAS AND ELECTRIC COMPANY

Kendrick R. Riggs
Robert M. Watt III
W. Duncan Crosby III
Stoll Keenon Ogden PLLC
2000 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202-2828
Telephone: (502) 333-6000

Allyson K. Sturgeon
Regulatory Counsel
E.ON U.S. LLC
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40202
Telephone: (502) 627-2088

Counsel for Kentucky Utilities Company
and Louisville Gas and Electric Company

FILED: **June 15, 2007**

TABLE OF CONTENTS

I. Introduction....2

II. The history of the Companies' administration of their fuel clauses during their membership in MISO demonstrates the propriety of their fuel costs....3

III. The Companies' fuel costs were proper because MISO required the Companies to run certain units to maintain transmission system reliability....8

- A. The Companies ran the units of which KIUC complains for reliability purposes and at MISO's direction, as the Companies were required to do, rendering proper the dispatch and fuel costs of those units....8
- B. The Companies' After-the-Fact Billing ("AFB") process properly stacked the highest cost units to off-system sales, leaving only a small fraction of purported higher-cost units stacked to native load....9

IV. The Companies' units were not run "uneconomically" or at an "excessive" fuel cost....9

- A. The MISO Day-Two markets require the commitment and dispatch of RAC units because actual economic dispatch must be constrained by reliability factors, not merely fuel costs....11
- B. The KIUC's suggestion that the only basis for determining the true amount of the Companies' improper fuel costs would be to run a production model of the Companies' dispatch outside of MISO Day-Two is based upon a purely hypothetical situation and should be disregarded as such....11

V. Because there is no evidence to support the KIUC's claim that the Companies' fuel costs were "improper" or "excessive," it would be arbitrary for the Commission to grant the disallowance the KIUC seeks....12

VI. RAC-committed units' fuel costs are proper because federal law requires that Companies be allowed to recover them....13

VII. RSG Make-Whole Payments are not fuel-related and thus are not appropriate to recover through the FAC....14

- A. RSG Make-Whole Payments bear no necessary relation to fuel costs or "the invoice price of fuel less any cash or other discounts." As such, they are not FAC items and must be addressed in the context of a base rate proceeding, not a FAC review....14
- B. Even a unit with no fuel costs could receive RSG Make-Whole Payments, and the methodology of allocating RSG Make-Whole Payments shows no connection to fuel costs....16

VIII. The hourly analysis of RAC committed units attributed to native load, which forms the basis of KIUC's claim for a $5.6 million disallowance, is not reasonable because the assumptions upon which it depends simply are contrary to the evidence....18

IX. The Commission has stated that FERC-approved rates should be addressed in base rate cases, where they can be accounted for in the full context of utilities' overall financial pictures. 20

X. Because there are no "improper fuel costs" and RSG Make-Whole Payments have no relation to fuel costs, KIUC's attempt to extract RSG Make-Whole Payments from the Companies constitutes improper single-issue ratemaking. 21

A. The Duke Energy Kentucky treatment of RSG Make-Whole Payments is neither precedent before this Commission nor relevant to these proceedings due to its coming about in the context of settling a full base rate case. 22

B. No other state has treated MISO cost recovery in a way similar to Duke; rather, either many MISO costs and revenues are recoverable through utilities' FACs or other rider mechanisms, or they are recoverable through base rates. 23

C. Having attacked as single-issue ratemaking the Companies' past proposal to account for **all** MISO costs and benefits with a MISO tracker, KIUC should not be heard to ask for a single MISO benefit without also accepting its attendant costs. 24

D. KIUC's desire to single out RSG Make-Whole Payments for "refund" is not surprising because there is no dispute that the Companies incurred a net expense as a result of their MISO membership. 27

XI. The Commission must take proper account of RSG Distributions. 28

A. If the Commission treats RSG Make-Whole Payments as fuel-related, it must also treat RSG Distributions as fuel-related. 28

1. RSG Distributions alone fund RSG Make-Whole Payments, and therefore must be set-off against RSG Make-Whole Payments. 28

B. The Commission should give no weight to Mr. Baron's faulty analysis of RSG Distributions. 29

C. In his live testimony, Baron incorrectly said that the Companies had only $1 million in RSG Distributions attributable to native load. 30

XII. If the Commission determines to grant a "refund," any interest thereon should be at the Three-Month Commercial Paper Rate, not the punitive rate proposed by the KIUC. 31

XIII. There exist adequate pricing safeguards for gas purchases from LG&E Local Distribution Company. 32

XIV. Conclusion. 34

I. Introduction.

Although perhaps obscured by the parties' arguments concerning revenues and costs such as Revenue Sufficiency Guarantee ("RSG") Make-Whole Payments and RSG Distributions, the purpose of these proceedings is to review and to evaluate the past operations of Louisville Gas and Electric Company's ("LG&E") and Kentucky Utilities Company's ("KU") (collectively, the "Companies") Fuel Adjustment Clauses ("FACs"). The Commission's Uniform Fuel Adjustment Clause Regulation, 807 KAR 5:056, states that in the course of this review the Commission should disallow improper expenses and, to the extent appropriate, reestablish the fuel clause charges in accord with the regulation. The evidence in these proceedings shows that the Companies complied with 807 KAR 5:056 by passing on to customers through their FACs only proper fuel expenses incurred to provide reliable and economic energy to the Companies' customers during the two-year period under review. The Companies accomplished this even while they were members of the Midwest Independent Transmission System Operator, Inc. ("MISO"), and therefore were compelled to participate in MISO's Real-Time and Day-Ahead ("Day-Two") markets from April 1, 2005, through September 1, 2006. It is uncontested that, although the Companies incurred substantial losses while they were MISO members, they insulated their customers from the vast bulk of MISO costs because they did not record any MISO-related costs or revenues in Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts ("USoA") Account No. 151, "Fuel Stock (major only)." Also, the Companies continued to operate their After-the-Fact Billing ("AFB") system as they had before MISO Day-Two, allocating their highest-cost generation's fuel costs to off-system sales. There was, therefore, nothing improper or excessive about the Companies' fuel costs or the recovery thereof through the Companies' FACs.

In contrast, the Kentucky Industrial Utilities Customers, Inc. ("KIUC"), has erroneously argued in these proceedings that the Commission should disallow the Companies recovery of

$5,584,489 in fuel costs during the periods under review, which fuel costs KIUC contends were "excessive" and "improper costs" because: (1) the cost of the Companies' generation exceeded market energy prices and (2) the Companies were reimbursed for these generating units by MISO in the form of RSG Make-Whole Payments. Among other reasons, the Companies have demonstrated in these proceedings that the KIUC's position is in error because: (1) the RSG Make-Whole Payments that MISO made to the Companies are not related to fuel costs, were not booked in FERC USoA Account 151, and did not cause the Companies to incur unreasonable fuel costs; (2) KIUC's attempt to credit to customers a single MISO revenue stream (RSG Make-Whole Payments) without also flowing through all MISO costs and revenues is not only outside the parameters of any fuel adjustment clause proceeding, but is also impermissible single-issue ratemaking; and (3) KIUC's recommendation conflicts with the requirements of the fuel adjustment clause regulation. Ultimately, the Companies have shown throughout the course of these proceedings and will show herein that the Companies did not charge their customers for "excessive expenses" and that the fuel expenses customers paid were reasonable and prudent expenses. For these reasons, the Companies respectfully request that the Commission conclude these proceedings by issuing an Order finding the Companies have complied with the provisions of Administrative Regulation 807 KAR 5:056, and resetting the base period component of the Companies' FAC formulas to be 17.03 mills per kWh for LG&E and 25.91 mills per kWh for KU going forward.

II. The history of the Companies' administration of their fuel clauses during their membership in MISO demonstrates the propriety of their fuel costs.

From April 1, 2005, through September 1, 2006, of the two-year period under review in these proceedings, the Companies were members of MISO and were compelled to participate in MISO's Day-Two energy markets. The Companies objected to the implementation of the MISO

Day-Two tariffs at the FERC;[1] however, FERC overruled the protests of the Companies and the Day-Two markets began operations effective April 1, 2005. LG&E and KU gave MISO notice of their intention to withdraw from their membership in MISO in December 2004 (and prior to the operation of the Day-Two markets),[2] and successfully completed their withdrawal on September 1, 2006.[3]

As participants in the Day-Two markets, each month the Companies paid and received credit for thirty-five different types of charges and credits associated with the operation of these energy markets.[4] One of the fundamental changes wrought by the Day-Two markets was the severing of the link between the Companies' generation and their load; all of the Companies' generation was offered into the MISO markets, and all load was served from those same markets. The Commission characterized the fundamental change wrought by MISO's Day-Two markets as follows:

> [O]ne major effect of the transfer to MISO is to sever the historic connection between their respective generation and the electric service provided to retail customers. The LG&E and KU generation used to serve native load customers must now be scheduled or bid through the MISO energy market at wholesale rates that are not subject to the Commission's jurisdiction. The

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[1] *See, e.g.,* Midwest Independent Transmission System Operator, Inc., FERC Docket No. ER03-1118-000, Motion to Intervene and Joint Protest of Louisville Gas and Electric Co. and Kentucky Utilities Co (Aug. 22, 2003).

[2] *In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc.*, Case No. 2003-00266, Supplemental Rebuttal Testimony of Paul W. Thompson (January 10, 2005) at 5 ll. 7-14, Exh. PWT-1.

[3] *In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission Operator, Inc.*, Case No. 2003-00266, Letter from E.ON U.S. LLC (Elizabeth L. Cocanougher) to Elizabeth O'Donnell at 3 (Dec. 21, 2006).

[4] *See In the Matter of an Examination of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 2004 to 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 to October 31, 2006*, Case No. 2006-00510 (collectively, "Companies' Current FAC Two-Year Review Cases"), Joint Rebuttal Testimony of Robert M. Conroy at Exh. RMC-1 (May 3, 2007) ("Conroy Testimony").

> energy thus scheduled or bid is then resold by LG&E and KU to their native load customers.[5]

During this same period, however, the Companies continued to utilize their long-established After-the-Fact Billing ("AFB") system for FAC calculation purposes, which system assumes a continued link between the Companies' generation and load. The AFB system stacks resources (both the Companies' generation and market purchases) from least-cost to highest-cost. In so doing, the Companies allocated fuel costs associated with the highest-cost resources to off-system sales, thereby excluding these fuel costs from recovery through the FAC.

The fuel cost associated with the generation resources dedicated to serving native load was recovered through the FAC; however, no MISO Day-Two charges or revenues were included in the calculation of the FAC except economic energy purchases from MISO, which were included in the AFB process using the Locational Marginal Price ("LMP"). Nor were any MISO Day-Two-related charges accounted for in FERC Account 151, as the Companies stated in their June 5, 2007 letter to the Commission:

> As the Companies stated during the informal conference, the Companies did not charge or credit any MISO revenues or costs to FERC USoA Account 151 from April 1, 2005 through October 31, 2006 while the Companies as members of MISO were participating in the MISO Real-Time and Day-Ahead power markets ("Day-Two Operations").

Were such costs and revenues truly fuel-related, the Companies would have recorded them in Account 151, which Kentucky's uniform fuel adjustment clause references:

> The cost of fossil fuel shall include no items other than the invoice price of fuel less any cash or other discounts. The invoice price of fuel includes the cost of the fuel itself and necessary charges for transportation of the fuel from the point of acquisition to the

---

[5] *In the Matter of Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator, Inc.*, Case No. 2003-00266, Order at 8 (May 31, 2006).

> unloading point, as listed in Account 151 of FERC Uniform System of Accounts for Public Utilities and Licensees.[6]

FERC defines Account 151 as: "Fuel stock (Major only). This account shall include the book cost of fuel on hand."[7] All of the items the FERC USoA states are to be recorded in Account 151 are:

> 1. Invoice price of fuel less any cash or other discounts.
>
> 2. Freight, switching, demurrage and other transportation charges, not including, however, any charges for unloading from the shipping medium.
>
> 3. Excise taxes, purchasing agents' commissions, insurance and other expenses directly assignable to cost of fuel.
>
> 4. Operating, maintenance and depreciation expenses and ad valorem taxes on utility-owned transportation equipment used to transport fuel from the point of acquisition to the unloading point.
>
> 5. Lease or rental costs of transportation equipment used to transport fuel from the point of acquisition to the unloading point.[8]

Thus, the fact that the Companies did not charge or credit any MISO revenues or costs to Account 151 is a clear indication of the Companies' conviction that no MISO costs or revenues, including RSG Make-Whole Payments and RSG Distributions, are fuel-related.

At all times during the periods under review, MISO was the Companies' Reliability Coordinator ("RC") and could, as the RC, require the Companies to dispatch their units strictly for reliability purposes. MISO committed units to run for reliability purposes through a process called the Reliability Assessment Commitment ("RAC"). Certain of the higher fuel costs associated with this MISO-required RAC commitment and dispatching are what the KIUC erroneously characterizes as "improper." Fuel costs for the dispatch of generation units for the

---

[6] 807 KAR 5:056 §1(6).
[7] Available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=5b2033a9494a622f2fa2666c5f2911b7&rgn=div5&view=text&node=18:1.0.1.3.34&idno=18
[8] *Id.*

reliability of the transmission system are reasonable *per se* in the absence of any evidence of imprudent dispatch operations.

In general, a RAC-committed generator received an RSG Make-Whole Payment when the Companies' offer amount for that generator exceeded the revenue collected in the energy market for that generator over the Commitment Period.[9] If over the Commitment Period an RSG Make-Whole Payment is determined by MISO to be necessary and the unit meets the eligibility rules defined by MISO, then the RSG Make-Whole Payment is allocated evenly over <u>all</u> hours of the Commitment Period regardless of and unrelated to the unit's fuel cost in a given hour. There is no guarantee that, for a given hour, if LMP is less than a unit's fuel cost an RSG Make-Whole Payment will be received for that hour.

The Day-Ahead and Real-Time RSG Make-Whole Payments the Companies received were funded through the Day-Ahead RSG Distribution Amount, the Real-Time RSG First Pass Distribution Amount, and a component of the Revenue Neutrality Uplift charge, all of which the Companies *paid* to fund RSG Make-Whole Payments, including those received by the Companies. None of these charges were paid by customers through the Companies' FACs. Indeed, it is undisputed that the Companies incurred a substantial net expense (i.e., the sum of the revenues, including the Make Whole-Payments, and expenses, including the Distribution charges, associated with the Day-Two markets) from operating in the Day-Two power markets. The Companies' shareholders absorbed this loss because it occurred between rate cases.

As discussed above, RSG Make Whole-Payments and Distributions have a direct relation only to the prices at which the Companies offered their generation into the Day-Two market and the revenue collected in the energy market where the Companies' offer exceeds the Companies'

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[9] "Commitment Period" is defined in the MISO Business Practices Manual BPM005. The Manual can be found at http://www.midwestiso.org/publish/Document/20f443_ffd16ced4b_-7e670a3207d2?rev=22.

revenues over the Commitment Period (the total period during which a generator is RAC-committed). No portion of MISO's Make Whole-Payments and Distributions are designated for or allocated to fuel costs. Day-Two market participants, including LG&E and KU, did not submit their fuel costs or fuel invoices to MISO for reimbursement or for calculation of the Make Whole-Payments and Distributions. Indeed, the Make Whole-Payments and Distributions are calculated and assessed without regard to the Companies' invoiced fuel costs.[10] Thus, RSG Make-Whole Payments and Distributions have no relationship to fuel costs.

III. The Companies' fuel costs were proper because MISO required the Companies to run certain units to maintain transmission system reliability.

A. The Companies ran the units of which KIUC complains for reliability purposes and at MISO's direction, as the Companies were required to do, rendering proper the dispatch and fuel costs of those units.

In clear contradiction of their claims that $5.6 million of the Companies' fuel costs at issue in these proceedings were "improper," KIUC agrees that, during their membership in MISO while the Day-Two energy markets operated, the Companies could not have run units other than the ones they actually ran because MISO required the Companies to dispatch them. Indeed, KIUC witness Stephen Baron confirmed that MISO was the Companies' NERC-certified reliability coordinator and that the Companies "were required to operate their units."[11] KIUC further conceded that the Companies' units were dispatched on an economic basis and to secure reliability: "MISO conducted a security constrained economic dispatch [SCED] and a Reliability Assessment Commitment ('RAC') process to insure that all loads are met with sufficient resources in a reliable manner."[12] Furthermore, Mr. Baron agreed that a purely fuel-cost-economic dispatch is not a feasible approach and that reliability is a worthy and necessary

[10] *See* Transcript of Hearing (May 10, 2007) ("Tr.") 33 ln. 6-10.

[11] Companies' Current FAC Two-Year Review Cases, Direct Testimony and Exhibits of Stephen J. Baron at 6 (Mar. 22, 2007) ("Baron Testimony").

[12] Baron Testimony at 6.

component of proper dispatch.[13] Given that the KIUC agrees that the Companies did precisely what they were required to do as part of MISO's economic and reliability-based Day-Two generation dispatch, it is clear that the Companies did not incur "improper" fuel costs.

B. The Companies' After-the-Fact Billing ("AFB") process properly stacked the highest cost units to off-system sales, leaving only a small fraction of purported higher-cost units stacked to native load.

While running their dispatch as MISO required and in a way to ensure reliable operation of the grid, the Companies also employed their AFB system properly by stacking the highest-cost units to OSS and the lowest-cost units to native load. Indeed, the KIUC agreed that the Companies appear to have run their AFB process properly and as they always had: "The AFB process stacks generation resources from lowest to highest and assigns the lowest cost generation to native load customers. The off-system market was allocated the highest cost resources."[14] Again, this proper administration of the AFB process supports a finding that the Companies did not incur and pass on to customers "improper" fuel costs.

IV. The Companies' units were not run "uneconomically" or at an "excessive" fuel cost.

KIUC witness Baron asserted that part of the Companies' fuel cost was "excessive" because it exceeded "the market price" of energy; indeed, this claim is the entire basis of his overall claim of improper fuel cost. But this assertion is based on two interrelated and fundamental fallacies. The fallacies become apparent by examining the way in which MISO establishes energy prices in the Day-Two markets. In both the day-ahead and real-time markets, MISO's Security-Constrained Economic Dispatch ("SCED") evaluates the offer prices of all the available generators and the amount of load that must be served, and then computes the economically optimal dispatch of generation that will be sufficient to serve load. Each generator

[13] Tr. 78-79.
[14] Baron Testimony at 8.

and load zone node is assigned a Locational Marginal Price ("LMP") -- the value of a marginal megawatt of electricity at that node at a given time. The LMP is calculated to be the market-clearing price of electricity for the entire grid, adjusted at each node for transmission constraints (resulting in a different LMP at each node). MISO then runs a Reliability Assessment Commitment ("RAC") process to commit additional generation necessary to provide appropriate reserve capacity and other reliability-related functions. By definition, RAC-committed units are not "economic" in the sense that they are not committed in the SCED process, but they are a necessary component of making the Day-Two markets function.

Thus, the first fallacy of KIUC's position is that there is a "market price" of energy independent of a particular generator's offer curve. In fact, there is no other provider of energy at a given generator node. There simply is no "market" from which to purchase power at the LMP of the specific generator node other than the power produced by the generator located at that specific generator node. Whether the broader market will "purchase" a given generator's energy is determined by the SCED and RAC unit commitment processes. Thus, a generator's price curve determines the "market price" of energy at its node.

The second fallacy of the KIUC's position is that there is other market-priced power to be purchased in lieu of a RAC-committed unit's energy. In fact, there is no other "market power" to be purchased at any given generator node -- the generator that is there is the sole provider and there can be no substitute for it, particularly insofar as reliability is concerned. Ensuring reliability often requires having units with certain characteristics at particular locations on the grid; had the Companies purchased power from other units in lieu of running their own units as they were obligated to do could well have created serious reliability issues, and could well have

incurred financial penalties as well. Therefore, purchasing "market power" from generators at other locations on the grid was not a viable substitute for running the Companies' units.

A. The MISO Day-Two markets require the commitment and dispatch of RAC units because actual economic dispatch must be constrained by reliability factors, not merely fuel costs.

With respect to the necessity of constraining an economic dispatch of generation by the requirements of the transmission grid, the KIUC's position is self-contradictory. On the one hand, KIUC witness Baron agrees that pure economics (divorced from reliability) cannot be the basis for proper economic dispatch of generation;[15] on the other hand, he asserts that certain of the Companies' fuel costs were "improper" because they were higher than the "market price."[16] Yet it cannot be both ways: either reliability is important, meaning that it is proper to dispatch units to maintain reliability even when such dispatch is not strictly fuel-cost-economic, or reliability is irrelevant. Clearly the latter cannot be true. As the KIUC acknowledges, one must take reliability into account in dispatching units.[17] Because reliability is important to proper economic dispatch, the KIUC's assertion that the Companies' fuel costs were "improper" because they were higher than "market prices" simply is not correct.

B. The KIUC's suggestion that the only basis for determining the true amount of the Companies' improper fuel costs would be to run a production model of the Companies' dispatch outside of MISO Day-Two is based upon a purely hypothetical situation and should be disregarded as such.

KIUC witness Baron testified that the KIUC could not know what was the real extent of the Companies' allegedly improper fuel costs because the Companies had not run a production model to compare the costs of dispatch had the Companies been outside of MISO to those the

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[15] Tr. 78-79.
[16] *See., e.g.,* Baron Testimony at 15 ln. 12-15; Tr. 92 ln. 10-18.
[17] Tr. 78-79.

Companies actually encountered inside MISO.[18] Yet under cross-examination, Mr. Baron confessed that his assertion was speculation.[19] Such a comparison would be improper per se: nothing in the UFAC regulation authorizes it. Moreover, such an exercise would be purely hypothetical and unprecedented, and could not possibly provide a meaningful comparison because there were actual contingencies that occurred during the period under review for which a model could not possibly account: abstraction cannot trump reality. Thus, rather than clarifying any issues in these proceedings, such a model could serve only to cloud them by injecting new concerns about the validity of the assumptions upon which to base the model, among other concerns.

V. Because there is no evidence to support the KIUC's claim that the Companies' fuel costs were "improper" or "excessive," it would be arbitrary for the Commission to grant the disallowance the KIUC seeks.

The kind of scrutiny that any Commission decision based on the KIUC's evidence must withstand is set out in the landmark case, *American Beauty Homes Corp. v. Louisville & Jefferson County Planning & Zoning Commission*.[20] In that case, Kentucky's highest court stated that, among other requirements, an administrative decision must have "substantial evidentiary support" to avoid being found arbitrary.[21] Given that the KIUC must concede that (1) dispatching higher-cost units to maintain reliability is a proper way to operate an economic dispatch, (2) the Companies had no choice but to follow MISO's dispatch orders, and (3) the Companies had no actual alternative "market power" they could purchase to substitute for their higher-cost units, there is no evidentiary support for the KIUC's assertion that the Companies' fuel costs were "improper," much less any "substantial evidentiary support" to that effect. In

[18] Tr. 101-02, 104-05.
[19] Tr. 104-05.
[20] 379 S.W.2d 450 (Ky. 1964).
[21] *Id.* at 456.

view of the arbitrariness of the KIUC's assertion that the Companies incurred and passed through their FACs "improper" fuel expenses, the Commission should refuse to grant the KIUC's proposed $5.6 million disallowance.

VI. RAC-committed units' fuel costs are proper because federal law requires that Companies be allowed to recover them.

The Commission has acknowledged that the legal doctrine of federal preemption requires that the Companies recover even elevated costs related to MISO's dispatch of the Companies' units. In its Order granting the Companies authority to withdraw from MISO membership, the Commission made it clear that the Companies are entitled to recover the increased costs of MISO-directed redispatch because they are related to a FERC tariff:

> [S]ince the inception of the Day-Two Markets, MISO has required a number of manual redispatches of the LG&E and KU generating facilities. These redispatches require LG&E and KU to substitute higher cost generation for available lower cost generation. Even though this redispatch is financially detrimental to retail customers, the Commission has no authority to disallow the additional costs because they are wholesale costs that are passed through a FERC tariff to retail customers.[22]

Thus, the Commission has acknowledged that federal preemption precludes the Commission from determining that the Companies may not recover the actual fuel costs they incurred to run RAC-committed units.[23]

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[22] *In the Matter of: Investigation into the Membership of Louisville Gas and Electric Company and Kentucky Utilities Company in the Midwest Independent Transmission System Operator, Inc.*, Case No. 2003-00266, Order at 21 (May 21, 2006).

[23] *See generally* Entergy Louisiana, Inc. v. Louisiana PSC, 539 U.S. 39, 42 (2003) ("The filed rate doctrine requires that interstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates. When the filed rate doctrine applies to state regulators, it does so as a matter of federal pre-emption through the Supremacy Clause.") (internal citation and quotation marks omitted); Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 487 U.S. 354, 374 (1988) ("[I]f the integrity of FERC regulation is to be preserved, it obviously cannot be unreasonable for MP & L to procure the particular quantity of high-priced Grand Gulf power that FERC has ordered it to pay for."); Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953, 962 (1986) ("[I]nterstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates.").

VII. RSG Make-Whole Payments are not fuel-related and thus are not appropriate to recover through the FAC.

A. RSG Make-Whole Payments bear no necessary relation to fuel costs or "the invoice price of fuel less any cash or other discounts."[24] As such, they are not FAC items and must be addressed in the context of a base rate proceeding, not a FAC review.

Assuming for the sake of the argument that (1) the evidence of record is ignored, (2) the Companies' FAC recovery from customers and the RSG Make-Whole Payments they received from MISO somehow overlapped by $5.6 million, (3) the problematic assumptions supporting KIUC's discovery request for the calculation of the $5.6 million are disregarded,[25] and (4) the RSG Distributions that offset the overlap are ignored, the Commission's authorities still do not support KIUC's position.

The requirements of 807 KAR 5:056 Section 1(6) define the cost of fuel recoverable through the fuel clause as follows:

> The cost of fossil fuel shall include no items other than the invoice price of fuel less any cash or other discounts. The invoice price of fuel includes the cost of the fuel itself and necessary charges for transportation of the fuel from the point of acquisition to the unloading point, as listed in Account 151 of FERC Uniform System of Accounts for Public Utilities and Licensees.

Revenues and costs associated with RSG (both Make-Whole Payments and Distributions) clearly do not meet these requirements; notably, the Companies have consistently held this position and have not recorded any MISO-related revenues or costs to FERC Account 151.[26]

First, MISO is not a fuel vendor and has never sent the Companies a fuel invoice; neither has MISO ever transported fuel for the Companies or received payment from the Companies for

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[24] 807 KAR 5:056 § 1(6).

[25] Tr. 65-66.

[26] *See* Letter of E.ON U.S. LLC (Robert M. Conroy) to Kentucky PSC (Elizabeth O'Donnell), Case Nos. 2006-00509 & 2006-00510 at 1 (June 5, 2007). Deviations from the requirements of 807 KAR 5:056 are not permissible. *In the Matter of: Application of Kentucky Utilities Company to Amortize, by Means of Temporary Decrease in Rates, Net Fuel Cost Savings Recovered in Coal Contract Litigation*, Case No. 93-113, Order at 5 (Dec. 8, 1993).

such services.[27] Hence, MISO cannot have provided a "cash or other discount" for the invoice price of the Companies' fuel.

Second, the Commission's interpretation of the fuel adjustment clause regulation also makes clear that damages or awards, even if fuel-related (and the Companies' RSG revenues are not), are not fuel costs and cannot be credited in the calculation of the fuel adjustment clause. In the Commission's December 8, 1993 Order in a KU proceeding to refund to Kentucky customers over $35 million in excessive fuel charges KU recovered from fuel suppliers and held in escrow, the Commission denied KU's request to flow the escrowed funds back to customers through KU's FAC:

> The use of the FAC to accomplish the refund of the escrow fund is not appropriate. 807 KAR 5:056 narrowly defines what constitutes fuel costs which are recoverable through the mechanism. The refund of the escrow fund does not conform to this narrow definition.[28]

The Commission described this holding in a subsequent order as "significantly limit[ing] the type of costs which qualify as fuel costs."[29] If the refund of excessive fuel costs recovered from fuel suppliers is not appropriate to credit through the FAC, neither is it appropriate to credit RSG Make-Whole Payments through the FAC, which payments are not related to fuel costs and were not provided by fuel vendors.

Then, in its July 21, 1994 Order in Case No. 90-360-C, the Commission expressly stated that "damages awarded by courts, while fuel related, are not fuel costs as defined by the FAC regulation." (Order, pp. 25-26). Furthermore, in its February 21, 1997 Order in Case No. 94-523, the Commission addressed whether the proceeds from litigation resulting from fraudulent

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[27] *See* Tr. 80-81.

[28] *In the Matter of: Application of Kentucky Utilities Company to Amortize, by Means of Temporary Decrease in Rates, Net Fuel Cost Savings Recovered in Coal Contract Litigation*, Case No. 93-113, Order at 4 (December 8, 1993) (emphasis in original).

[29] *In the Matter of Big Rivers Electric Corporation's Proposed Mechanism to Credit Customers Amounts Recovered in Judicial Proceedings Involving Fuel Procurement Contracts*, Case No. 94-453, Order at 10 (February 21, 1997).

fuel procurement contracts should be returned through the fuel adjustment clause, and held that the proceeds could not be returned to customers through utility's FAC because such proceeds were not sufficiently fuel-related.[30] The Commission stated:

> [S]ince the recovered amounts are not fuel cost refunds coming from fuel suppliers and are for actions other than fuel procurement (i.e. breach of fiduciary duty), considering the proceeds as a reduction or adjustment to fuel costs is contrary to the literal language of Commission Regulation 807 KAR 5056.

If "damages awarded by courts, while fuel related, are not fuel costs as defined by the FAC regulation," neither are RSG Make-Whole Payments appropriate to include in the Companies' FAC calculations or review process because such payments are not necessarily or directly related to fuel costs, were not provided by fuel vendors, and were for actions other than fuel procurement (i.e., the difference between the offer price and the LMP).

B. Even a unit with no fuel costs could receive RSG Make-Whole Payments, and the methodology of allocating RSG Make-Whole Payments shows no connection to fuel costs.

Two additional issues raised during the hearing of these cases before the Commission further illustrate that RSG Make-Whole Payments have no connection to fuel costs and therefore cannot be passed through the Companies' fuel adjustment clause. First, as KIUC witness Baron conceded during his live testimony, "[A]ctual fuel cost does not enter into that determination [the determination of RSG Make-Whole Payments]."[31] Indeed, Mr. Baron agreed that the Companies never provided MISO with information concerning their units' fuel costs.[32] And though he quibbled with some details of the hypothetical, Mr. Baron further conceded that if MISO

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[30] *In the Matter of Big Rivers Electric Corporation's Proposed Mechanism to Credit Customers Amounts Recovered in Judicial Proceedings Involving Fuel Procurement Contracts*, Case No. 94-453, Order at 6-8 (February 21, 1997).

[31] Tr. 81 ln. 22-23. *See* Tr. 81.-82.

[32] Tr. 81 ln. 4-7. In the cited portion of the hearing transcript, Mr. Baron notes that Mr. Conroy "testified to that" in response to counsel's question whether Day-Two market participants supply their fuel invoices or other fuel cost information to MISO. The testimony to which Mr. Baron refers is at Tr. 64 ln. 6-12, wherein Mr. Conroy states that the Companies did not supply fuel cost information to MISO.

committed a zero-fuel-cost generating unit during its RAC process, and if MISO actually dispatched the unit during a time when the LMP at that generator's node was less than the generator's offer price, such a unit could receive an RSG Make-Whole Payment.[33] In other words, Mr. Baron agreed that a generator could receive an RSG Make-Whole Payment even though it incurred no fuel cost at all: this is precisely because -- in Mr. Baron's own words -- "actual fuel cost does not enter into that determination."[34] This fact is conclusive evidence that RSG Make-Whole Payments simply bear no relation at all to fuel costs.

Second, the fact that MISO determines hourly RSG Make-Whole Payments with reference to multiple-hour commitment periods is further conclusive evidence that there is no relation between RSG Make-Whole Payments and fuel costs because at no point in the calculation of RSG Make-Whole Payments does MISO consider a unit's fuel cost. Rather, MISO calculated RSG Make-Whole Payments by comparing the energy market revenue a unit received over all hours of the unit's commitment period to the unit's total offer price for the entire commitment period. If the total energy market revenue for a unit's commitment period exceeded the unit's total offer price, MISO issued no RSG Make-Whole Payment, regardless of hourly LMPs and offer prices; on the other hand, if a unit's total energy market revenue for its commitment period was less than its total offer price, MISO issued the Companies an RSG Make-Whole Payment for the commitment period. Thus, for any given hour of a RAC-committed unit's commitment period, MISO might allocate an RSG Make-Whole Payment to the unit even though LMP was higher than the unit's offer price during that hour. All of these facts inexorably establish that RSG Make-Whole Payments have no relation at all to fuel costs because fuel costs do not at any time enter into the calculation of RSG Make-Whole Payments.

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[33] Tr. 85 ln. 5-11.
[34] Tr. 81 ln. 22-23. *See* Tr. 81.-82.

The KIUC has offered no evidence to contradict these facts. Rather, the KIUC's "evidence" is nothing more than result-oriented and unsupported assertions.

VIII. The hourly analysis of RAC committed units attributed to native load, which forms the basis of KIUC's claim for a $5.6 million disallowance, is not reasonable because the assumptions upon which it depends simply are contrary to the evidence.

As Mr. Conroy stated at length during the hearing in these proceedings, the analysis upon which the KIUC has based its claim for a $5.6 million disallowance was nothing more than the Companies' best effort to answer a data request the KIUC put to the Companies.[35] Despite the Companies' best efforts, the analysis contains several fundamental flaws that cannot be overcome because of the way in which various systems and data relate -- or do not relate -- to one another. First, the analysis depends upon the faulty assumption that there is a direct link between Make-Whole Payments and fuel cost; as shown above, there is not.[36] Second, it assumes a nonexistent link between MISO Day-Two nMarket data in the determination of all the charges and the Companies' after-the-fact billing system. As Mr. Conroy explained,

> The MISO Day-Two market essentially disconnected your generation from your load. All generation was provided into MISO and all load was served from MISO. However, for fuel clause purposes, we continued to use the after-the-fact billing system that essentially stacked the company-owned resources from least cost to highest cost and allocated those to either off-system sales or native load to determine our fuel adjustment clause recovery.[37]

Third and finally, the analysis assumes that RSG Make-Whole Payments are done on an hourly basis; they are not. Though the AFB system is an hour-by-hour calculation, RSG Make-Whole Payments are determined over the commitment period of a unit: "[W]hether the fuel cost or the offer is higher or lower than the LMP in any given hour during that commitment period

[35] *See, e.g.*, Tr. 21 ln. 10-19.
[36] Tr. 65.
[37] *Id.*

doesn't necessarily mean that the companies would receive a Make-Whole Payment."[38] All of these flaws demonstrate that the analysis the Companies performed resulted in an approximation to what the KIUC requested, but that fundamentally what the KIUC requested is not possible to generate because the concepts that must be linked to perform the analysis are independent of each other and cannot be properly related.

Thus, the single hour of the analysis upon which the KIUC chose to fixate in the hearing (set out in KIUC Hearing Exhibit 1) does not in fact demonstrate that the Companies "made out like a bandit" due to RSG Make-Whole Payments.[39] Rather, the exhibit shows that hourly RSG Make-Whole Payments, because they are calculated and spread evenly across all the hours of a unit's commitment period, have no relationship to the Companies' fuel cost in that hour, and have only a mitigated relationship to the Companies' offer price in that hour. This point is further illustrated in the charts attached hereto as Appendices B and C, which show two hourly breakdowns of commitment periods of hypothetical units. The first, Appendix A, depicts a scenario in which the hypothetical unit was running over a ten-hour period wherein during nine of those hours the LMP was lower than the offer price. Yet during the remaining hour of that commitment period the LMP was so great that the unit did not receive a Make-Whole Payment for the commitment period. Likewise, in the second scenario, set out in Appendix B, a hypothetical RAC-committed unit ran for nine of ten hours when the LMP was greater than the offer price. Yet during the remaining hour the LMP was so much less than the offer price that it resulted in an RSG Make-Whole Payment for the unit for the commitment period, which resulted in an hourly RSG Make-Whole Payment being allocated for each hour of the commitment period. These hypotheticals show a major problem with the analysis upon which KIUC relies:

[38] Tr. 66.
[39] Tr. 92 ln. 19-22.

hourly RSG Make-Whole Payments simply are not related to fuel costs. In fact, they are only remotely related to a unit's offer price. Furthermore, the KIUC example ignores the fact that the Companies had to pay MISO the load zone LMP for the generation (147 MW) that MISO provided for native load. This seriously undermines the KIUC's claim for a $5.6 million disallowance.

IX. The Commission has stated that FERC-approved rates should be addressed in base rate cases, where they can be accounted for in the full context of utilities' overall financial pictures.

In addition to being unrelated to fuel costs, as part of a FERC-approved wholesale tariff, RSG Make-Whole Payments are base rate items. The Commission has in the past expressed that though FERC-filed rates preempt the Commission's authority to disallow them, they are properly accounted for only in base rates:

> Despite our inability to investigate the reasonableness of CG&E's FERC-filed rate, we can exercise our discretion under KRS 278.190(2) to suspend ULH&P's proposed rates and conduct an investigation of ULH&P's overall financial condition to determine if other expenses have decreased or economies have been achieved. . . . In such a situation, the increased FERC-filed rate may properly be off-set with other changes in revenues or expenses, potentially resulting in no increase to retail customers.[40]

Thus, pursuant to Commission precedent, the proper approach to RSG Make-Whole Payments, were there to be a rate accounting of them, would be to include them in base rates with the rest of the Companies' MISO costs and revenues.[41]

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[40] *In the Matter of Application of the Union Light, Heat and Power Company to Adjust Electric Rates*, Case No. 91-370, Order at 4 (May 26, 1992).
[41] As discussed below, however, any such reconciliation of MISO costs and revenues in the Companies' next base rate case would violate the prohibition against retroactive ratemaking.

X. Because there are no "improper fuel costs" and RSG Make-Whole Payments have no relation to fuel costs, KIUC's attempt to extract RSG Make-Whole Payments from the Companies constitutes improper single-issue ratemaking.

It is now clear that RSG Make-Whole Payments have nothing to do with fuel costs and that there was nothing "improper" about any of the Companies' fuel costs or the recovery thereof, rendering KIUC's proposal to "refund" $5.6 million through the FAC impermissible single-issue ratemaking. The Commission has made clear in the past its strong position against single-issue ratemaking:

> The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Oftentimes a change in one item of the revenue formula is offset by a corresponding change in another component of the formula.[42]

Other than in a full-fledged base rate case, any attempt to credit to customers RSG Make-Whole Payments constitutes single-issue ratemaking because any such credit would ignore all the other MISO costs and revenues LG&E and KU faced during the periods under review, many of which are not presently included in the Companies' current base electric rates (only Schedule 10 Day-One costs have been considered, and the accounting treatment for the MISO exit fee has been agreed upon). KIUC's proposal to select one revenue stream from MISO -- day-ahead and real-time RSG Make-Whole Payments -- and credit it to customers without accounting for all of the other 33 MISO Day-Two costs and revenues not already included in base rates is a clear example of single-issue ratemaking, and the Commission should reject it as such.

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[42] *In the Matter of: Big Rivers Electric Corporation's Proposed Mechanism to Credit Customers Amounts Recovered in Judicial Proceedings Involving Fuel Procurement Contracts*, Case No. 94-453, Order at 7 (February 21, 1997) (quoting *Business & Professional People for the Public Interest v. Illinois Commerce Comm'n*, 585 N.E.2d 1032, 1061 (Ill. 1991)). In the *Business & Professional People* case, which concerned recovery of capital costs incurred in building nuclear plants, the court held that it would be single-issue rate-making to allow the utility to recover deferred charges without also accounting for offsetting decreased operating expenses combined with higher revenues from increased demand. *Id.* at 1062.

A. The Duke Energy Kentucky treatment of RSG Make-Whole Payments is neither precedent before this Commission nor relevant to these proceedings due to its coming about in the context of settling a full base rate case.

KIUC's counsel argued erroneously while cross-examining the Companies' witness that "the most relevant precedent" concerning RSG Make-Whole Payments and the fuel adjustment clause is the arrangement to which Duke Energy Kentucky recently agreed, whereby Duke credits to customers through its FAC its RSG make-whole revenues, "as well as corresponding expenses, which relate to Duke Energy Kentucky's dispatching of its generating units out-of-merit at MISO's request."[43] In fact, by its own terms this "precedent" is no precedent at all. Rather, it was one small component of a global base rate case settlement for Duke, which resulted in a net overall rate *increase* for Duke of $49 million.[44] To the first point, the settlement agreement that the Commission approved to resolve Duke's most recent base rate proceeding states:

> Neither the Settlement Agreement nor any of the terms shall be admissible in any court or Commission except insofar as such court or Commission is addressing litigation arising out of the implementation of the terms herein or the approval of this Settlement Agreement. This Settlement Agreement shall not have any precedential value in this or any other jurisdiction.[45]

In its Order approving the Duke settlement agreement, the Commission stated explicitly and without caveat: "The Settlement Agreement . . . is approved in its entirety."[46] Therefore, Duke's peculiar and voluntary treatment of RSG Make-Whole Payments is not precedent before this Commission.

Even were the Duke rate case settlement applicable precedent in these proceedings -- which it is not -- the base rate case context of determining Duke's RSG treatment serves to

[43] *In the Matter of Application of the Union Light, Heat and Power Company d/b/a Duke Energy Kentucky for an Adjustment of Electric Rates*, Case No. 2006-00172, Order at 4 (Dec. 21, 2006).
[44] *Id.* at 3.
[45] *Id.* at Appx. B ¶ 33.
[46] *Id.* at 10.

bolster, not erode, the Companies' argument that KIUC's approach to RSG Make-Whole Payments in this case is single-issue ratemaking. As evidenced by its rate case application, Duke did not volunteer to place such revenues in its FAC; rather, it conceded to the arrangement as part of obtaining a $49 million *increase* in rates. Moreover and by necessity, all of the rest of Duke's MISO-related costs and revenues were accounted for in setting its base rates, eliminating any single-issue ratemaking concern.[47] In these proceedings, however, *none* of the Companies' other MISO-related costs and revenues are being taken into account; it is only the RSG Make-Whole Payment revenue stream that KIUC seeks to cherry-pick. The Commission should refuse such an invitation to engage in prohibited single-issue ratemaking.

B. No other state has treated MISO cost recovery in a way similar to Duke; rather, either many MISO costs and revenues are recoverable through utilities' FACs or other rider mechanisms, or they are recoverable through base rates.

Not only is Duke's RSG arrangement not precedent in these proceedings, it is a clear aberration in the context of how other states' utility commissions have chosen to allow for MISO-related cost recovery. As shown in the Companies' post-hearing response to the Commission Staff's data request concerning this issue, several states' commissions have allowed their MISO-member utilities extensive MISO energy market cost recovery through their fuel clauses (e.g., Minnesota, Indiana, and North and South Dakota), some have allowed cost recovery through non-fuel-clause riders (e.g., Iowa and Ohio), and some appear to have allowed no fuel clause or other rider-type recovery of MISO costs (e.g., Michigan and Kentucky, with the exception of Duke Energy Kentucky).[48] In none of these states, however -- <u>not one</u> -- are RSG Make-Whole Payments singled out for crediting through a fuel clause or other rider mechanism

[47] *See* Tr. 62 ln. 13-22.
[48] *See* sources cited in Companies' Current FAC Two-Year Review Cases, Post-Hearing Response to Data Request of Commission Staff and Kentucky Industrial Utility Customers, Inc., Made During Hearing on May 10, 2007 (May 24, 2007).

without being offset by cost recovery (and usually quite comprehensive recovery). This underscores the fallacy of the KIUC's claim that Duke's arrangement is "the most relevant precedent." In fact, it is no precedent at all. It is not relevant because it came about in the context of the settlement of a full base rate proceeding. Moreover, it is starkly at odds with the way in which other states' commissions have provided for MISO cost recovery.

C. Having attacked as single-issue ratemaking the Companies' past proposal to account for **all** MISO costs and benefits with a MISO tracker, KIUC should not be heard to ask for a single MISO benefit without also accepting its attendant costs.

In 2004 the Companies filed an application for a "MISO Tracker Mechanism," which would have passed through to customers *all* MISO-related revenues and costs not already included in base rates. Ironically, KIUC objected to the Companies' MISO tracker proposal -- which accounted for *all* MISO costs and revenues not already in base rates, including RSG Make-Whole Payments -- as single-issue ratemaking.[49] Applying KIUC's own analysis of the prohibition against single-issue ratemaking from the MISO Tracker Mechanism case to the facts in this case shows why the Commission should reject KIUC's recommendation in these cases:

- "There is no justification for creating an alternative form of regulation whereby the Companies cherry-pick which components to include in their filing and which to exclude."[50] If it was "cherry-picking" to include in a tracker mechanism all MISO costs and revenues not already included in base rates, then certainly it is cherry-picking to select just one MISO revenue stream to credit to customers while ignoring all other related costs

[49] *See In the Matter of the Application of Louisville Gas and Electric Company for Approval of New Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates*, and *In the Matter of the Application of Kentucky Utilities Company for Approval of New Tariffs Containing a Mechanism for the Pass-Through of MISO-Related Revenues and Costs Not Already Included in Existing Base Rates*, Case Nos. 2004-00459 and 2004-00460 ("MISO Tracker Cases"), KIUC Brief at 3-5 (Jan. 21, 2005); MISO Tracker Cases, KIUC Reply Brief at 2-3 (Feb. 7, 2005).
[50] MISO Tracker Cases, KIUC Brief at 3; MISO Tracker Cases, KIUC Reply Brief at 2-3.

and revenues.

- "It is inequitable and counter to Commission policy to allow the recovery of one item without reference to every other item."[51] If it would have been "inequitable and counter to Commission policy" to allow the Companies to have recovery of the net of all MISO costs and revenues, it is even more inequitable and counter to Commission policy to credit to customers a single MISO revenue stream without also taking account of all other related costs and revenues.
- "If a utility can be ordered to refund particular revenues, it can also be authorized to collect a particular expense."[52] This is the very concern that has supported the Commission's strict interpretation of the fuel adjustment clause for many years.

It is evident from the KIUC's past position that there is a glaring conflict between the KIUC's vigorous opposition to what it characterized as single-issue ratemaking in the MISO tracker proceeding and its assertion of what is much more clearly single-issue ratemaking in these proceedings. The application of the KIUC's MISO Tracker analysis to its proposal in these proceedings clearly demonstrates why the KIUC's disallowance proposal violates the restriction against single-issue ratemaking.

Indeed, Mr. Baron all but conceded that the KIUC's proposed disallowance is cherry-picking when he stated in response to the Commission's Request for Information Item No. 3, "In addition, the Company received substantial Make Whole revenues from MISO that KIUC is not recommending for crediting to native load customers. These amounts will be retained by the

[51] MISO Tracker Cases, KIUC Brief at 5.
[52] MISO Tracker Cases, KIUC Reply Brief at 3 (quoting *Re Big Rivers Electric Corp.*, Case No. 94-453, 1997 WL 152646 (1997).

Company to offset any of its expenses." This is a plain admission that RSG Make-Whole Payments are not related to fuel costs; if they were, the KIUC would seek disallowance of the full $29.6 million of the Companies' RSG Make-Whole Payments allocated to native load.

During the hearing in these proceedings, Mr. Baron provided a non-response to the clear logic presented above. Instead of presenting a reason to support the KIUC's argument that only one portion of native-load-allocated RSG Make Whole-Payments are fuel-related, Mr. Baron simply reiterated that the KIUC is not seeking disallowance of all RSG Make-Whole Payments the Companies received:

> If my recommendation was to take the entirety of the $63 million and credit it to the fuel clause, there might be certainly an argument, "Well, you can't just pick that number," even if we limited it to just, say, the $29 million that the companies got associated with native load and said, "Okay, that needs to be credited to the fuel clause, all of that," but I haven't done that. KIUC is not recommending that. KIUC is only recommending that the excessive fuel costs - and the 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 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.[53]

This statement summarizes the entirety of the KIUC's case and most clearly displays why it lacks merit. The KIUC has attempted to interrelate two completely independent issues in order to mask the fact that neither indicates that the Companies' fuel costs were in any way improper. The answer to the question whether the Companies' fuel costs were excessive in no way depends upon, nor is it affected by, RSG Make-Whole Payments: if the Companies' fuel costs were excessive, it was because the Companies either paid too much for fuel or dispatched higher-priced units than they should have, neither of which conditions implicate RSG Make-Whole

[53] Tr. 97-98.

Payments. Likewise, the answer to the question whether RSG Make-Whole Payments are fuel-related has nothing to do with whether the Companies' fuel costs were excessive: either there is a valid conceptual relation between such payments and fuel costs or there is not. In fact, as the Companies have demonstrated, neither did the Companies incur excessive fuel costs, nor are RSG Make-Whole Payments related to fuel. But it is the complete independence of the answers to these questions that gives the lie to the notion that the amount of RSG Make-Whole Payments that is fuel related can be bounded by "excessive fuel costs." Because they are independent concepts, RSG Make-Whole Payments either are fuel-related in their entirety or they are not. The Companies have demonstrated conclusively that such payments in fact have no relation to or dependence upon fuel costs and thus are not in any way fuel-related.

D. KIUC's desire to single out RSG Make-Whole Payments for "refund" is not surprising because there is no dispute that the Companies incurred a net expense as a result of their MISO membership.

What may at first seem to be a perplexing contradiction between KIUC's present advocacy its $5.6 million "refund" proposal (which is in fact single-issue ratemaking) in view of its past opposition to the MISO Tracker is in fact easily explained: simply put, there is no dispute that the Companies incurred a net expense as a result of their MISO membership, and KIUC wants the Companies' shareholders to bear the full burden thereof. Of course, because the Companies have successfully exited MISO, there also is no dispute that the Companies' shareholders should *not* be allowed to recover any part of their net MISO expense in the Companies' next rate case: the Companies' MISO Day-Two costs are now non-recurring and therefore inappropriate to include in a test year, as it would violate the prohibition against retroactive rate-making to include a reconciliation of such costs in the Companies' next base rate

case.[54] That being the case, it should be noted that the Companies' customers have in fact already received the benefit of RSG Make-Whole Payments, which payments helped offset greater costs of MISO membership and enabled the Companies to sustain their operations without having to seek a base rate increase while they remained MISO members. Thus, to accede to the KIUC's single-issue ratemaking "refund" proposal would be to give customers a RSG Make-Whole Payment double-benefit, leaving the shareholders with a double penalty.

XI. The Commission must take proper account of RSG Distributions.

A. If the Commission treats RSG Make-Whole Payments as fuel-related, it must also treat RSG Distributions as fuel-related.

1. RSG Distributions alone fund RSG Make-Whole Payments, and therefore must be set-off against RSG Make-Whole Payments.

RSG Distributions are uplift costs MISO collects from all market participants to fund RSG Make-Whole Payments. More specifically, Day-Ahead and Real-Time RSG Make-Whole Payments, including those the Companies received, are funded through the Day-Ahead RSG Distribution Amount, the Real-Time RSG First Pass Distribution Amount, and a component of the Revenue Neutrality Uplift charge, all of which the Companies paid. None of these charges were paid by customers through the FAC charges. The very fact that RSG Make-Whole Payments are funded by socialized uplift costs, not fuel-related revenues of any kind, is yet more evidence that RSG Make-Whole Payments have no relation to fuel costs, making such payments inappropriate to consider in a fuel adjustment clause review proceeding. Moreover, though, if the Commission determines it is appropriate to disallow some amount of fuel costs due to the Companies' receipt of RSG Make-Whole Payments, then it must offset at least some of that

[54] Commission Staff counsel suggested at hearing that the Companies might defer their MISO Day-Two costs for reconciliation in their next base rate cases. Tr. 69-70. As discussed above, such a deferral and reconciliation would violate the prohibition against retroactive ratemaking. Also, the Companies proposed such a deferral in the MISO Tracker proceeding, which deferral the Commission denied. *See* MISO Tracker Cases, Order at 3, 9-11 (Apr. 15, 2005).

disallowance with the amount of RSG Distributions the Companies paid to obtain such RSG revenues. In other words, if RSG Make-Whole Payments are erroneously construed to be "cash or other discounts" for FAC purposes, then RSG Distributions must be construed to be part of the "invoice price of fuel." Indeed, KIUC's position in its February 7, 2007 First Set of Data Requests expressly defines "Make Whole-Payment" to include both RSG Make-Whole Payments and RSG Distributions.

B. The Commission should give no weight to Mr. Baron's faulty analysis of RSG Distributions.

In the event the Commission decides to take RSG Make-Whole Payments and RSG Distributions into account in these proceedings, it should disregard Mr. Baron's "analysis" thereof. Mr. Baron asserts that because $15.8 million (which is the difference between the $29.6 million of RSG Make-Whole Payments "associated" with native load and the $13.8 million the Companies paid in RSG Distributions for native load) is greater than the $5.6 million disallowance he recommends, there is no need to take RSG Distributions into account.[55] Mr. Baron provides no justification for his assertion.

In fact, RSG Make-Whole Payments make the Companies whole for the times when the Energy Market Revenue for a unit's Commitment Period was not sufficient to meet the Companies' offer for that Commitment Period. Thus, RSG Make-Whole Payments are not a windfall profit, but merely serve to make the Companies whole compared to their offer price.

The RSG Distributions the Companies and others paid are what funded the RSG Make-Whole Payments the Companies received. Based on the analysis to match the MISO settlement amounts with the Companies' AFB system, $13.8 million in RSG Distributions paid by the Companies to MISO is attributable to native load. Thus, the Companies had to pay $13.8 million

[55] Baron Testimony at 16.

to obtain the $29.6 million they needed to be made whole; in other words, though the Companies needed $29.6 million to be made whole for the generation MISO required the Companies to dispatch to maintain reliable grid operations, the Companies received a net payment of only $15.8 million because they had to pay $13.8 million in RSG Distributions. The net effect of the RSG Make-Whole Payments the Companies received and the RSG Distributions they had to pay is that the Companies are still $13.8 million short of being made whole. (Mr. Baron contested this assertion during the hearing, claiming that the Companies incurred only about $1 million in native load RSG Distributions.[56] As shown in the following section, this claim is incorrect.)

Thus, assuming for the sake of the argument that the Companies' FAC recovery from customers and the RSG Make-Whole Payments they received from MISO somehow overlapped by $5.6 million, when RSG Distributions are taken into account the "overlap" disappears and continues to leave the Companies $8.2 million short of being made whole. In sum, when RSG costs and revenues are netted, as they should be, there is no reasonable basis to claim that $5.6 million of the Companies' FAC recovery was improper because there is no overlap between the Companies' FAC recovery and the Companies' net RSG revenue.

C. In his live testimony, Baron incorrectly said that the Companies had only $1 million in RSG Distributions attributable to native load.

It is important to resolve an issue Mr. Baron raised in his live testimony before the Commission in these proceedings when he erroneously stated that the Companies had incurred only $1 million in RSG Distributions attributable to native load.[57] In fact, as Mr. Baron stated in his own pre-filed testimony, the Companies incurred $13.8 million in RSG Distribution costs associated with the $29.6 million of RSG Make-Whole Payments they received.[58] The

[56] Tr. 99-100.
[57] Tr. 99-100.
[58] Baron Testimony at 16 ln. 14-16.

approximately $1 million of RSG Distributions Mr. Baron cited is an amount the Companies calculated in an attempt to respond to the KIUC's February 8, 2007 Data Request No. 2; it is the pro rata share of RSG Distributions the Companies paid during the hours when they received RSG Make-Whole Payments and the cost of fuel exceeded the energy market revenue. This $1 million figure is relevant because, although the Companies do not believe that any disallowance is appropriate or permissible because RSG Make-Whole Payments simply have no relationship to fuel costs or discounts, if the Commission disagrees with the Companies, it should offset KIUC's proposed $5.6 million disallowance with approximately $1 million of prorated RSG Distributions.

XII. If the Commission determines to grant a "refund," any interest thereon should be at the Three-Month Commercial Paper Rate, not the punitive rate proposed by the KIUC.

If the Commission disagrees with the Companies and determines that some amount of RSG-related "refund" is appropriate, and if the Commission further determines that interest on such a "refund" is appropriate, then the Commission should refuse to impose the KIUC's proposed interest rate, stated as "each Company's respective weighted cost of capital or, at a minimum, the short term cost of debt capital for each Company."[59] Such an interest rate plainly would be punitive in view of the Commission's long-standing policy to use the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release.[60] Thus, if the Commission does grant KIUC's request for interest, it should be no more than the Three-Month Commercial Paper Rate.

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[59] Baron Testimony at 15 ln. 5-7.

[60] *In the Matter of an Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of the Louisville Gas and Electric Company from November 1, 1996 to April 30, 1997*, Case No. 96-524-A, and *In the Matter of an Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of the Louisville Gas and Electric Company from May 1, 1997 to October 31, 1997*, Case No. 96-524-B, and *In the Matter of an Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause*

XIII. There exist adequate pricing safeguards for gas purchases from LG&E Local Distribution Company.

During the hearing, Staff Counsel questioned the LG&E witnesses on the gas purchases made by the LG&E Electric Generation Business from the LG&E Gas Distribution Business. Specifically, John Malloy was asked to describe the circumstances under which gas purchases were made by the electric generation business from LG&E's Gas Distribution business.[61] He stated that LG&E's gas distribution facilities are connected to the Mill Creek and Cane Run coal-fired generating stations, which use natural gas for start-up and stabilization, and to the Paddy's Run combustion turbines, which use natural gas during the generation process.[62] The Staff Attorney [Mr. Cowan] then asked whether LG&E purchased gas from several vendors and Mr. Malloy responded that it did not.[63] The Staff Attorney [Mr. Cowan] then asked if there are any safeguards in place to assure that gas is purchased at the lowest cost available.[64] Mr. Malloy explained that the gas is purchased from the LG&E Gas Distribution Business at its average system cost.[65]

LG&E's Gas Distribution Business serves three electric generation facilities that are owned and operated by the Electric Generation Businesses of LG&E and KU. Those facilities are the Mill Creek, Cane Run, and Paddy's Run stations. These facilities of the Electric Generation Businesses of LG&E and KU have been served by LG&E's Gas Distribution Business for several years. At Mill Creek and Cane Run, the Gas Distribution Business charges the Electric Generation Businesses the weighted average cost of purchased gas of the Gas Distribution Business during the month the gas is used at the respective generating facility. At

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of the Louisville Gas and Electric Company from November 1, 1997 to April 30, 1998, Case No. 96-524-C, Order at 8-9 (December 2, 1999) (citing *re Equitable Gas Co.*, 144 P.U.R.4th 378 (Ky. P.S.C. April 12, 1993).

[61] Tr. 57 ln. 22-25.

[62] Tr. 58 ln. 1-5.

[63] Tr. 58 ln. 15-17.

[64] Tr. 58 ln. 18-20.

[65] Tr. 58 ln. 21-24.

Paddy's Run, because the volume used is very large and highly variable, the Gas Distribution Business acquires discrete volumes of gas for that facility on the open market at the best prevailing price at the time of purchase and charges the Electric Generation Businesses with the actual cost of the gas purchased to serve the loads at Paddy's Run. In addition, the Gas Distribution Business charges the Electric Generation Businesses one hour of time per day for services related to pricing, purchasing and accounting for the gas. These practices were examined during the Commission's 2002 Audit of Five Major Kentucky Gas Local Distribution Companies. The auditor concluded that the methods used to charge the plants for gas were appropriate.[66] The auditor also concluded that the gas procurement function appeared to be in compliance with the affiliate transaction provisions of KRS Chapter 278.[67]

In November of 2005, in an LG&E Gas Cost Adjustment case (No. 2005-00454), the Attorney General sent a data request to LG&E concerning the sale of gas by the Gas Distribution Business to the Electric Generation Business. LG&E provided an explanation of the practice that was consistent with the practice examined by the management auditor in 2002 described above.[68]

LG&E's current business practices, together with the findings of the 2002 Audit, demonstrate LG&E has adequate safeguards in place to assure that gas is purchased at the lowest cost available at the time of purchase.

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[66] Final Report: Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.3.

[67] Final Report: Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.4.

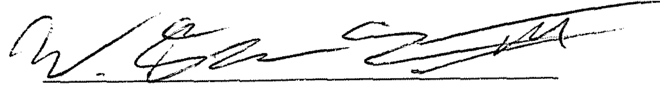
[68] A copy of the response to the data request is attached hereto as Appendix C.

XIV. Conclusion.

As shown above, the Companies incurred and passed through their FACs no improper fuel costs. Contrary to the unfounded assertions of the KIUC, there was in fact no less expensive "market power" available for the Companies to purchase in lieu of running certain higher fuel cost units, which units the KIUC acknowledges MISO, the Companies' NERC-certified reliability coordinator, *required* the Companies to run to ensure reliable grid operation. The KIUC has also acknowledged that the Companies properly administered their AFB process, properly assigning all of the highest-cost generation to off-system sales, not native load. There is no merit, therefore, in the KIUC's claim that the cost of running these units was "excessive." Moreover, there simply is no way in which RSG Make-Whole Payments are related to fuel costs: at no point in the calculation of such payments are fuel costs taken into account, and indeed a zero-fuel-cost unit could receive such a payment. For these reasons, the Companies respectfully request that the Commission conclude these proceedings by issuing an Order finding the Companies have complied with the provisions of Administrative Regulation 807 KAR 5:056, and resetting the base period component of the Companies' FAC formulas to be 17.03 mills per kWh for LG&E and 25.91 mills per kWh for KU going forward.

Dated: June 15, 2007

Respectfully submitted,



Kendrick R. Riggs
Robert M. Watt III
W. Duncan Crosby III
Stoll Keenon Ogden PLLC
2000 PNC Plaza
500 West Jefferson Street
Louisville, Kentucky 40202-2828
Telephone: (502) 333-6000

Allyson K. Sturgeon
Regulatory Counsel
E.ON U.S. LLC
220 West Main Street
Post Office Box 32010
Louisville, Kentucky 40202
Telephone: (502) 627-2088

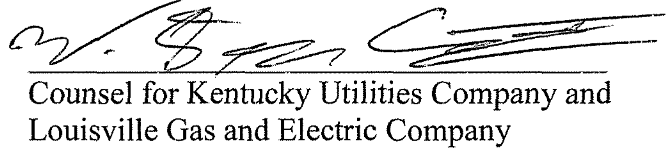
Counsel for Kentucky Utilities Company
and Louisville Gas and Electric Company

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Joint Brief was served on the following persons on the 15th day of June 2007, U.S. mail, postage prepaid:

Lawrence W. Cook
Assistant Attorney General
Office of the Kentucky Attorney General
Office of Rate Intervention
1024 Capital Center Drive, Suite 200
Frankfort, KY 40601-8204

Michael L. Kurtz
Boehm Kurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, OH 45202



Counsel for Kentucky Utilities Company and
Louisville Gas and Electric Company

Example 1: No RSG received even though LMP < Offer for 9 of 10 hours

	"Market Value"			Production Cost						
HE	MW	LMP	MV	Startup	No Load	Incremental Energy Cost	Total	Net	Make-whole Payment	Incremental Energy Cost > LMP
10	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
11	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
12	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
13	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
14	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
15	100	$300.00	$30,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$0.00
16	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
17	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
18	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
19	100	$80.00	$8,000.00	$500.00	$100.00	$9,000.00	$9,600.00		$0.00	$1,000.00
			$102,000.00	$5,000.00	$1,000.00	$90,000.00	$96,000.00	$6,000.00		$9,000.00

Energy Market Revenue (→ $102,000.00)

Units Offer (→ $96,000.00)

No RSG Payment (→ $6,000.00)

Example 2: RSG received even though LMP > Offer for 9 of 10 hours

	"Market Value"			Production Cost						
HE	MW	LMP	MV	Startup	No Load	Incremental Energy Cost	Total	Net	Make-whole Payment	Incremental Energy Cost > LMP
10	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
11	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
12	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
13	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
14	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
15	100	$40.00	$4,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$5,000.00
16	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
17	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
18	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
19	100	$100.00	$10,000.00	$500.00	$100.00	$9,000.00	$9,600.00		-$200.00	$0.00
			$94,000.00	$5,000.00	$1,000.00	$90,000.00	$96,000.00	-$2,000.00		$5,000.00

Energy Market Revenue → $94,000.00

Units Offer → $96,000.00

RSG Payment → -$2,000.00

LG&E Energy LLC
220 West Main Street
P O Box 32030
Louisville, Kentucky 40232
(502) 627-3450
(502) 627-3367 FAX

November 22, 2005

Dennis G. Howard, II
Acting Director
Office of Rate Intervention
1024 Capital Center Drive
Suite 200
Frankfort, Kentucky 40601-8204

RECEIVED
NOV 2 3 2005
PUBLIC SERVICE
COMMISSION

RE: LG&E Gas Cost Adjustment
Case No. 2005-00454

Dear Mr. Howard:

Enclosed please find LG&E's responses to your questions referenced in your November 15, 2005 letter regarding the above-referenced matter.

If you have any questions or concerns, please do not hesitate to contact me.

Sincerely,

Elizabeth L. Cocanougher
Senior Corporate Attorney

ELC/kmw
Enclosure
cc: Beth O'Donnell, Executive Director
Public Service Commission

Question No. 1

With reference to gas used by LG&E for consumption in its gas-fired electrical generators, and gas used to supply its end-use retail customers:

- **a. Is there any difference in price? If so, what? If pricing can be compared only on a periodic basis (i.e., January compares to January), please indicate the period compared.**
- **b. Are there different suppliers? If so, why?**
- **c. Is or are any of LG&E's suppliers affiliated in any way with E.ON or any of its subsidiaries?**
- **d. Are there different terms of supply? If so, what?**
- **e. Is any of the gas supply for use in generation of electricity stored, and if so, where?**

a. The gas costs charged to the electric generation units served by LG&E's gas distribution system and the gas costs recovered from retail gas customers through the Gas Supply Clause ("GSC") are the same. Natural gas used in electric generation is charged at the weighted average cost of purchased gas ("WACOG"),[1] with one exception as explained below.

LG&E provides natural gas supplies to five different generating stations located behind its natural gas distribution system. Specifically, these stations are Cane Run, Mill Creek, Paddy's Run, Zorn, and Waterside.

For all units at these stations except Paddy's Run 13 ("PR13"), gas is transferred from the Gas Business to the Electric Business at the monthly WACOG, which is the same cost level that is recovered from customers through the GSC. Except for PR13, these units generally use volumes of gas which can typically be supplied through LG&E's contractual pipeline entitlements. However, the volume of gas used at PR13 can be both very large and very erratic because it is used to generate electricity. Consequently, LG&E's pipeline capacity is inadequate to supply these volumes and LG&E's Gas Business must purchase gas to meet PR13's forecasted needs.. These gas purchases are charged directly to the Electric Business.

None of the amounts charged to the Electric Business for gas used at these stations are recovered from gas customers through the Gas Supply Clause.

This aspect of LG&E's gas procurement was described in the Commission's "Final Report: Audit of Five Major Kentucky Gas Local Distribution Companies" ("Audit Report"). In Conclusion No. 3 of Section 7 of the audit report dealing with LG&E, the auditors stated:

[1] The WACOG does not reflect the cost of gas from storage, only the cost of the gas that is purchased during that month.

LG&E is a combination gas and electric utility, and Gas Supply provides gas for five (5) electric plants behind the LG&E distribution system. The methods used to charge the plants for gas are appropriate.

Gas Supply procures gas for start-up and stabilization at four (4) of the electric plants, and the electric side of the company pays the average purchased gas cost. The remaining plant (Paddy's Run Unit #13) requests gas as needed, and Gas Supply makes a discrete purchase to meet that requirement, charging the actual cost of the discrete purchase. Further, to insure that no cross-subsidization between the gas and electric sides takes place, Gas Supply charges one (1) hour of time per day for services related to pricing, purchasing, and accounting for that supply.[2]

In Conclusion No. 6 of Section 7 of the audit report dealing with LG&E, the auditors stated:

The procurement function appears to be in compliance with KRS 278.

Transactions with Servco (the shared services affiliate), which are detailed in the C[ost] A[llocation] M[anual], are based upon Service Agreements that have been filed with the SEC as required by PUHCA, and therefore meet the pricing requirements of KRS 278.2207. Gas procurement services provided to five electric plants behind the LG&E gas distribution lines (see Conclusion #3) are appropriately charged to the electric side of the utility.[3]

b. The suppliers from which LG&E purchases gas supplies to serve the gas needs of its Electric Business are among some of the same suppliers that supply gas to LG&E for its retail gas customers.

c. None of LG&E's suppliers are affiliated in any way with E.ON or any of its subsidiaries.

d. The term of the supply matches the need for those supplies. Therefore, purchases to serve shorter-term (e.g., daily) needs have different terms than purchases to serve longer-term (e.g., weekly, monthly, seasonal) needs.

e. Because the natural gas supplied by LG&E to the electric generation facilities described is priced at the weighted average cost of purchased gas as described above,

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[2] Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.3
[3] Audit of Five Major Kentucky Gas Local Distribution Companies, November 15, 2002, Page III.C.7.4

LG&E's electric generation stations do not benefit from any gas stored by LG&E in its storage facilities.