



Ernie Fletcher
Governor

LaJuana S. Wilcher, Secretary
Environmental and Public
Protection Cabinet

Christopher L. Lilly
Commissioner
Department of Public Protection

Commonwealth of Kentucky
Public Service Commission
211 Sower Blvd.
P.O. Box 615
Frankfort, Kentucky 40602-0615
Telephone: (502) 564-3940
Fax: (502) 564-3460
psc.ky.gov

Mark David Goss
Chairman

Teresa J. Hill
Vice Chairman

Gregory Coker
Commissioner

February 2, 2006

Honorable Elizabeth E. Blackford
Assistant Attorney General
Office of the Attorney General Utility & Rate Intervention Division
1024 Capital Center Drive
Suite 200
Frankfort, KY 40601-8204

CERTIFICATE OF SERVICE

RE: Case No. 2005-00042
The Union Light, Heat and Power Company

I, Beth O'Donnell, Executive Director of the Public Service Commission, hereby certify that the enclosed attested copy of the Commission's Order in the above case was served upon the addressee by U.S. Mail on February 2, 2006.

Executive Director

BOD/jc
Enclosure

Honorable Elizabeth E. Blackford
Assistant Attorney General
Office of the Attorney General
Utility & Rate Intervention Division
1024 Capital Center Drive
Suite 200
Frankfort, KY 40601-8204

Honorable John J. Finnigan, Jr.
Senior Counsel
The Union Light, Heat and Power
Company
139 East Fourth Street
Cincinnati, OH 45202

Kate E. Moriarty
Attorney at Law
The Union Light, Heat and Power
Company
139 East Fourth Street
Cincinnati, OH 45202

John P. Steffen
Vice President, Rates
The Union Light, Heat and Power
Company
139 East Fourth Street
Cincinnati, OH 45202

Honorable Robert M. Watt, III
Attorney At Law
Stoll, Keenon & Park, LLP
300 West Vine Street
Suite 2100
Lexington, KY 40507-1801

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS RATES OF THE) CASE NO.
UNION LIGHT, HEAT AND POWER COMPANY) 2005-00042

O R D E R

On January 13, 2006, the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), filed a petition for rehearing on two issues addressed in the Commission's December 22, 2005 Order granting The Union Light, Heat and Power Company ("ULH&P") an increase in its gas base rates. Specifically, the AG seeks rehearing on the amount included as an expense for rate-making purposes for ULH&P's employee incentive plans and the Commission's determination that a return on equity may be recovered under the provisions of KRS 278.509. On January 31, 2006, ULH&P filed its memorandum in opposition to the AG's petition for rehearing.

On January 17, 2006, pursuant to the Commission's December 22, 2005 Order, ULH&P filed its refund plan. ULH&P requested that the Commission rule on its proposed refund plan no later than February 3, 2006 in order for it to perform the programming design and coding change associated with the refund.

Based on the petition and refund plan and being otherwise sufficiently advised, the Commission makes the following findings of fact on each issue raised on rehearing and the refund plan.

REHEARING ISSUES

Employee Incentive Plan Expenses

The December 22, 2005 Order provided that the \$656,697 in employee incentive plan¹ expenses be allocated between ratepayers and shareholders. As a result of the Commission's approved allocation, plan expenses included for rate-making purposes were reduced by \$294,290. In his petition for rehearing, the AG contended the decision was inconsistent with prior Commission decisions on incentive compensation and inconsistent with the reasoning expressed in the December 22, 2005 Order.

The AG contended that in prior Commission decisions involving employee incentive plans, the Commission had charged 100 percent of expenses related to corporate financial performance goals to shareholders. The AG stated that the Commission had made a similar finding in this case concerning the LTIP.²

The AG noted that the Corporate Goals component of the AIP was based on corporate financial performance goals. The AG stated that while 100 percent of the same goal in the LTIP was allocated to shareholders, the Commission allocated only 50 percent of the Corporate Goals component of the AIP to shareholders. The AG argued that, to be consistent, 100 percent of the Corporate Goals component expense should have been allocated to shareholders.³

¹ ULH&P has three employee incentive plans: the Annual Incentive Plan ("AIP"), the Long-Term Incentive Plan ("LTIP"), and the Union Employee's Incentive Plan ("UEIP").

² AG Petition for Rehearing at 2.

³ Id. at 2-3.

The AG noted that 100 percent of the UEIP had been allocated to ratepayers. The AG claimed that 50 percent of this plan was based on a corporate financial performance goals component and 50 percent based on a regulated business unit component. Based on his analysis of the components, the AG stated that 75 percent⁴ of the plan was based upon corporate financial performance goals, the same as for the other two employee incentive plans. The AG argued that to be consistent, 75 percent of the UEIP expenses should have been allocated to shareholders.⁵

In its memorandum ULH&P contended that the sharing of the employee incentive plan expenses contained in the December 22, 2005 Order was just and reasonable because ratepayers were required to pay for the portion of the incentive compensation expense that directly benefits ratepayers. While ULH&P noted that the Commission rejected its proposal to allocate any of the incentive plan expenses based on financial performance to ratepayers, it argued that the Commission did accept the allocation of incentive plan expenses related to individual and operational performance goals to ratepayers. ULH&P stated that the AG's petition for rehearing failed to provide convincing evidence that the original decision was unreasonable and the request should be rejected.

The Commission has reviewed the petition for rehearing, ULH&P's response, and the evidence of record, and finds that rehearing should be granted on this issue. While noting that the Commission had not permitted the allocation of incentive plan

⁴ The AG stated that the 75 percent reflects the 50 percent corporate financial performance goals component of the plan and 25 percent from the regulated business unit component, which reflected the corporate financial performance goal.

⁵ Id. at 4-5.

expenses related to corporate financial performance goals to ratepayers, ULH&P fails to recognize that these goals were part of the other incentive plan component goals. After reexamining the components and component goals of the AIP, we agree with the AG that 100 percent of the expense for the Corporate Goals component should be borne by shareholders rather than allocated 50 percent to shareholders and 50 percent to ratepayers as directed in our Order of December 22, 2005. As noted by the AG, this conclusion is consistent with our treatment of the corporate financial performance goals in the LTIP.

Concerning the UEIP, the Commission cannot find the basis for the component percentages referenced by the AG. ULH&P's testimony shows that the award percentages for the corporate measure, safety, and customer satisfaction components vary depending on the award levels achieved. ULH&P stated that the achievement level for 2004 corresponded to a 1.0 achievement level. Based on this information, the Commission concludes that 33 percent of the plan expenses are related to corporate financial performance goals and should be allocated to shareholders. The remaining 67 percent of the plan expenses are related to safety and customer satisfaction and should be allocated to ratepayers.⁶ Allocation of the UEIP expenses related to corporate financial performance goals to shareholders is consistent with the treatment of the LTIP.

Based on these findings, the Commission has recalculated the amount of employee incentive plan expenses included for rate-making purposes. The Commission finds that ULH&P's forward-looking test period expense of \$656,697

⁶ See Verhagen Direct Testimony at 12-14. Under an award level of 1.0, plan participants have a "total incentive opportunity" of 1.5 percent. This percentage is comprised of equal 0.5 percent values for the three plan components.

should be reduced by \$433,621, instead of the \$294,290 discussed in the December 22, 2005 Order.

The Commission also finds that the increase in revenues of \$8,090,750 contained in the December 22, 2005 Order should be reduced to \$7,951,186. This reflects the reduction in employee incentive plan expense, the income tax effects of that adjustment, and the gross-up applied when determining the total increase in revenues. The rates contained in Appendix A reflect the revised increase in revenues approved for ULH&P.

Cost Recoverable Under KRS 278.509

In the December 22, 2005 Order the Commission stated:

We further do not accept the AG's position that KRS 278.509 precludes or prohibits the inclusion of a component for return on investment in the AMRP. KRS 278.509 states:

Notwithstanding any other provision of law to the contrary, upon application by a regulated utility, the commission may allow recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility. No recovery shall be allowed unless the costs shall have been deemed by the commission to be fair, just, and reasonable.

It is generally accepted in rate-making that the return on an investment is properly considered part of the cost of that investment. The AG has failed to provide any legal authority or precedent for the exclusion of a return on utility plant investment that the Commission has determined to be reasonable.⁷

In his petition for rehearing, the AG argued that the ruling ignored the fact that KRS 278.509 is a cost recovery statute that must be implemented according to its own terms. The AG stated that a return on equity is not a cost but profit. He contended that KRS

⁷ December 22, 2005 Order at 70.

278.509 is a cost recovery statute that functions differently from fair, just, and reasonable rates by ensuring the production of net revenues rather than establishing a rate. The AG requested rehearing to exclude a return on equity from recovery under KRS 278.509.⁸

In its memorandum ULH&P stated that its next Accelerated Mains Replacement Program Rider will not be filed until March 2008 and recovery of the costs included in that filing will not begin until after the Commission rules on that filing. Consequently, it argued that until the Commission grants it a return on investment in that future case, this issue is not ripe for decision or appeal. If the Commission decides this issue is ripe for decision, ULH&P argued that by not explicitly identifying costs eligible for recovery, KRS 278.509 authorizes the Commission to approve a return on investment because of the general acceptance that cost of capital is a component of a utility's costs.

The Commission has reviewed the petition for rehearing, the response comments, and the evidence of record, and finds that rehearing should be denied on this issue. The AG's rehearing petition only restates and expands upon the arguments he previously presented to the Commission. The Commission gave full consideration to these arguments when it rendered its December decision. Accordingly, we find that rehearing on this issue should be denied.

REFUND PLAN

On September 30, 2005, ULH&P notified the Commission in writing that it planned to place its proposed rates into effect on October 1, 2005 pursuant to KRS 278.190(2). The Commission acknowledged ULH&P's decision and ordered it to keep

⁸ AG Petition for Rehearing at 5 and 6.

appropriate customer records in the event a refund was ordered. In its Order of December 22, 2005, the Commission directed ULH&P to file with the Commission a report on the amount of excess revenues collected from October 1, 2005 through the date of the order and to file a plan for refunding the excess revenues collected. It further directed ULH&P to include interest for the period the excess revenues were collected at the average of the Three Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release and to base the refunds on each customer's usage during the period the rates were in effect.

ULH&P determined that from October 1, 2005 through December 22, 2005 it collected excess revenues of \$1,242,876.96. After adding interest based on the average of the Three-Month Commercial Paper Rate, ULH&P proposes to refund \$1,244,803.82. The proposed refund plan provides for current customers to receive a one-time bill credit and former customers to receive payment by check. All refund amounts will be based on the customers' actual usage while ULH&P's proposed rates were in effect. ULH&P stated that if the Commission rules by February 3, 2006, the refunds adjustments would occur during one revenue period and allow it to complete the refund process within 60 days, as required by KRS 278.190(4).

ULH&P noted that the proposed Refund Plan provided reflected that a few of its General Service ("GS") customers owed ULH&P more due to the fact the Commission approved a lower customer charge but a higher commodity charge than ULH&P had proposed. ULH&P proposed to cancel these additional amounts and not charge these GS customers anything additional. ULH&P stated it was willing to cancel these charges

in order to avoid customer confusion. ULH&P calculated this amount to be \$18,788.39.⁹

The AG has filed no comments on ULH&P's proposed refund plan.

Concerning the GS customers, the Commission has reviewed the information provided by ULH&P and believes the situation reflects an extraordinary occurrence. We further believe that the changes in the customer charge and commodity charge resulted in the unintended consequence that some customers would actually owe ULH&P money during a period where rates were subject to refund. The Commission concludes that this event represents a unique situation.

KRS 278.190(2) provides in pertinent part:

If the proceeding has not been concluded and an order made at the expiration of five (5) months, or six (6) months, as appropriate, the utility may place the proposed change of rate, charge, classification, or service in effect at the end of that period after notifying the commission, in writing of its intention so to do. Where increased rates or charges are thus made effective, the commission may, by order require the interested utility or utilities to maintain their records in a manner as will enable them, or the commission, or any of its customers, to determine the amounts to be refunded and to whom due in the event a refund is ordered, and upon completion of the hearing and decision may, by further order, require such utility or utilities to refund to the persons in whose behalf the amounts were paid that portion of the increased rates or charges as by its decision shall be found unreasonable.

Emphasis added

We interpret the General Assembly's use of the term "may," which is permissive,¹⁰ to authorize the Commission, in its sound discretion, to determine whether a refund is appropriate in the event a utility collects revenues in excess of those found

⁹ ULH&P Refund Plan, Attachment A.

¹⁰ See KRS 446.010(20).

fair, just and reasonable at the conclusion of a rate proceeding. We also interpret the General Assembly's silence on the issue of under collection of revenues to indicate that it did not intend to authorize the Commission to order a utility to collect additional revenues in the event a utility places rates into effect that are lower than those approved at the conclusion of a rate proceeding. Therefore, the Commission finds that our decision on the proposed refund plan is limited to the reasonableness of the proposed refunds. On January 27, 2006, ULH&P filed, at the request of Commission Staff, calculations to support its proposed refunds. Having reviewed those calculations, and being otherwise sufficiently advised, we find that ULH&P's proposed refund plan is reasonable and that it should be approved as proposed.

IT IS THEREFORE ORDERED that:

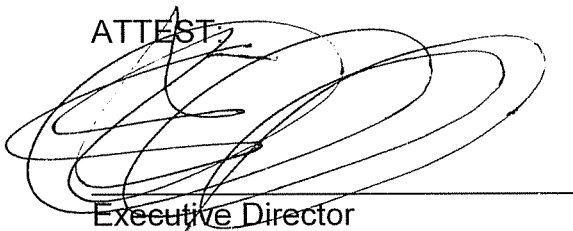
1. Rehearing is granted on the issue of the employee incentive plan expenses to the extent that the overall revenue deficiency for ULH&P is reduced from \$8,090,750 to \$7,951,186.
2. The base rates in Appendix A are approved for service on and after the date of this Order.
3. Rehearing is denied on the issue of the inclusion of a return on investment as a cost recoverable under KRS 278.509.
4. ULH&P's refund plan is approved as proposed.
5. ULH&P shall make its refunds to customers during the March 2006 revenue period, as it proposed, and ULH&P shall submit a report setting forth the amounts refunded no later than 30 days from completion of the refund.

6. ULH&P shall, within 20 days of the date of this Order, file its revised tariff sheets setting out the base rates approved herein.

Done at Frankfort, Kentucky, this 2nd day of February, 2006.

By the Commission

ATTEST



Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00042 DATED FEBRUARY 2, 2006

The following rates and charges are prescribed for the customers in the area served by The Union, Light, Heat and Power Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

	<u>Commodity Charge</u>	+	<u>Gas Cost Adjustment Rate</u>	=	<u>Total Rate</u>
Rate RS Residential Service					
Monthly Customer Charge					\$12.10 ¹
All Ccf	\$.26687		\$1.0336		\$1.30047
Rate GS General Service					
Monthly Customer Charge					\$30.00
All Ccf	\$.20949		\$1.0336		\$1.24309
Rate FT-L Firm Transportation Service					
Monthly Administrative Charge					\$430.00
All Ccf	\$.17713				
Rate IT Interruptible Transportation Service					
Monthly Administrative Charge					\$430.00
All Ccf	\$.07626				

¹ An increase of \$0.10 in the residential customer charge was approved in Case No. 2005-00402, The Annual Cost Recovery Filing for Demand Side Management by the Union Light, Heat and Power Company, Order dated January 31, 2005.