COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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PUBLIC SERVICE COMMISSION

IN THE MATTER OF:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIRONMENTAL SURCHARGE MECHANISM OF LOUISVILLE GAS AND ELECTRIC COMPANY FOR THE SIX-MONTH BILLING PERIODS ENDINGS OCTOBER 31, 2003, APRIL 30, 2004, OCTOBER 31, 2004, OCTOBER 31, 2005 AND APRIL 30 2006 AND FOR THE TWO-YEAR BILLING PERIOD ENDING APRIL 30, 2005)	**CASE NO: 2006-00130**

IN THE MATTER OF:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIRONMENTAL SURCHARGE MECHANISM OF KENTUCKY UTILITIES COMPANY FOR THE SIX-MONTH BILLING PERIODS ENDINGS JULY 31, 2003, JANUARY 31, 2004, JANUARY 31, 2005, JULY 31, 2005, AND JANUARY 31, 2006 AND FOR THE TWO-YEAR BILLING PERIOD ENDING JULY 31, 2004)	**CASE NO: 2006-00129**

INITIAL BRIEF OF KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

David F. Boehm, Esq.
Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph: (513) 421-2255 Fax: (513) 421-2764
E-Mail: dboehm@BKLlawfirm.com
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com

COUNSEL FOR KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

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I. SUMMARY OF ARGUMENT

Pursuant to KRS 278.183(3) every two years the Kentucky Public Service Commission ("Commission") is required, to the extent appropriate, to incorporate the existing environmental surcharge revenue requirement into base rates. While no base rate roll-in methodology is prescribed by law, KRS 278.030(1) requires that base rates be *"fair, just and reasonable."* The Supreme Court of Kentucky recognizes that the right of ratepayers to reasonable rates is fundamental. Except for states

that have deregulated and gone to market pricing, the almost universally recognized measuring stick for judging reasonableness is cost-of-service. Cost-of-service has long been recognized by this Commission as a fundamental regulatory principle and the touchstone of reasonable ratemaking.

In the record of this case there are five uncontested cost-of-service studies which all show that the existing base rates of Louisville Gas & Electric Company ("LG&E") and Kentucky Utilities Company ("KU") (collectively "the Companies") deviate substantially from cost-of-service. With no evidence to the contrary, reasonable minds cannot differ on this. Because the law requires that base rates be reasonable, and given the uncontradicted and overwhelming evidence that they are not, it would be unjust, unlawful and arbitrary for the Commission to change base rates without regard to cost-of-service.

As more of KU's and LG&E's revenue requirements are satisfied through the environmental surcharge, the frequency of traditional base rate cases is diminished. KU has initiated only two base rate cases in the last 20 years; and LG&E two in the last 15 years. This makes it all the more important for cost-of-service to be addressed here. Arguing that we should wait until the next base rate case and then start a gradual move toward cost-of-service is really code for saying that the goal is to never get to cost-of-service. KIUC is not arguing that cost-of-service must be blindly obeyed. But we are arguing that it cannot be ignored.

This case is fundamentally different from Case Nos. 2004-00426 and 2004-00421 where the Commission rejected KIUC's request to address base rate cost-of-service inequities through the imposition of multiple environmental surcharges. That proposal could have resulted in a greater allocation of environmental costs to the Kentucky retail jurisdiction and less to off-system sales. It also created concerns about the legality of multiple surcharges. Those are not issues now. Most importantly, here we are not attempting to address base rate inequities through the environmental surcharge; we are attempting to address base rate inequities through base rates.

The Commission should adopt the KU/LG&E alternative (cost-of-service) proposal to transfer the environmental surcharge revenue requirement into base rates. The KU/LG&E alternative proposal makes only a modest, gradual reduction in the huge subsidies currently being paid by the commercial and industrial customers to the residentials ratepayers. According to the Companies' cost-of-service study the annual KU residential subsidy is $45.8 million and the annual LG&E residential subsidy is $33.7 million. The KU/LG&E alternative (cost-of-service) base rate roll-in proposal would reduce only $5.0 million (11%) of the KU residential subsidy, and only $2.0 million (6%) of the LG&E residential subsidy.

The price of bringing rates closer to being reasonable (e.g., closer to cost) for any individual customer is small. Under the KU/LG&E cost-of-service proposal the increase to the average KU residential customer would be 73 cents per month (1.2%) and for the average LG&E residential customer 70 cents per month (1.0%). No one likes to have their subsidized service reduced, but given the facts of this particular record, the KU/LG&E proposal to do so gradually is appropriate.

II. INTRODUCTION AND PROCEDURAL BACKGROUND

On April 25, 2006, the Commission initiated the above-captioned proceeding to review the existing environmental surcharge of KU and LG&E and, pursuant to KRS 278.183(3), to the extent appropriate, incorporate existing environmental surcharge amounts found just and reasonable into base rates. The Commission ordered the Companies to file testimony establishing the reasonableness of any surcharge and proposing a methodology for incorporating the environmental surcharge revenue requirement into base rates.

The Companies filed the testimony of Steven Seelye who testified on the proper method of transferring the surcharge revenue requirement into base rates. Mr. Seelye is a widely respected national expert and former employee of LG&E. Mr. Seelye described two possible methodologies that the

Commission could use to allocate the roll-in amount to the different customer classes. The first methodology described by Mr. Seelye would allocate the roll-in amount to the customer classes on the basis of total revenues (referenced herein as the "revenue methodology").[1] This methodology allocates the surcharge amount to each customer class in an amount that approximately corresponds to the environmental surcharge revenue collected from each rate class over a 12-month period.

The second methodology presented, and the methodology that is recommended by the Companies, would allocate the surcharge revenue requirement among the customer classes in a way that gives some recognition to the inter-class rate subsidies that currently exist in LG&E's and KU's rates (referenced herein as the "cost-of-service methodology"). The Companies support this allocation methodology as a way to take another step in the important task of aligning rates more closely with cost-of-service. Mr. Seelye explains why an adoption of the cost-of-service methodology is appropriate in this roll-in case:

> *"Although the roll-in only deals with environmental-related costs, it would be reasonable to take this opportunity to correct some of the general subsidies that currently exist in the company's rates. A problem frequently encountered in trying to correct subsidies in a general rate case proceeding is that the subsidies are often too large to address in any meaningful way in a general rate case. Taking any significant steps toward alleviating the amount of rate subsidies paid by some rate classes would require that those rate classes benefiting from the subsidies - which are often residential customer classes - receive unacceptably high increases in a rate case. With a roll-in proceeding, the Commission has an opportunity to move rates closer to the cost of providing service, thus reducing the rate subsidies that exist in the current rate structure. Using a roll-in proceeding to correct rate subsidies would therefore be consistent with the recognized ratemaking principles of gradualism, rate continuity, and cost of service. We are therefore presenting for the Commission's consideration an alternative methodology that would allow the Commission to use the base-rate roll-in process to make gradual corrections to the subsidy problem rather than waiting until general rate cases to address the issue -- at which time, the measures necessary to reduce subsidies in any meaningful way could result in unacceptably large increases to the rate classes currently receiving rate subsidies."*[2]

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[1] Seelye Direct Testimony, p. 2 lines 12-18.
[2] Id. p. 3 lines 1-20.

The cost-of-service study relied upon by Mr. Seelye is the base-intermediate-peak (BIP) methodology used in the last KU/LG&E rate case, as adjusted to reflect the rate increase approved in that case. This study indicated, for example, that LG&E earned a rate of return of only 3.5% on the residential class while earning rates of return between 6% and 12% on commercial and industrial customer classes. For KU, the rate of return for residential customers was only 2.4% while commercial and industrial customers contributed to a rate of return between 8.3% and 16%.[3] Stated in dollars, Mr. Seelye's BIP cost-of-service study showed an annual KU residential subsidy of $45.8 million and an annual LG&E residential subsidy of $33.7 million.[4]

The subsidies contained in current rates, as demonstrated in the Companies' cost-of-service study, lead Mr. Seelye to the conclusion that "*with the class rates of return varying to this extent, it would be reasonable for the Commission to address the subsidy issue in transferring Environmental Surcharge revenue requirements into base rates.*"[5] Mr. Seelye supports his conclusion that the Commission should adopt the cost-of-service methodology with a detailed proposal for gradually moving rates toward cost-of-service through: 1) the interclass allocation of the transfer of the environmental surcharge revenue requirement into base rates; and 2) by allocating the primarily demand-related environmental costs that are the subject of these proceedings to the appropriate demand-related charges within the Companies' tariffs.[6] Step one, the allocation of the environmental surcharge revenue requirement, addresses the existing subsidies between rate classes. This would gradually allocate more of the environmental surcharge revenue requirement to the residential class and away from the business customers. Step two, the design of the rates for those commercial and industrial rate schedules which have a demand charge, only affects the particular customers on a given rate schedule.

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[3] Id. p. 4 lines 3-9, and Table 1.
[4] Baron Direct Testimony, Table 2 and Table 4.
[5] Seelye Direct Testimony. p. 5 lines 11-13.
[6] Id. pp. 10-15.

Step two more properly aligns costs within the commercial and industrial customer class and has no effect at all on residential customers.

KIUC supports the Companies' recommendation that the Commission should use the cost-of-service methodology when transferring the environmental surcharge revenue requirement into base-rates. KIUC conducted five separate cost-of-service studies. The first confirmed the accuracy of Mr. Seelye's BIP study. The next four (Average & Excess, Summer/Winter Peak, Single Coincident Peak, and 12 Month Coincident Peak) reached the same conclusions as the BIP study: huge subsidies are currently being paid by the commercial and industrial customers. Given the statutory requirement that rates be "*just and reasonable*"[7], the fundamental tenet of ratemaking that reasonableness is judged primarily on cost-of-service, and the new reality of ratemaking in Kentucky which has shifted cost-recovery toward the environmental surcharge and away from traditional rate cases, KIUC recommends that the Commission adopt the Companies' step one cost based allocation proposal. We also support the Companies' proposed step two rate design which would place the entire environmental surcharge revenue requirement on to the base rate demand charge for the commercial and industrial rate schedules.

III. ARGUMENT

1. The Companies' Base Rates Contain Significant Subsidies and Bear Little Relationship To Cost-Of-Service.

This is a case of first impression. KU/LG&E have never before proposed that the transfer of the environmental surcharge revenue requirement to base rates be done so as to move rates closer to cost-of-service. We support the Companies as their proposal is legally and economically sound.

The Companies' BIP cost-of-service study demonstrates that commercial and industrial customers are collectively paying large subsidies to the residential class under current rates. The five cost-of-service studies submitted by KIUC confirm the conclusion derived from the Companies' study.

[7] KRS 278.030(1).

Those five studies, which were conducted by KIUC expert witness Stephen Baron, show that the Companies' rates are not cost-based and contain subsidies that should be reduced. Each of these five methodologies, though they differ in their underlying cost causation foundation, showed that the Companies' large commercial and industrial customers were providing substantial subsidies to the Companies' residential customers.[8]

The Tables below show the current rates of return and dollar subsidies for each KU and LG&E rate schedule based on the Companies' BIP method which was confirmed by Mr. Baron and the four alternative cost of service methodologies (A&E, 1 CP, S/W CP and 12 CP) performed by Mr. Baron.[9] As can be seen from these tables, KU's and LG&E's rates continue to contain substantial subsidies, confirming Mr. Seelye's analysis using the BIP methodology.

Tables 1[10] and 2[11] show KU's current rates and the subsidies received/paid by the various customer classes respectively.

Table 1
KU Class Rates of Return at Rates Approved by the Commission
Case No. 2003-00434

Rate Class	BIP	A&E	SWCP	SCP	12CP
Residential	2.42%	2.22%	2.10%	3.07%	2.85%
General Service	8.67%	6.59%	7.94%	6.29%	6.79%
Combined Light & Power	12.01%	13.34%	12.78%	10.76%	11.25%
Large Comm/Ind TOD	8.32%	9.92%	10.35%	9.37%	8.41%
Coal Mining Power	15.68%	15.45%	17.45%	19.15%	14.30%
Large Power Mine Power TOD	12.72%	11.50%	14.22%	15.97%	12.19%
All Electric School	7.43%	4.84%	6.65%	4.46%	5.36%
Water Pumping	2.74%	4.89%	2.16%	2.59%	2.95%
Street Lighting	3.76%	3.54%	4.07%	5.18%	4.72%
NAS	16.24%	17.97%	12.40%	8.25%	21.38%
System Average	6.33%	6.33%	6.33%	6.33%	6.33%

[8] Baron Direct Testimony, p. 5 lines 5-17.
[9] Table 1 (KU) and Table 3 (LG&E), which show the subsidy dollars, also provide values for the BIP method.
[10] Baron Direct Testimony, p. 7.
[11] Id. p. 8.

Table 2 KU Class Subsidies Received and (Paid) Case No. 2003-00434					
Rate Class	BIP	A&E	SWCP	SCP	12CP
Residential	45,761,527	48,769,677	50,767,041	36,161,694	39,281,116
General Service	(5,663,758)	(727,454)	(4,074,716)	103,660	(1,251,802)
Combined Lt & Pw	(32,593,720)	(38,043,691)	(35,728,215)	(26,987,784)	(29,226,088)
Large Comm/Ind TOD	(4,429,416)	(7,389,406)	(8,039,935)	(6,389,825)	(4,614,040)
Coal Mining Power	(1,879,160)	(1,851,555)	(2,088,627)	(2,265,952)	(1,693,013)
LG Pw Mine Pw TOD	(988,471)	(846,217)	(1,143,592)	(1,301,892)	(927,972)
All Electric School	(151,542)	237,414	(45,791)	308,732	150,832
Water Pumping	131,413	45,195	160,307	138,764	121,875
Street Lighting	2,334,143	2,577,399	2,007,849	939,543	1,360,077
NAS	(2,521,016)	(2,771,363)	(1,814,319)	(706,939)	(3,200,986)

Tables 3[12] and 4[13] show LG&E's current rates and the subsidies received/paid by the various customer classes respectively.

Table 3 LG&E Class Rates of Return at Rates Approved by the Commission Case No. 2003-00433					
Rate Class	BIP	A&E	SWCP	SCP	12CP
Residential	3.45%	3.45%	2.92%	3.20%	4.11%
General Service	11.98%	9.32%	10.78%	8.24%	9.62%
Rate LC	10.00%	10.39%	10.10%	9.42%	8.35%
Rate LC-TOD	8.04%	9.25%	8.76%	8.76%	7.53%
Rate LP	11.52%	10.33%	12.68%	10.98%	9.87%
Rate LP-TOD	6.08%	7.15%	7.91%	10.41%	5.95%
Special Contract*	–	7.61%	9.09%	8.87%	7.73%
Lighting	3.45%	4.32%	5.50%	7.91%	6.77%
System Average		6.36%	6.36%	6.36%	6.36%

[12] Id.

[13] Id. p. 9.

*LG&E earned rates of return of 3.72%, 4.33% and 6.19% on its three special contract customers according to the Companies' BIP analysis.

Table 4
LG&E Class Subsidies Received and (Paid)
Case No. 2003-00433

Rate Class	BIP	A&E	SWCP	SCP	12CP
Residential	33,651,273	33,542,076	41,659,048	37,369,976	24,682,492
General Svc	(16,222,657)	(9,835,244)	(13,565,692)	(6,673,713)	(10,651,497)
Rate LC	(14,170,679)	(15,356,716)	(14,453,323)	(12,277,854)	(8,499,700)
Rate LC-TOD	(1,563,525)	(2,499,742)	(2,128,607)	(2,133,938)	(1,120,928)
Rate LP	(5,213,773)	(4,274,151)	(6,028,073)	(4,797,261)	(3,869,288)
Rate LP-TOD	2,866,817	(1,966,267)	(3,634,581)	(8,208,447)	1,088,695
Sp Contract	(864,381)	(1,246,885)	(2,479,906)	(2,306,493)	(1,348,361)
Lighting	1,516,925	1,636,929	631,135	(972,271)	(281,414)

No testimony or evidence has been submitted by any party in this proceeding disputing the results of the Companies' or KIUC's cost-of-service studies. Whether the Commission looks to the Companies' cost-of-service study or any one of KIUC's cost-of-service studies the conclusion is clear and uncontested; commercial and industrial customers continue to pay a considerable subsidy to residential customers in both service territories.

2. For Jurisdictions That Have Not Deregulated And Gone To Market Pricing, Cost-Of-Service Remains The Almost Universally Recognized Measure Of Reasonableness.

It is a fundamental tenet of ratemaking that rates should align as close as possible with cost-of-service. This is the resounding conclusion reached by this and other regulatory commissions, ratemaking experts and the testimony submitted in this case. Cost-of-service is synonymous with reasonableness. Conversely, rates that bear little relationship to the underlying cost to serve are not reasonable.

Commission precedent holds that cost-of-service is, and should be, the predominant consideration in setting rates.

> *"The Commission reemphasizes its concern that one segment of LG&E's operation that is earning an excessive rate of return should not subsidize a segment that is under earning. The customers of the individual gas and electric operations should pay no more or no less than the cost of service. ... The primary objective of a cost-of-service study is to determine the rates of return on a company's investment at present and proposed rates for each rate class. ... A cost-of-service study may also be used as a guide in developing an appropriate rate design for each customer class."* (emphasis added) (Case No. 2000-080, September 27, 2000 Order at 66.)

* * *

> *"Costs properly allocable to wholesale customers cannot, and must not, be reallocated to retail customers merely because such costs are not being recovered from wholesale customers. Reallocating such costs to retail customers violates the principle that costs be allocated to the cost-causer."* (emphasis added) (Case No. 2000-107, February 8, 2001 Order at 5.)

* * *

> *"To adopt Kentucky Power's proposal would require the Commission to abandon the bedrock principle of basing rates on cost causation. Nothing in the record justifies such a drastic step."* (emphasis added) (Case No. 2002-00169, March 1, 2003 Order at 39.)

* * *

> *"Assigning cost liability to the cost-causer is fundamental in utility regulation."* (emphasis added) (Kentucky Power Siting Board, Case No. 2002-00150, December 5, 2003 Order at 11.)

The Commission's belief in the importance of cost-of-service in setting rates is not limited to its own environmental surcharge and rate cases, but also characterizes the Commission's view on national energy policy. The Commission has consistently argued in proceedings at the FERC that interstate cost allocations should follow cost-of-service.[14] In the Commission's Initial Comments in FERC Docket No. RM1-12-000, concerning FERC's proposed Standard Market Design ("SMD") the Commission makes strong arguments that cost should be assigned on the basis of cost of service:

> *"It is of paramount importance that the costs associated with SMD be borne by those who benefit. Yet, the rules proposed in the SMD NOPR, if implemented, are certain to unfairly*

[14] FERC Docket No. RM01-12-000, Initial Comments of Kentucky Public Service Commission at p. 3-4.

increase the price paid by Kentucky retail ratepayers who would realize little, if any, benefit."[15]

* * *

"[T]*he* <u>*principle of cost causation*</u> *demands that the costs of developing a robust wholesale market be borne by the participants in the wholesale market, not by bundled retail ratepayers. Kentucky's utilities have been able to use the existing regulatory framework, which contemplates sales of excess power through bilateral contracts, with great success. Wholesale market participants and customers in retail choice states must be financially responsible for supporting the development of the market designed to serve them. However, previous FERC decisions on cost allocation favor spreading costs over a larger group of participants rather than just those who directly benefit. If success of competition hinges on socializing costs to customers who do not want it, have not asked for it, and do not benefit from it, then there is no reasonable justification for electricity restructuring.*

This <u>*principle of cost causation*</u> *is also applicable to the issue of transmission expansions and upgrades. These projects must be participant funded, with those who directly benefit paying the costs."* (emphasis added)[16]

This Commission's belief that federally regulated rates should be based on the "touchstone" of cost-of-service (absent compelling reasons to the contrary) was again advocated in Federal Court on appeal from FERC's Order setting of the rate of return for the MISO transmission owners. In the United States Court of Appeals for the District of Columbia, this Commission argued:

"While FERC's rate-setting discretion may be broad enough to encompass consideration of non-cost factors, <u>*departures from the cost-based touchstone require special justification*</u>*. ... FERC 'must specify the nature of the relevant non-cost factor and offer a reasoned explanation of how the factor justifies the resulting rates.'* <u>*Id.*</u> *(Internal punctuation omitted). Thus, when FERC departs from well-developed standards of cost-of-service ratemaking, it faces a heightened obligation to demonstrate that the departure is factually supported and narrowly tailored to serve statutory objectives."* <u>*Public Service Commission of Kentucky, et. al., v. FERC*</u>, United States Court of Appeals District of Columbia, Case Nos. 03-1092 and 03-1097, Initial Brief October 7, 2004 at p. 39. (Emphasis added).

It would be arbitrary and unreasonable for the Commission to criticize FERC for ignoring cost-of-service when setting interstate wholesale power and transmission rates, only to then share the same disregard when setting Kentucky retail rates.

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[15] <u>Id</u>. at p. 10.
[16] <u>Id</u>. at 12-13.

Commission policy concerning cost-of-service is consistent with the position of regulators [17] and utility scholars that cost of service should be the primary consideration in setting rates. The National Association of Regulatory Utility Commissions' ("NARUC"), a non-profit organization comprised of regulators in all fifty states, Electric Utility Cost Allocation Manual (January 1992) states:

> *"Cost of service studies are among the basic tools of ratemaking. While opinions vary on the appropriate methodologies to be used to perform cost studies, few analysts seriously question the standard that service should be provided at cost. Non-cost concepts and principles often modify the cost of service standard, but it remains the primary criterion for the reasonableness of rates."* (Id. p. 12.) (Emphasis added).

The most widely accepted authorities in the field of public utility regulation also follow the premise that the standard for measuring reasonableness is cost. *"Nevertheless, one standard of reasonable rates can fairly be said to outrank all others in the importance attached to it by experts and public opinion alike – the standard of costs of service. ..."* James C. Bonbright, Principles of Public Utility Rates, Second Edition 1988 at 109-110.

The testimony submitted by the Companies in this proceeding also contains a strong argument for setting rates based on cost-of-service. Company witness Mr. Seelye states on pages 8 and 9 of his Direct Testimony:

> *"Although there are a number of considerations in determining the level and structure of the rates that a utility should charge its customers, there are two basic principles of fairness used in designing utility rates that stand out above all of the others. The first principle of fairness is that customers should pay the costs that they impose on the system. It is generally recognized by both experts and non-experts alike that a utility's rates should reflect the cost of providing service. A cost of service study helps to determine what it costs to provide service to a class of customers so that this first principle can be applied. The second principle of fairness is that all customers should*

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[17] Re: Kentucky Utilities Co., 15 FERC ¶61,222 (1981). *"The Commission's long standing practice has been to base class revenue allocations on the cost-of-service."* The Rhode Island Supreme Court described cost-of-service as the "*golden rule*" of ratemaking and of "*paramount importance*" in rate design. 150 PUR 4th 31, 635 A.2d 1135 (R.I. Supreme Court, 1993). See also Connecticut Power and Light, 144 PUR 4th 161 (Connecticut Department of Public Utility Control, 1993) (Commission moved all rates of return closer to company average thus reducing cost-of-service differentials and improving the state's business climate); Re Niagara Mohawk Power Corp., 140 PUR 4th 481 (New York PSC, 1993) (Commission approved rate design based on cost-of-service study which resulted in residential rate increase of 5.8% versus industrial rate increase of 1.4%); Re North Carolina Power, 142 PUR 4th 117 (North Carolina PUC, 1993) (utility was directed to realign its rates to move toward equalized rates of return.

pay their fair share of the utility's margins (or operating income). While it is sometimes necessary to consider the value of service and the competitiveness of service, the starting point in assessing the reasonableness of the rates to be charged by a utility is to evaluate the cost of service.

Designing rates that reflect the cost of providing service helps ensure that customers pay their fair share of the utility's costs. In other words, implementing cost-based rates helps ensure that one class of customers does not subsidize another class of customers. From the perspective of inter-class and intra-class subsidies, cost-based rates are more equitable. Besides equity considerations, it is important for a utility's rates to send the right price signals to customers so that they can make informed decisions regarding their energy usage. Customers' usage patterns have a direct impact on the utility's costs, which in turn have a direct impact on the utility's rates. Therefore, with cost-based rates, customers are provided a proper price signal that reflects both the utility's costs and the results of their own purchase decisions. With cost-based rates, customers can make informed decisions based on the actual cost structure of the utility. When rates reflect the cost of providing service, the economics of a customer's decisions to purchase more or less of a utility service are aligned with the utility's economics, thus creating greater economic and engineering efficiencies for both the utility and its customers."

It is a fundamental tenet of ratemaking that service should be provided at cost, or as near as reasonably possible to cost. The Commission has long observed the importance of cost of service and has made strong arguments that cost of service should be a primary consideration in determining who should bear the costs associated with establishing interstate power markets and transmission rates. The Commission's position on this issue is supported by NARUC, other regulatory Commissions, ratemaking experts and the Companies' testimony in this case: rates that do not have a foundation in cost-of-serve are not fair, just and reasonable. This must be so or else ratemaking would be standardless and arbitrary.

While some may view cost-of-service as a quaint concept to be given mere lip service when it suits their other agendas, we take the concept more seriously. Ratepayers have a right to expect that the price of government-regulated public utility services will bear some reasonable relationship to the cost. This is sound public policy and sound economics. For whatever reason the rates of KU and LG&E have been allowed to drift away from their theoretical moorings. The only fair thing to do is to try to set things straight.

3. Kentucky Law Requires That Base Rates Be Reasonable And Reasonableness Is Measured Against Cost-Of-Service.

As demonstrated above, rates that do not reflect cost-of-service are not fair, just and reasonable according to the Commission, NARUC, and other regulatory experts. Kentucky law requires that the Commission set "*fair, just and reasonable rates*". KRS 278.030(1) states that "*[e]very utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person.*" This fundamental right has been recognized by the Supreme Court of Kentucky. "*Ratepayers have a right to expect reasonable utility rates. Regulators and utilities alike should respect that right.*" Kentucky Industrial Utility Customers v. Kentucky Utilities Co., 983 S.W. 2d, 493, 497 (Ky. 1998).

KRS 278.030 requires that when changing base-rates, through a roll-in or otherwise, the new rates must be fair, just and reasonable. The universal measuring stick of reasonableness is cost-of-service. Therefore, the Commission is compelled to consider cost-of-service when setting new base-rates through a surcharge roll-in. Given the uncontested facts of this record, to transfer the environmental surcharge revenue requirement to base rates without some recognition of cost-of-service would be unlawful, unreasonable and arbitrary.

4. The Transfer Of The Surcharge Revenue Requirement To Base Rates Using The "Revenue Methodology" Results In Base Rates That Are Not Fair, Just And Reasonable In Violation Of KRS 278.030.

Simply rolling in the current environmental surcharge into base-rates on a "revenue" basis does not result in fair, just and reasonable rates given the Companies' cost-of-service study and the four additional uncontested cost-of-service studies filed by KIUC. Each of these five studies demonstrates that the Companies' rates are not cost-based and that they contain significant subsidies.

The "revenue" method used in the past is a mere creature of convenience that deliberately ignores both cost causation and fairness. The revenue allocation method is a rule of thumb mechanism that is appropriate only when there is no cost-of-service information to otherwise guide the Commission. Allocating rate changes on the basis of total revenue maintains the existing relationships among rate classes as a way to maintain the status quo until cost-of-service can be examined. But maintaining the status quo is exactly what should not occur here. While the total revenue method is appropriate in the absence of any proof of inequity, such proofs have been made in this case and cannot be ignored. Convenience must yield to fairness.

5. KIUC Supports The Transfer Of The Environmental Surcharge Revenue Requirement Into Base Rates By The "Cost-Of-Service" Methodology Proposed By The Companies.

The Companies propose that the Commission roll-in the surcharge revenue requirement according to a method that helps reduce subsidies and aligns rates more closely with cost-of-service. As described in Mr. Seelye's Testimony, under the Companies' proposed cost-of-service methodology, the roll-in amount allocated to the customer classes under the revenue methodology would be adjusted by either a credit or charge depending on whether a class rate of return is above, below or roughly equal to its class cost-of-service.

Customer classes that do not pay or receive a subsidy under current rates will continue to be allocated costs according to the "revenue methodology."[18] These customer classes will not receive a credit or charge to correct for the rate subsidies that exist in base rates because their rates are approximately equal to cost-of-service under existing rates.[19]

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[18] According to the Direct Testimony of Steven Seelye at p. 10, customer classes with a rate of return falling between 5.36% and 7.36% for LG&E, and 5.33% and 7.33% for KU, would receive the revenue methodology allocation of the roll-in amount (i.e., the amount determined based on a base-rate allocation using the methodology applied in prior roll-in proceedings.)
[19] Seelye Direct Testimony, p. 10 lines 5-19.

For all customer classes with rates of return above cost of service (7.36% for LG&E and 7.33% for KU customer classes) the revenue methodology roll-in amount would be adjusted downward by a credit amount which lowers the roll-in amount that would otherwise be allocated to the customer class.[20]

For all customer classes with rates of return below cost-of-service (5.36% for LG&E and 5.33% for KU customer classes) the revenue methodology roll-in amount would be adjusted upward by a charge amount which increases the roll-in amount that would otherwise be allocated to the customer class.[21] The amount collected from the charges to the subsidized classes will be used to pay for the credit to the subsidizing classes on a dollar-for-dollar basis per the Companies' proposal.[22]

Although the cost-of-service methodology proposed by the Company provides a modest reduction in the subsidies paid by commercial and industrial customers, in the interest of gradualism it does not eliminate such subsidies. The Company proposes that the amount rolled-in to each class is at least 25% of the amount that would otherwise be allocated to that class under the revenue methodology even if that class would not have to pay any portion of the rolled-in amount if the roll-in were based purely on cost-of-service.[23] This ensures that customer classes that are currently being subsidized will only see a minor increase in their total bill.

For example, based on Mr. Seelye's KU exhibit WSS-2, the KU residential class is currently receiving a subsidy of $45.8 million from other ratepayers (*see* Table 2). The impact of the alternative ECR roll-in methodology is a reduction in this subsidy of $5 million, or about 11%. The corresponding numbers for LG&E are as follows: current annual residential subsidy of $33.7 million (*see* Table 4) with subsidy reduction proposal of $2.0 million (6%). At this rate of change the KU residential customers would no longer be subsidized after eight more base rate roll-ins. For the LG&E residential customers, it would take 15 more base rate roll-ins to finally bring the residential rates up to cost. This is gradualism by any

[20] Id. p. 10 lines 20-22.
[21] Id. p. 11 lines 1-4.
[22] Id. p. 11 lines 4-12.
[23] Id. p. 11 lines 14-20.

definition. KIUC believes that this results in a reasonable outcome for both the subsidized and subsidizing customer classes.[24]

The modest effect on rates is demonstrated in the Exhibits filed by Mr. Seelye that compare the average customer bills under the "revenue methodology" and the "cost-of-service methodology", which KIUC has converted into Tables 5 and 6 below. The tables below compare the average customer bill by rate class for LG&E and KU customers. The first vertical column shows the average bill at current rates before any roll-in. The next two columns compare average bills using the revenue methodology versus the cost-of-service methodology. The final column shows the percentage change the average customer would experience if the Commission adopted the cost-of-service methodology.

Table 5[25]
Kentucky Utilities
Comparison Of Average Monthly Bills By Customer Class Using
"Revenue Methodology" And "Cost-Of-Service Methodology"

Customer Class	Average Customer Bill As Of May 1, 2006	Average Customer Bill Using" Revenue Methodology"	Average Customer Bill Using Cost-Of-Service Methodology	Percent Change Between Average Customer Bill As Of May 1, 2006 And "Cost-Serve Methodology"
Residential	$60.32	$60.26	$61.05	1.2%
General Service	$106.08	$106.07	$105.63	-0.4%
LP-Secondary	$1,648.79	$1,651.61	$1,628.74	-1.2%
LP-Primary	$18,231.95	$18,217.93	$17,908.97	-1.7%
LP-Transmission	$43,527.37	$43,511.24	$42,955.35	-1.3%
LCI-TOD Primary	$238,814.02	$238,450.62	$238,043.36	-0.3%
LCI-TOD Transmission	$444,609.86	$444,433.53	$443,638.20	-0.2%

[24] Baron Direct Testimony, p. 14 lines 17-20, p. 15 lines 1-2.
[25] KU Response to Second Data Request of Commission Staff (June 29, 2006), Answer to Question 3, pp. 1-7.

Table 6[26]
Louisville Gas & Electric Company Utilities
Comparison Of Average Monthly Bills By Customer Class Using
"Revenue Methodology" And "Cost-Of-Service Methodology"

Customer Class	Average Customer Bill As Of May 1, 2006	Average Customer Bill Using" Revenue Methodology"	Average Customer Bill Using Cost-Of-Service Methodology	Percent Change Between Average Customer Bill As Of May 1, 2006 And "Cost-Serve Methodology"
Residential	$68.39	$68.61	$69.09	1.0%
General Service	$110.60	$110.98	$109.90	-0.6%
LP-Secondary	$3,511.51	$3,524.73	$3,503.16	-0.2%
LP-Primary	$12,874.72	$12,930.14	$12,847.58	-0.2%

Under the cost-of-service roll-in, KU residential customers would see their bills on average increase by only about 1.2% (73 cents per month) and 1% for LG&E (70 cents per month). Given the substantial subsidy paid by the other classes to the Residential Class, this slight increase is justified.

6. KIUC Supports The Companies' Proposal To Recover The Primarily Demand-Related Environmental Costs At Issue Through The Demand-Related Charges Contained In The Companies' Tariffs.

Independent of its rate allocation proposal, the Companies propose to recover the roll-in amount entirely through the energy charge for rate schedules (primarily residential) that contain only a customer charge and energy charge. For rate schedules (primarily commercial and industrial) that have customer, energy and demand charges the Companies propose to recover the entire roll-in amount through the demand charge.[27] Company witness Mr. Seelye explains that *"because these costs are predominately fixed production costs, we believe that it is appropriate to recover these costs through the fixed demand charge rather than through the customer charge or energy charge of the rate."*[28]

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[26] LG&E Response to Second Data Request of Commission Staff (June 29, 2006), Answer to Question 4, pp. 1-4.
[27] Seelye Direct Testimony, pp. 14-15. For lighting rates that consist only of a charge per fixture, the roll-in amount allocated to the lighting rates would be recovered through the charge per fixture, as in prior roll-ins.
[28] Id. p. 15, lines 3-5.

KIUC agrees with the Companies that this rate design is reasonable. The Companies' characterization of the environmental surcharge costs being rolled into base rates in this case as demand-related is sound. The NARUC Electric Utility Cost Allocation Manual states that *"[c]osts that are based on the generating capacity of the plant, such as depreciation, debt service and return on investment, are demand-related costs."* (Id. p. 21). The costs that are the subject of this case (primarily costs associated with the construction and installation of scrubbers, SCRs, etc.) clearly fall into this category.

Allocating these environmental costs to the demand charge is sound ratemaking policy that is consistent with Commission precedent.[29] Allocating the environmental costs at issue in this case to anything other than the demand charge understates the economic cost of demand-related assets, which in turn distorts consumption decisions, and calls forth a greater level of investment in fixed assets than is economically desirable. When this happens, higher-load-factor customers on a given rate schedule that use fixed assets efficiently through relatively constant energy usage are forced to pay the demand-related costs of lower-load-factor customers on the same rate schedule. This amounts to a cross-subsidy among customers on the same rate schedule that decreases the efficiency of the system as a whole by unfairly penalizing the very type of customers that the Companies and the Commission should encourage: high load-factor customers.

KIUC recommends that the Commission adopt the Companies' proposal to allocate the rolled-in costs to the cost-causers within each rate schedule. The demand-related costs being recovered through the environmental surcharge should be recovered through the demand charge of the Companies' tariffs that contain a demand charge. This rate design proposal will only affect the commercial or industrial customers on a particular rate schedule. It has no impact on residential customers.

[29] Baron Direct Testimony, p. 15, lines 1-6.

7. Unlike The Prior Case Where KIUC Attempted To Address Base Rate Inequities Through The Environmental Surcharge Itself; Here LG&E/KU And KIUC Are Attempting To Address Base Rate Inequities Through Base Rates.

In the Companies' recent environmental surcharge and compliance plan approval cases (Case Nos. 2004-00426 and 2004-00421), the Commission denied KIUC's proposal to impose multiple different surcharges on different customer classes in order to address the cost of service inequities embedded in base rates. Though the Commission recognized that the Companies' base rates did not reflect cost of service, the Commission found that the environmental surcharge was not the appropriate forum to address such issues.

KU and LG&E believe, and KIUC agrees, that this proceeding in which the Commission will directly change base rates is an appropriate venue to address base rate cost-of-service discrepancies. This case is fundamentally different from the prior one. Here we are not attempting to address base rate cost-of-service inequities through the surcharge; we are attempting to address base rate inequities through base rates. There is no legal or policy roadblock to making base rates more reasonable (e.g., bringing them closer to cost-of-service) in a proceeding whose explicit purpose is to change base rates.

Also, the concerns expressed by the Commission in the prior case are not present here. In its Order in the prior surcharge case, the Commission indicated that it was concerned with the jurisdictional allocation issue under the KIUC proposal, which the Commission believed could have resulted in a shifting of costs to the retail jurisdiction and an increase in Kentucky retail environmental surcharge revenue requirements.[30] Any proposal that may have shifted environmental costs away from off-system sales and to Kentucky retail ratepayers has obvious drawbacks. However, there is no jurisdictional revenue requirement "issue" in the instant roll-in cases since the environmental surcharge roll-in only involves retail revenue requirements.

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[30] KPSC Case Nos. 2004-00426, Order of June 20, 2005 pp. 29-31

The second concern raised by the Commission in the prior Order related to the legality of multiple environmental surcharges (and therefore multiple true-ups) under the KIUC recommendation.[31] The Attorney General took the position that multiple surcharges are illegal and that the Commission is prohibited from addressing base rate cost-of-service issues through the surcharge itself. No such limit on the Commission's ratemaking authority is presented here. In fact we believe the opposite is true. That is, in the establishment of new base rates the Commission must consider whether the new rates are "*fair, just and reasonable*" as measured against some non-arbitrary, measurable standard. Except for jurisdictions that have gone to market pricing that standard has long been recognized to be cost-of-service.

8. The Growing Reliance On Environmental Surcharge Recovery By KU/LG&E Necessitates That The Commission Consider Cost-Of-Service In This Environmental Surcharge Roll-In Proceeding.

It is particularly important to address cost-of-service in this roll-in proceeding because Kentucky's environmental surcharge has shifted a large amount of the Companies' cost recovery away from traditional rate cases. For example, in KU's last environmental surcharge proceeding, it requested, and was granted, surcharge recovery by 2009 of almost $100 million dollars (prior to jurisdictional allocations) in order to recover environmental capital costs of approximately $700 million. This amounted to almost double the base rate increase awarded to KU in its last base rate case.[32] The practical effect of the recovery of such a large portion of the Companies' costs through surcharge cases, rather than base rate cases, is that base rate cases will become less and less frequent. KU has initiated only two base rate cases in the past 20 years, LG&E has initiated only two base rate cases in the past 15 years. Therefore, it is imperative that the Commission address cost-of-service when these large surcharge amounts are rolled into base rates. Any other result would effectively deprive customer classes that are paying large subsidies to other classes of any means to address those subsidies.

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[31] Id.

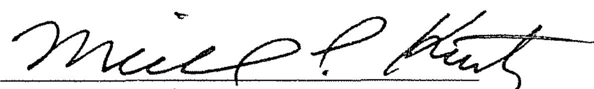
[32] Case Nos. 2004-00426, 00421, Response to Staff Set One, Item 3 at p. 4 of 4.

Each of the Companies is expected to continue filing for environmental surcharge increases. The Companies have projected that KU will collect an additional \$86.5 million and \$30.6 million for LG&E in environmental surcharge revenue over the first 12 months after the roll-in.[33] These environmental surcharge increases may be the primary source of rate changes for each Company for the foreseeable future. Indeed, a substantial amount of the Trimble County Two construction costs are environmental and will be collected via surcharge. The Commission has an opportunity in these KU and LG&E roll-in cases to move each Company's rates towards cost of service in a gradual manner. The methodology proposed by the Companies in Mr. Seelye's testimony represents a reasonable approach to reducing subsidies, while recognizing the ratemaking principle of gradualism.

IV. CONCLUSION

WHEREFORE, for the reasons set forth herein, this Honorable Commission should adopt the cost-of-service base rate roll-in proposal of LG&E and KU.

Respectfully submitted,



David F. Boehm, Esq.
Michael L. Kurtz, Esq.
Kurt J. Boehm, Esq.
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Ph: (513) 421-2255 Fax: (513) 421-2764
E-Mail: mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com

COUNSEL FOR KENTUCKY INDUSTRIAL UTILITY CUSTOMERS, INC.

September 28, 2006

[33] KU Response to First Data Request of KIUC (June 27, 2006) answer to Question 5; and LG&E Response to First Data Request of KIUC (June 30, 2006), answer to Question 5.