BOEHM, KURTZ & LOWRY
ATTORNEYS AT LAW
36 EAST SEVENTH STREET
SUITE 1510
CINCINNATI, OHIO 45202
TELEPHONE (513) 421-2255

TELECOPIER (513) 421-2764

RECEIVED
OCT 14 2011
PUBLIC SERVICE COMMISSION

Via Overnight Mail

October 13, 2011

Mr. Jeff Derouen, Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, Kentucky 40602

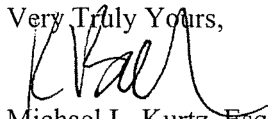
Re: Case No. 2011-00161 and 2011-00162

Dear Mr. Derouen:

Please find enclosed the original and fifteen (15) copies each of the RESPONSES OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC to FIRST SET OF DATA REQUESTS OF THE COMMISSION STAFF and DATA REQUESTS OF KENTUCKY UTILITIES COMPANY AND LOUISVILLE GAS AND ELECTRIC COMPANY for filing in the above-referenced matter. By copy of this letter, all parties listed on the Certificate of Service have been served.

Please place this document of file.

Very Truly Yours,



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

MLKkew
Attachment
cc: Certificate of Service

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served by mailing a true and correct copy via electronic mail (when available) and by via Overnight Mail to all parties on the 13th day of October, 2011.

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

Lonnie Bellar
Vice President, State Regulation & Rates
Kentucky Utilities Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40232-2010

Honorable Leslye M Bowman
Director of Litigation
Lexington-Fayette Urban County Government
Department Of Law
200 East Main Street
Lexington, KY 40507

David Brown
Stites & Harbison, PLLC
1800 Providian Center
400 West Market Street
Louisville, KY 40202

Robert M Conroy
Director, Rates
Kentucky Utilities Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40202

Honorable Dennis G Howard II
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KY 40601-8204

Honorable Kendrick R Riggs
Attorney at Law
Stoll Keenon Ogden, PLLC
2000 PNC Plaza
500 W Jefferson Street
Louisville, KY 40202-2828

Honorable Iris G Skidmore
415 W. Main Street
Suite 2
Frankfort, KY 40601

Edward George Zuger, III
Zuger Law Office PLLC
P.O. Box 728
Corbin, KY 40702

Thomas J FitzGerald
Counsel & Director
Kentucky Resources Council, Inc.
Post Office Box 1070
Frankfort, KY 40602

Robert A Ganton, Esq
Regulatory Law Office - U.S. Army Leg
901 North Stuart Street, Suite 525
Arlington, VA 22203

Scott E Handley, Esq.
Administrative Law Division - Office
50 Third Avenue, Room 215
Fort Knox, KY 40121

Allyson K Sturgeon
Senior Corporate Attorney
LG&E and KU Services Company
220 West Main Street
Louisville, 40202

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

RECEIVED

OCT 14 2011

PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC. TO THE COMMISSION STAFF'S FIRST SET OF DATA REQUESTS

1. Refer to pages 6-8 of the Direct Testimony and Exhibits of Lane Kollen ("Kollen Testimony"), which, among other things, cites the fact that the U.S. Environmental Protection Agency's ("EPA") Hazardous Air Pollutants ("HAPSs") rule has been proposed but is not yet final.

   a. On page 8, in response to a question beginning at line 17 on page 7, Mr. Kollen states that, "The Commission should not simply assume that the proposed regulations will become final regulations. The proposed regulations may never be adopted and may be modified and/or delayed even if they do become final." Confirm that the regulations referred to in this response pertain solely to the HAPs rule.

   b. At lines 7-10 on page 8, Mr. Kollen states, "If at a later date, the U.S. EPA issues final regulations, then the companies may file Applications for approval of the projects necessary to comply with the final regulations and for recovery of the related costs through the ECR." Explain whether Mr. Kollen is aware that EPA is under a court order to finalize the HAPs rule by November 16, 2011.

   c. If the HAPs rule is finalized by November 16, 2011, in essentially the same form as was proposed, explain how Mr. Kollen believes the Commission should address the requests by Kentucky Utilities Company ("KU") and Louisville Gas and Electric Company ("LG&E") for Certificates of Public Convenience and Necessity and for approval of their new environmental compliance plans.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

<u>RESPONSE</u>:

a. Yes.

b. Yes. However, that does not mean that the EPA is under Court order to finalize the proposed HAPs Rule. It may be modified.

c. If the HAPs Rule is finalized in the same form as the proposed rule, then the Commission could proceed with its review of the Company's response in this proceeding. However, if there are changes and the rule is modified, then the Companies and the Commission would have to determine if there has been any material change that would affect any of the Companies' proposed projects. The procedural schedule does not afford the flexibility to perform this review given that the Intervenors and Staff are precluded from further written discovery and the Intervenors already have filed their testimony.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	))))))	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	))))))	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

2. Lines 19-20 on page 8 of the Kollen Testimony refer to KU and LG&E each having $1,050 million in short-term debt available. At lines 19-23 on page 9 of the testimony, Mr. Kollen refers to KU and LG&E maximizing the use of short-term debt during construction as that is "by far the least cost source of financing available to the Companies..." Describe Mr. Kollen's understanding of how the rating agencies and capital market participants would view shifts in KU's and LG&E's capital structures that reflected increases of several hundred million in their short-term debt balances.

RESPONSE:

Mr. Kollen does not believe that there will be negative effects on the Companies' secured debt ratings if the utilities increase their use of short term debt by several hundred million during construction over the next five years. The greater risk is the sheer magnitude of the proposed construction program and the timely recovery of the costs, not the use of more short-term debt to temporarily finance the construction.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	
COMPANY FOR CERTIFICATES OF	)	
PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00161**
AND APPROVAL OF ITS 2011 COMPLIANCE	)	
PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND	)	
ELECTRIC COMPANY FOR CERTIFICATES	)	
OF PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00162**
AND APPROVAL OF ITS 2011	)	
COMPLIANCE PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

3. Refer to page 10, lines 17-19, of the Kollen Testimony. Provide the calculations of the savings of $161 million for KU customers and $225 million for LG&E customers, respectively, which Mr. Kollen states will occur if the entire amount of their construction expenditures is financed with 0.16 percent commercial paper compared to their proposed rates of return.

RESPONSE:

Refer to KIUC's response to LG&E 1-12 and KU 1-12.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

4. Refer to pages 16-19 of the Kollen Testimony. On page 16, lines 17-20, he deals with modifying the rate of return ("ROR") on the environmental cost recovery ("ECR") rate base to allocate any new tax-exempt pollution control financing "in its entirety to the debt component of the ROR used in the ECR revenue requirement." Refer also to pages 19-23 of the testimony where Mr. Kollen discusses modifying "ROR to properly allocate short-term debt to the ECR."

a. Mr. Kollen has previously testified in general rate cases and ECR cases of KU and LG&E. Describe his understanding of the historic treatment of tax-exempt pollution control debt for ratemaking purposes in both types of rate proceedings.

b. If Mr. Kollen's proposal, which results in allocating a larger share of lower cost (1) tax-exempt pollution control debt and (2) short-term debt to the ECR, was adopted by the Commission, confirm that, absent these lower cost forms of financing, the capital structures of both utilities would have larger long-term debt and equity components for ratemaking purposes in future general rate cases.

RESPONSE:

a. The Commission's treatment of tax-exempt debt has varied since the environmental surcharge statute was enacted. Mr. Kollen describes the history of the treatment of tax-exempt debt in the ECR proceedings in his Direct Testimony at 15-16. The present methodology is to

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

use an overall rate of return, which includes tax-exempt debt, on capitalization for base rate and on rate base for the ECR.

b. There would be differentiated returns to reflect the larger share of short-term and tax-exempt debt in the rate of return applied to the ECR rate base compared to the rate of return applied to the base rate capitalization.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

5. Refer to pages 25-26 of the Kollen Testimony where Mr. Kollen cites an administrative rule of the Florida Public Service Commission ("FPSC") in support of this proposal that KU's, LG&E's, and LG&E and KU Energy, LLC's ("LKE") returns on rate base and income tax expense be considered together, rather than separately.

a. Explain whether the FPSC is the only regulatory commission of which Mr. Kollen is aware that has adopted an approach comparable to what he is proposing for KU, LG&E, and LKE.

b. The Commission has historically used a "stand-alone" approach in establishing income tax expense and revenue requirements for utilities that are part of a holding company organization. Explain in detail why Mr. Kollen believes it should adopt a different approach in these KU and LG&E cases.

RESPONSE:

a. Mr. Kollen is only aware of the FPSC's Rule due to his experience in FPSC rate proceedings. He hasn't researched other state commissions to determine if they have similar rules or precedents.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

b. Mr. Kollen believes that his proposal is consistent with the standalone approach due to the unique LKE structure and does not represent an imputation of consolidated tax savings due to unregulated affiliate losses. LKE is structured to own and finance PPL's regulated investments in LG&E and KU. Mr. Kollen does not believe that LKE holds investments in unregulated affiliates. Thus, the LKE financing structure superimposed on the two regulated utilities is uniquely related to financing the two utilities and lowers PPL's cost to own and finance its equity investments in the two utilities. This is unlike the typical energy company holding company structure where it holds investments in regulated and unregulated affiliates and uses taxable income from its regulated affiliates to monetize taxable losses from its unregulated affiliates.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

6. Refer to page 5 of the Direct Testimony of Stephen J. Baron ("Baron Testimony"). Beginning at line 18, Mr. Baron states that, "[b]ecause the environmental costs at issue in this case are primarily demand-related there is no basis to allocate those costs to business customers based on their fuel usage." Explain why this statement would not also be true for non-business customers.

RESPONSE:

The statement is true for non-business customers. However, KIUC is not proposing any changes to the determination of the ECR billing factor for non-business customers due to potential rate impacts and to mitigate the overall impact of the KIUC proposal in this case.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	))))))	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	))))))	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

7. Refer to page 7, lines 12-15 of the Baron Testimony. Mr. Baron states that, "[b]ecause the majority of ECR revenue requirements are fixed costs that are unrelated to energy use or the level of the Companies' fuel expenses, it is not appropriate to apply the environmental surcharge to customers on the basis of fuel expenses."
   a. Provide documentation to support the statement that "the majority of ECR revenue requirements are fixed costs that are unrelated to energy use."
   b. Explain whether KIUC has made this same argument in past environmental surcharge proceedings and, if so, identify those cases and where in those case materials KIUC's argument can be found.
   c. Explain why inclusion of some fuel expenses should not be considered when there are ECR costs that are proportional to the level of fuel burned.

<u>RESPONSE</u>:

a. The vast majority of ECR revenue requirements at issue in this case are fixed costs associated with production plant in service. As such, these costs are unrelated to the level of kWh usage on the system, in the same manner as any other fixed investment in a coal fired power plant (for example, a feed-water pump). KIUC has not done a specific analysis of the

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	
COMPANY FOR CERTIFICATES OF	)	
PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00161**
AND APPROVAL OF ITS 2011 COMPLIANCE	)	
PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND	)	
ELECTRIC COMPANY FOR CERTIFICATES	)	
OF PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00162**
AND APPROVAL OF ITS 2011	)	
COMPLIANCE PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

composition of incremental operating expenses at issue in this case to determine the portion directly related to energy use, but believes that some portion of the O&M expenses is variable and some portion, such as labor, is fixed. With the recognition that not all incremental O&M expense is variable, the following table calculates the ratio of total O&M expense to the total ECR revenue requirement for each Company. This represents the maximum portion that could be variable, based on the Companies' projections each year.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

**RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS**

	LG&E			**KU**		
Year	Total E(m)	Total O&M Exp.	Percentage O&M Exp.	Total E(m)	Total O&M Exp.	Percentage O&M Exp.
2012	25,242,731	-	0.0%	22,997,753	8,692	0.0%
2013	76,600,187	1,693,407	2.2%	69,805,282	8,229,481	11.8%
2014	127,030,692	7,079,485	5.6%	143,787,858	35,411,561	24.6%
2015	218,208,998	35,608,091	16.3%	199,866,832	60,770,160	30.4%
2016	248,966,263	55,017,095	22.1%	232,668,107	86,877,161	37.3%
2017	242,411,497	56,294,535	23.2%	229,310,577	88,644,555	38.7%
2018	236,137,532	57,597,523	24.4%	226,180,760	90,448,193	40.0%
2019	230,143,875	58,926,571	25.6%	223,282,928	92,288,826	41.3%
2020	224,411,731	60,282,200	26.9%	220,603,254	94,167,222	42.7%

While it may be appropriate to classify all ECR revenue requirements on a pure demand/energy basis, following the underlying cost causality of each cost component in which all fixed ECR revenue requirements would be allocated to rate classes on the basis of a kW demand allocation factor and all variable ECR revenue requirements would be allocated on the basis of rate class

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

energy use (adjusted for losses), the KIUC proposal in this case is a simplified methodology that is administratively feasible and does not require a mini-rate case each to determine the cost allocation methodology and to develop separate rate class demand and energy allocation factors that would normally be developed in a full base rate case. The KIUC proposal is designed to better align ECR cost recovery with cost responsibility by using non-fuel base revenues, which reflects a blend of both energy and demand related allocations and is administratively easy to implement in ECR filings.

b. No. Mr. Baron, on behalf of KIUC proposed a non-fuel base rate ECR allocation mechanism for ECR revenue requirements in Case Nos. 2004-00426 and 2004-00421. In those cases, Mr. Baron proposed separate ECR factors for each of 8 rate groupings based on non-fuel base revenues. This is in contrast to the KIUC proposal in this case that only allocates the ECR

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

**RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS**

revenue requirement to C&I rate classes on the basis on non-fuel base revenues, but continues to use total revenues to set the ECR for non-C&I rate classes.

c. As discussed in part (a) to this question, it may be appropriate to utilize a pure demand/energy classification and allocation of ECR revenue requirements following cost of service principles. However, KIUC believes that its proposal in this case to allocate all ECR revenue requirements on the basis on non-fuel base revenues among the C&I rate classes is a reasonable approach, is administratively easy to implement in an ECR proceeding and recognizes the underlying costs included in the ECR revenue requirements.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

8. Explain whether Mr. Baron believes that the need to comply with EPA's emissions requirements is due to the amount of generation capacity required to meet demand or to the generation of energy required to meet daily energy usage. If the response is "the generation of energy required to meet daily energy usage," explain why fuel revenues should be excluded from the ECR mechanism of any customer class.

RESPONSE:

Mr. Baron agrees that the need to comply with EPA emission requirements is due to the production of energy, in the first instance. However, this is also true of all other fixed production demand related costs (such as a power plant boiler, generator, etc.). Once the decision is made to continue to operate an affected coal plant, the majority of ECR revenue requirements are fixed costs and do not vary with the level of kWh usage by customers. As such, these costs are demand related in the same manner that all other fixed production costs are demand related. In the Companies' class cost of service studies, these fixed environmental related investment costs,

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	
COMPANY FOR CERTIFICATES OF	)	
PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00161**
AND APPROVAL OF ITS 2011 COMPLIANCE	)	
PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND	)	
ELECTRIC COMPANY FOR CERTIFICATES	)	
OF PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00162**
AND APPROVAL OF ITS 2011	)	
COMPLIANCE PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

which are included in production plant in service, are treated in the same manner as all other fixed production costs; that is, they are classified as demand related. From an economic standpoint, once the investment is made, it does not make sense to classify these fixed costs as energy related and, for example, assign a greater proportion of costs to off-peak energy usage that does not affect the level of such costs.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

9. Refer to pages 10-11 of the Baron Testimony. Mr. Baron states that in response to a Staff data request, Mr. Bellar stated that, "the use of non-fuel base revenues more properly reflects the demand-related component of revenue, which is appropriate to allocate ECR costs because 'the preponderance of ECR costs are demand-related.'"

RESPONSE:

Mr. Baron assumes that this question is related to Question No. 10.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

10. Explain whether it is Mr. Baron's understanding that Mr. Bellar would segregate customer classes in a manner similar to Mr. Baron's proposal when considering whether to use fuel-related revenue in the development of the ECR rate factor.

RESPONSE:

Mr. Baron does not know how Mr. Bellar would segregate customer classes in consideration of the fact that a majority of ECR revenue requirements are fixed investment related production demand costs.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

**RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS**

11. Refer to the Direct Testimony of Stephen G. Hill ("Hill Testimony") at pages 6-8. Compare an investor's expected return on an equity investment in a retirement portfolio to an expected return on a firm's investment in a capital project.

RESPONSE:

Investors' expected return on an investment in the common stock of a firm is, by definition, the cost of equity capital to that firm. That is, the cost of equity capital to the firm is the rate of return that the firm has to provide to the equity investor in order to induce him or her to invest; and that investor-required rate of return is estimated through the use of market data and economic models such as the DCF and CAPM. When those models are applied to the market data of a group of similar-risk electric utility companies, an estimate of the cost of equity capital for that particular risk-class of companies can be determined.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

Because the capital projects in which a regulated utility invests are relatively homogenous, i.e., they are all related to the regulated production and provision of electric utility service and are not widely dispersed in terms of risk (for example, as unregulated retail operations would be), it is reasonable to assume that the expected return on the equity-financed portion of a utility capital project is similar to the utility's cost of equity. While it could be argued that there are some gradations of risk in utility investment (e.g., nuclear generation would be riskier than transmission or pollution control investment due to the relative size and complexity of the investment), and on a stand-alone basis distribution investment would most likely be considered to have lower risk than generation investment. However, in general, for regulatory purposes the cost of (and the investor-required return on) the equity portion of utility capital projects is considered to be similar to the market-based cost of equity capital of the utility company.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

As to the issue of the relevance of an investor's expectation with regard to the long-term return on the equity investments in a retirement portfolio, that expectation provides direct evidence as to the cost of equity capital for stocks, generally. That is because, as noted above, the cost of equity capital is the return that investors expect on their equity investments. Therefore, if investors expect a return of 8% on the equity investments in their retirement portfolio (as is the case for KU and LGE) then a DCF/CAPM equity cost estimate range of 9% to 9.75% is shown to be conservative in light of available direct evidence regarding investor expectations. Therefore, the direct information provided by KU and LGE's own long-term equity return expectations is used in Mr. Hill's testimony to confirm the reasonableness of his market-based equity cost estimate.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

Finally, as noted on pages 7 and 8 of Mr. Hill's Testimony, while it is reasonable to believe that investors (in this case, the utility companies) would not want to *overstate* expected

portfolio equity returns, it would also be disadvantageous for them to *understate* those expected returns. Therefore, expected investment portfolio equity returns provide direct evidence as to the cost of equity capital—investors' expected returns. That evidence, based on the equity return expectations of KU and LGE, shows that the current cost of equity capital is low by historical standards.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	
COMPANY FOR CERTIFICATES OF	)	
PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00161**
AND APPROVAL OF ITS 2011 COMPLIANCE	)	
PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND	)	
ELECTRIC COMPANY FOR CERTIFICATES	)	
OF PUBLIC CONVENIENCE AND NECESSITY	)	**CASE NO. 2011-00162**
AND APPROVAL OF ITS 2011	)	
COMPLIANCE PLAN FOR RECOVERY BY	)	
ENVIRONMENTAL SURCHARGE	)	

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

12. Refer to the Hill Testimony at pages 30-31.

a. Compare KU's and LG&E's percentage of coal used for generation to that of each company in the proxy group.

b. Explain why selection criteria for the proxy group do not include electric generation fuel mixes similar to that of KU and LG&E.

RESPONSE:

The comparison of generation mix is shown in the table below:

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

	Coal	Gas/Oil	Nuclear Purch/Other
LGE	78.0%	20.4%	1.6%
KU	65.6%	33.9%	0.5%
AVG	**71.8%**	**27.1%**	**1.1%**
SCG	51.0%	28.0%	22.0%
TE	53.0%	38.0%	9.0%
ALE	55.0%	0.0%	45.0%
AEP	82.0%	8.0%	10.0%
CNL	29.0%	30.0%	41.0%
ETR	12.0%	22.0%	66.0%
WR	51.0%	41.0%	8.0%
AVA	13.0%	13.0%	74.0%
BKH	42.0%	0.0%	58.0%
HE	0.0%	60.0%	40.0%
PCG	0.0%	5.0%	95.0%
PNW	37.0%	12.0%	51.0%
POR	23.0%	21.0%	56.0%
UNS	90.0%	10.0%	0.0%
AVG	**38.4%**	**20.6%**	**41.1%**

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC. TO THE COMMISSION STAFF'S FIRST SET OF DATA REQUESTS

While it is clear from this comparison that KU and LGE have a greater percentage of coal-fired generation than Mr. Hill's sample group on average, it does not follow that, for that reason, KU and LGE have higher operating risk than the sample group. For one thing, the sample group, in general has a higher proportion of nuclear generation that KU or LGE, which have none. As underscored in the recent earthquake incident in Japan, nuclear generation (in addition to being more expensive and technically complex than fossil generation) has significant and far-reaching risks that other types of generation do not have. Also, many of the other utilities that do not have coal generation rely heavily on purchased power, which adds financial obligation risks that owning generation does not impart. Hawaii Electric, which has no coal generation, generates 60% of its power from oil, delivered by ship, has no electric interconnections with other utilities

and buys the remaining power from co-generators (who also rely on oil) and wind or solar generation. One would be hard pressed to say that KU's generation mix makes it more risky than that of Hawaii Electric, and it is reasonable to believe that, overall, the generation mix risk of the sample group is reasonably similar to that of KU and LGE.

Therefore, in Mr. Hill's opinion, while distinctions can certainly be made in the relative operational and financial risks of generation sources, investors today do not place substantial weight on the generation fuel mix of an electric utility and he did not include that parameter as part of his similar-risk sample selection process. Finally, in Mr. Hill's opinion the selection parameters he did use (percentage of regulated electric revenues, merger status, dividend status, the presence of generation assets, financial stability, and bond rating) provide sufficient, reliable

measures to select utilities that are generally similar in risk to KU and LGE for the purpose of estimating the cost of common equity capital.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00161**

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	**CASE NO. 2011-00162**

RESPONSE OF
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.
TO THE COMMISSION STAFF'S FIRST SET OF
DATA REQUESTS

13. Refer to the Hill Testimony at page 34 and Exhibit (SGH-1) Schedule 5. In the context of a regulated utility proceeding, explain whether the use of earned returns on equity is circular and deterministic, especially for utilities with a high proportion of revenues from regulated operations.

RESPONSE:

The use of earned returns on common equity in an analysis of the long-term sustainable growth required in a DCF analysis is neither circular nor deterministic. Initially, it is important to understand that the earned return on equity is not equal to the cost of equity capital. The earned return (ROE) is the result of an historical accounting process, while the cost of common equity is a forward-looking, market-based concept based on investor expectations.

One reliable method historically used to determine investor expectations, set out originally by the originator of the DCF, Professor Myron Gordon, is the type of sustainable growth analysis

undertaken by Mr. Hill as part of his DCF growth rate estimate. While Mr. Hill uses many other growth rate indicators besides the sustainable growth rate, as he explains in Appendix B attached to his testimony, the sustainable growth method (which relies, in part on both historic and projected ROEs) represents the manner in which utility earnings and dividends actually grow over the long term. Utility investors are certainly aware of utility earned returns (they are widely published) and, while those accounting returns are not necessarily equal to the investors' required returns (the cost of equity capital) they are part of an investors' determination of what returns they might expect and, given the return they require, what stock price they should provide for a particular utility investment. Because those data are published and available to investors it is reasonable to consider those data in estimating the cost of equity capital.

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	CASE NO. 2011-00161

In the Matter of:

APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR CERTIFICATES OF PUBLIC CONVENIENCE AND NECESSITY AND APPROVAL OF ITS 2011 COMPLIANCE PLAN FOR RECOVERY BY ENVIRONMENTAL SURCHARGE	)	CASE NO. 2011-00162

RESPONSE OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC. TO THE COMMISSION STAFF'S FIRST SET OF DATA REQUESTS

For example, assume Utility A has a book value of $100, an allowed return of 10% and has earned a 10% return in the past and is expected to do so in the future. We also assume, for ease of exposition, that our utility pays out all earnings in dividends. Also assume that the opportunity cost of capital for utility equities—the return investors require for a utility investment—is 8% (different from either the allowed or earned return).

In our assumed situation, the investor would be willing to provide a market price of $125 for a utility that is expected to earn a 10% return on a $100 book value (or $10 in earnings/dividends), because that market price would provide the investor with his or her required return of 8% ($10/$125 = 8%). In that hypothetical situation, a DCF analysis based on Professor Gordon's sustainable growth methodology would show a dividend yield of 8% ($10 dividend /$125 stock price) and a growth rate of zero percent (retention ratio (0%--all earnings are paid out in

dividends) x expected ROE of 10% = 0%); and a DCF equity cost estimate of 8% (8% dividend yield + 0% growth). Therefore, the use of the earned return in a sustainable growth rate analysis does not produce an equity cost estimate equal to the earned return when market prices are different from book value (as they are in the current economic environment) and is neither deterministic nor circular. Finally, it should be noted that even when utility market prices are near book value, then investors' market return expectation (the cost of equity) is similar to the utility's expected return on book value, but that occurs not because the former is determined by the latter, but because investors' required market returns are similar to utility's earned returns.