STOLL·KEENON·OGDEN
PLLC

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

KENDRICK R. RIGGS
DIRECT DIAL 502-560-4222
DIRECT FAX 502-627-8722
kendrick.riggs@skofirm.com

September 28, 2006

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PUBLIC SERVICE COMMISSION

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

RE: ***An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Utilities Company for the Six-Month Billing Periods Ending 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***
KPSC Case No. 2006-00129

An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Louisville Gas and Electric Company for the Six-Month Billing Periods Ending 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
KPSC Case No. 2006-00130

Dear Ms. O'Donnell:

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

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

Very truly yours,

Kendrick R. Riggs

KRR/ec
Enclosures
cc: Elizabeth E. Blackford, Esq. (w/ enclosure)
Michael L. Kurtz, Esq. (w/ enclosure)
Elizabeth L. Cocanougher, Esq. (w/ enclosure)
Kent W. Blake (w/ enclosure)

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

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 ENDING 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**

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 ENDING 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**

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

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

Elizabeth L. Cocanougher
Senior Corporate Attorney
E.ON U.S. LLC
220 West Main Street
Louisville, Kentucky 40202
Telephone: (502) 627-4850

Counsel for Kentucky Utilities Company
and Louisville Gas and Electric Company

FILED: **September 28, 2006**

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing Joint Brief was served on the following parties of record this 28th day of September 2006, by mailing a copy thereof, postage prepaid, via U.S. mail to:

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

Elizabeth E. Blackford
Assistant Attorney General
Office of the Attorney General
Office of Rate Intervention
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601-8204

Counsel for Kentucky Utilities Company
and Louisville Gas and Electric Company

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COMMONWEALTH OF KENTUCKY

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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 ENDING 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

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

Kentucky Utilities Company ("KU") and Louisville Gas and Electric Company ("LG&E") (collectively, the "Companies"), for their Joint Brief, state as follows:

I. INTRODUCTION

The purpose of these proceedings is to review the past operation of the environmental surcharge KU billed during the five six-month billing periods ending July 31, 2003, January 31, 2004, January 31, 2005, July 31, 2005 and January 31, 2006, and the two-year billing period ended July 31, 2004. In the Commission's Order issued May 22, 2006, the Commission granted KU's motion to expand the current 6-month review of KU's environmental surcharge mechanism to include the billing period from February 1, 2006 through April 30, 2006 and expand the scope of the current 2-year review of KU's environmental surcharge mechanism to include the billing period from August 1, 2004 through April 30, 2005.

The purpose of these proceedings is also to review the past operation of the environmental surcharge LG&E billed during the six-month billing periods ending October 31, 2003, April 30, 2004, October 31, 2004, October 31, 2005, and April 30, 2006 and the two year billing period ending April 30, 2005, as well as to determine the appropriate amount of environmental surcharge revenue to incorporate into base rates for both Companies through a "roll-in" of environmental costs and expenses.

The Companies submit that their under-collected amounts, proposed roll-in amounts, suggested roll-in methodologies, and rates of return are reasonable and supported by the record of these proceedings. The Companies therefore request that the Commission:

a. Approve KU's proposed increase to its Environmental Surcharge Revenue Requirement of $63,663 in the first four billing months following the Commission's decision in this proceeding, and likewise approve LG&E's proposed increase to its Environmental Surcharge Revenue Requirement of $662,267 in the first four billing months following the Commission's decision in these proceedings;

b. Find environmental surcharge amounts for the two-year billing period ending April 2005 to be just and reasonable;

c. Find that LG&E should eliminate the expense reduction ordered in Case No. 2002-00147 from its monthly ECR filings beginning with the expense month of July 1, 2004;

d. Approve $23,731,313 (KU) and $8,669,729 (LG&E) to be the amounts to be incorporated into base electric rates for bills rendered on and after the second full billing month following the month in which an order is received in these cases;

e. Decide as a matter of policy whether the Environmental Surcharge mechanism should be used to address the inter-class rate subsidies that currently exist in the Companies' base rates and based on that decision approve either the use of allocating the roll-in amount on the basis of class base rate revenues or a methodology that allocates the roll-in amount in a way that gives some recognition to the inter-class rate subsidies that currently exist in base rates;

f. Reset the Companies' Base Environmental Surcharge Factors to amounts based on the roll-in amounts and base revenues from the most recent 12-month period available following the Commission's Order in these proceedings; and

g. Establish the rate of return for KU's Post-1994 Plan to be 11.52%, and the rate of return for LG&E's Post-1995 Plan to be 11.23%.

II. OVER- AND UNDER-COLLECTION

A. KU

KU billed an environmental surcharge to its customers from February 1, 2003 through April 30, 2006.[1] For purposes of the Commission's examination in this case, the monthly KU environmental surcharges are considered as the five six-month billing periods ended July 31, 2003; January 31, 2004; January 31, 2005; July 31, 2005 and January 31, 2006 (as extended to April 30, 2006 by the Commission's Order issued May 22, 2006), as well as the sixth six-month billing period ending July 31, 2004, which is part of the two-year billing period ending July 31, 2004 (as extended to February 28, 2005, by the Commission's Order issued May 22, 2006).[2] In each month of all of these periods, KU calculated the environmental surcharge factors by using

[1] *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 Ending 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, Direct Testimony of Robert M. Conroy ("Conroy KU") at 2 (June 19, 2006).
[2] Conroy KU at 2.

the costs incurred as recorded on its books and records for the expense months of December 2002 through February 2006.[3]

As a result of the operation of the environmental surcharge during the billing periods under review, KU experienced a cumulative under-recovery of $254,652 for the billing periods ending April 30, 2006.[4] Therefore, an adjustment to the revenue requirement is necessary to reconcile the collection of past surcharge revenues with actual costs for the billing periods under review.[5]

KU proposes to recover over the four months following the Commission's Order in Case No. 2006-00129 the cumulative under-recovery of $254,652.[6] Specifically, KU recommends that the Commission approve the increase of the Environmental Surcharge Revenue Requirement by $63,663 per month beginning in the first full billing month following the Commission's Order in this proceeding.[7] This method is consistent with the method of implementing previous over- or under-recovery positions in prior ECR review cases.[8]

B. LG&E

LG&E billed an environmental surcharge to its customers from May 1, 2003 through April 30, 2006.[9] For purposes of the Commission's examination in this case, the monthly LG&E environmental surcharges are considered as the five six-month billing periods ended October 31, 2003; April 30, 2004; October 31, 2004; October 31, 2005 and April 30, 2006, as well as the

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[3] Conroy KU at 2-3.
[4] Conroy KU at 3. KU's response to Question No. 3 of the Commission Staff Request for Information shows the calculation of the $254,652 cumulative under-recovery.
[5] Conroy KU at 3.
[6] Conroy KU at 5.
[7] Conroy KU at 5.
[8] Conroy KU at 5.
[9] *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 Ending 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, Direct Testimony of Robert M. Conroy ("Conroy LG&E") at 2 (June 19, 2006).

sixth six-month billing period which is the final six month period in the two-year billing period ending April 30, 2005.[10] In each month of these periods, LG&E calculated the environmental surcharge factors by using the costs incurred as recorded on its books and records for the expense months of March 2003 through February 2006.[11]

As a result of the operation of the environmental surcharge during the billing periods under review, LG&E experienced a cumulative under-recovery of $2,649,068 for the billing periods ending April 30, 2006.[12] Therefore, an adjustment to the revenue requirement is necessary to reconcile the collection of past surcharge revenues with actual costs for the billing periods under review.[13]

LG&E proposes to recover over the four months following the Commission's Order in Case No. 2006-00130 the cumulative under-recovery of $2,649,068.[14] Specifically, LG&E recommends that the Commission approve the increase of the Environmental Surcharge Revenue Requirement by $662,267 per month, beginning in the first full billing month following the Commission's Order in this proceeding.[15] This method is consistent with the method of implementing previous over- or under-recovery positions in prior ECR review cases.[16]

III. THE ROLL-IN AMOUNTS ARE REASONABLE

The evidence of record shows the roll-in amounts and Base Environmental Surcharge Factors (BESF) provided by KU and LG&E are reasonable.

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[10] Conroy LG&E at 2.
[11] Conroy LG&E at 2.
[12] Conroy LG&E at 2. LG&E's response to Question No. 2 of the Commission Staff Request for Information shows the calculation of the $2,649,068 cumulative under-recovery.
[13] Conroy LG&E at 2-3.
[14] Conroy LG&E at 5.
[15] Conroy LG&E at 5.
[16] Conroy LG&E at 6.

A. KU's Roll-In Amount Is Reasonable

The Commission should approve the incorporation into KU's base electric rates the environmental surcharge amounts found just and reasonable for the two-year billing period, as extended by the Commission's Order issued May 22, 2006, ending April 2005. KU recommends that a surcharge amount of $23,731,313 be incorporated into base rates at the conclusion of this case.[17] KU determined the roll-in amount of $23,731,313 using the base-current methodology as proposed by Commission Staff and further recommends adoption of the base-current methodology to calculate the monthly environmental surcharge factors going forward.[18] Although KU's recommendation to incorporate $23,731,313 into base rates will increase base rates, it will simultaneously reduce ECR revenues by an equal amount.[19] Therefore, there will be no net impact on KU's revenue requirement.[20]

B. LG&E's Roll-In Amount Is Reasonable

The Commission should likewise approve the incorporation into LG&E's base electric rates the environmental surcharge amounts found just and reasonable for the two-year billing period ending April 2005. LG&E recommends that a surcharge amount of $8,669,729 be incorporated into base rates at the conclusion of this case.[21] LG&E determined the roll-in amount of $8,669,729 using the base-current methodology as proposed by Commission Staff and further recommends adoption of the base-current methodology to calculate the monthly environmental surcharge factors going forward.[22] Although LG&E's recommendation to incorporate the recommended surcharge amounts into base rates will increase base rates, it will

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[17] Conroy KU at 6.
[18] Conroy KU at 6. The details of this methodology and the calculation of the amount are presented as attachments to KU's response to Question No. 12 to the Commission Staff Request for Information.
[19] Conroy KU at 8.
[20] Conroy KU at 8.
[21] Conroy LG&E at 7.
[22] Conroy LG&E at 7. The details of this methodology and the calculation of the amount are presented as attachments to LG&E's response to Question No. 11 to the Commission Staff Request for Information.

simultaneously reduce ECR revenues by an equal amount.[23] Therefore, there will be no impact on LG&E's revenue requirement. [24]

C. The Companies' Base Environmental Surcharge Factors (BESF) Will Be Determined Using Latest Twelve Months within Issuance of KPSC Order

The Companies calculated, and propose to use, a new BESF for KU, using base revenues for the 12 months ending February 2006, of 3.21%.[25] The Companies likewise calculated, and propose to use, a new BESF for LG&E, using base revenues for the 12-months ending February 2006, of 3.36%.[26] However, the actual BESF will be calculated using base revenues for the 12-month period ending with the month preceding the month in which the Commission issues an order approving the roll-in.[27] The timing and method KU and LG&E will use to determine the final BESF is consistent with the Commission's Order in Case No. 2003-00068.[28]

IV. ROLL-IN METHODOLOGY

The Commission previously approved the Companies' proposed roll-in methodology as part of the approval of written unanimous settlements that spread the amount of the roll-in equally to every tariff subject to the environmental surcharge.[29] In these proceedings, in response to the Commission's inquiries, the Companies present two roll-in methodologies for the Commission's consideration -- the revenue methodology and an alternative methodology for

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[23] Conroy LG&E at 8.
[24] Conroy LG&E at 8.
[25] Conroy KU at 8.
[26] Conroy LG&E at 9.
[27] Conroy KU at 8; Conroy LG&E at 9.
[28] Conroy KU at 8; Conroy LG&E at 9.
[29] *See 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 Ending January 31, 200, July 31, 2001, January 31, 2002, and January 31, 2003, and for the Two-Year Billing Periods Ending July 31, 2000, and July 31, 2002,* Case No. 2003-00068, Order (October 17, 2003) (approving unanimous written settlement spreading amount of roll-in equally to every tariff subject to environmental surcharge); *In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Louisville Gas and Electric Company for the Two-Year Billing Period Ending April 30, 2003,* Case No. 2003-00236, Order (December 11, 2003) (spreading amount of roll-in equally to every tariff subject to environmental surcharge).

allocating the roll-in amounts to the various classes of service in a way that gives some recognition to the inter-class rate subsidies that currently exist in the Companies' base rates. Though either method will effectively incorporate the correct amount of the surcharge revenues and expenses into base rates, the appropriateness of either method is a policy question for this Commission. In previous environmental surcharge proceedings, the Attorney General and the Kentucky Industrial Utility Customers, representing their respective interests, have advanced proposals for correcting inter-class subsidies or have challenged any such movements toward addressing inter-class subsidies.[30] The Companies will be guided by the Commission's decision in this case on whether the change in base rates associated with the ECR roll-in should be accomplished in a way that gives some recognition to the inter-class rate subsidies in current base rates.

A. The Revenue Method

This first approach, quite familiar to the Commission because it is the methodology used in prior roll-in proceedings, would allocate the Companies' roll-in amounts to the classes of service on the basis of base-rate revenues. "Base-rate revenues" are the revenues determined from the application of the company's base rates to test-year billing units and therefore exclude the application of all surcharges or surcredits from other cost recovery mechanisms, such as the fuel adjustment clause. Such an approach would have no impact on any subsidies currently built into base rates.

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[30] *See, e.g., In the Matter of the Application of Louisville Gas and Electric Company for Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge*, Case No. 2004-00421, and *In the Matter of the Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct Flue Gas Desulphurization Systems and Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge*, Case No. 2004-00426, Post-Hearing Brief of the Attorney General at 10-15 (May 31, 2005); *In the Matter of the Application of Louisville Gas and Electric Company for Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge*, Case No. 2004-00421, and *In the Matter of the Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct Flue Gas Desulphurization Systems and Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge*, Case No. 2004-00426, Brief of Kentucky Industrial Utility Customers, Inc., at 3-19 (May 31, 2005).

B. The Alternative Method

As an alternative to simply allocating the roll-in amount on the basis of base rate revenues, the Companies also present an allocation methodology for the Commission's consideration that would allocate the roll-in amount in a way that gives some recognition to the inter-class rate subsidies that currently exist in the Companies' rates. 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.[31] The first principle of fairness is that customers should pay the costs that they impose on the system.[32] It is generally recognized by both experts and non-experts alike that a utility's rates should reflect the cost of providing service.[33] The second principle of fairness is that all customers should pay their fair share of their utility's margins (or operating income).[34] Though 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.[35]

Designing rates that reflect the cost of providing service helps ensure that customers pay their fair share of the utility's costs.[36] In other words, implementing cost-based rates helps ensure that one class of customers does not subsidize another class of customers.[37] The

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[31] *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 Ending 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, Direct Testimony of William Steven Seelye ("Seelye LG&E") at 8 (June 14, 2006); *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 Ending 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, Direct Testimony of William Steven Seelye ("Seelye KU") at 8 (June 14, 2006).
[32] Seelye LG&E at 8; Seelye KU at 8.
[33] Seelye LG&E at 8; Seelye KU at 8.
[34] Seelye LG&E at 8; Seelye KU at 8.
[35] Seelye LG&E at 8-9; Seelye KU at 8-9.
[36] Seelye LG&E at 9; Seelye KU at 9.
[37] Seelye LG&E at 9; Seelye KU at 9.

Companies' current base rates contain subsidies between various rate classes, as the tables that follow show:[38]

TABLE 1 Kentucky Utilities Company Summary of Class Rates of Return Based on Service Rates Approved by the Commission in Case No. 2003-00434	
Rate Class	**Rate of Return**
Residential	2.42%
General Service	8.67%
Combined Light & Power	12.01%
Large Comm/Ind TOD	8.32%
Coal Mining Power	15.68%
Large Power Mine Power TOD	12.72%
All Electric School	7.43%
Water Pumping	2.74%
Street Lighting	3.76%
NAS	16.24%
Total	**6.33%**

TABLE 2 Louisville Gas and Electric Company Summary of Class Rates of Return Based on Service Rates Approved by the Commission in Case No. 2003-00433	
Rate Class	**Rate of Return**
Residential	3.45%
General Service	11.98%
Rate LC	10.00%
Rate LC-TOD	8.04%
Rate LP	11.52%
Rate LP-TOD	6.08%
Special Contract	3.72%
Special Contract	4.33%
Special Contract	6.19%
Lighting	3.45%
Total	**6.36%**

[38] Table 1: Seelye KU at 4. Table 2: Seelye LG&E at 4.

Under the Companies' proposed alternative 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 falls outside of a range of plus or minus 100 basis points around the overall rates of return for KU and LG&E.[39] For KU, customer classes with a rate of return falling between 5.33% and 7.33% 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).[40] In other words, customer classes with a rate of return between 5.33% and 7.33% will not receive a credit or charge to correct for the rate subsidies that exist in base rates.[41] Likewise for LG&E, customer classes with a rate of return falling between 5.36% and 7.36% 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).[42] In other words, customer classes with a rate of return between 5.36% and 7.36% will not receive a credit or charge to correct for the rate subsidies that exist in base rates.[43] If a class rate of return is within plus or minus 100 basis points of the overall rate of return then the service rates can be considered to reasonably reflect the cost of providing service.[44]

For all customer classes with rates of return above the range – i.e., above 7.33% for KU and 7.36% for LG&E -- 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.[45] For all customer classes with rates of return below the range – i.e., below

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[39] Seelye KU at 10; Seelye LG&E at 10.
[40] Seelye KU at 10.
[41] Seelye KU at 10.
[42] Seelye LG&E at 10.
[43] Seelye LG&E at 10.
[44] Seelye KU at 10; Seelye LG&E at 10.
[45] Seelye KU at 10; Seelye LG&E at 10.

5.33% for KU and 5.36% for LG&E -- 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.[46] Under the alternative methodology for KU, $5,173,724 of the total roll-in amount of $23,731,313 would be used to correct the subsidies that currently exist in base rates.[47] The $5,173,724 correction for KU would be allocated as a credit to those rate classes with rates of return above 7.33% based on the total amount of subsidy above this threshold rate of return paid by each customer class.[48] Similarly, the $5,173,724 correction would be allocated as a charge to those rate classes with rates of return below 5.33% on the basis of the total subsidy below 5.33% received by each customer class.[49] Likewise for LG&E, under the alternative methodology, $2,005,940 of the total roll-in amount of $8,669,729 would be used to correct the subsidies that currently exist in base rates.[50] The $2,005,940 correction for LG&E would be allocated as a credit to those rate classes with rates of return above 7.36% based on the total amount of subsidy above this threshold rate of return paid by each customer class.[51] Similarly, the $2,005,940 correction would be allocated as a charge to those rate classes with rates of return below 5.36% on the basis of the total subsidy below 5.36% received by each customer class.[52] The amount used to correct the subsidies would thus be allocated to the affected rate classes in a symmetrical manner based on the amount of subsidy paid or the amount of subsidy received.

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[46] Seelye KU at 11; Seelye LG&E at 11.
[47] Seelye KU at 11.
[48] Seelye KU at 11.
[49] Seelye KU at 11.
[50] LG&E's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 3.
[51] LG&E's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 3; Seelye LG&E at 11.
[52] LG&E's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 3; Seelye LG&E at 11.

The amounts used to correct subsidies ($5,173,724 for KU, $2,005,940 for LG&E) were determined so that no rate class would receive less than 25 percent of the roll-in amount that the class would otherwise receive if the roll-in were allocated on the basis of base-rate revenues.[53] In other words, when the subsidy-correction amount is allocated on the basis of annual subsidies paid by those rate classes above 7.33% for KU and 7.36% for LG&E, the roll-in amounts for none of the classes are below 25% of the roll-in amount that would otherwise be allocated to the class using the revenue methodology.[54] This requirement would ensure that each class will bear a significant responsibility for the rolled-in costs, even though the cost of service study would suggest that some classes should not bear any responsibility for the costs based on the current level of subsidies.

The amounts used to correct subsidies also have the advantage of being sufficiently small that, though they serve to move in the direction of mitigating subsidies, they comport with the ratemaking axiom of gradualism.[55] No part of this proposal should result in a "rate shock," but the proposal is nonetheless a step toward alleviating the significant subsidies between certain of the Companies' rate classes.

The Companies are aware of no statutory or regulatory obstacles to the approval and implementation of this alternative proposal. The Companies suggest that it may serve as a gradual means of correcting significant subsidies currently embedded in the Companies' base rates. Nevertheless, the Companies will be guided by the Commission's decision in these cases

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[53]LG&E's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 3; Seelye KU at 11; Seelye LG&E at 11.
[54] Seelye KU at 11; Seelye LG&E at 11.
[55] Attachments to KU's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 3; Attachments to LG&E's Response to Second Data Request of Commission Staff, Dated June 29, 2006, Question No. 4.

on whether the change in base rates associated with the ECR roll-in should be accomplished in a way that gives some recognition to the inter-class rate subsidies in current base rates.

C. Rate Design: No Part of Roll-In Should Be Recovered Through Customer Charge

Also, under either roll-in methodology, the Companies should not recover any part of the roll-in amount through a customer charge. For schedules containing both energy and demand charges, the roll-in amount will be recovered through the demand charge; and for schedules containing an energy charge but no demand charge, the roll-in amount will be recovered through the energy charge.[56] For lighting rates consisting 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.[57] Except for the lighting rates, the Companies' recommended approach would represent a departure from prior roll-ins.[58] In prior roll-ins the amounts allocated to each rate class were assigned to all components of base rates (customer charge, energy charge and demand charge, as applicable) on a pro-rata basis.[59] The Companies' approach to converting the roll-in amount into unit charges is consistent with cost of service principles.[60]

V. RATE OF RETURN

Calculated using adjusted capitalization and using the currently approved 10.50% return on equity, the Companies recommend an overall rate of return of 11.52% for KU[61] and an overall rate of return of 11.23% for LG&E.[62] The Companies believe that these overall rates of return,

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[56] Seelye KU at 14; Seelye LG&E at 14.
[57] Seelye KU at 14; Seelye LG&E at 14.
[58] Seelye KU at 14; Seelye LG&E at 14.
[59] Seelye KU at 14; Seelye LG&E at 14.
[60] Seelye KU at 14-15; Seelye LG&E at 14-15.
[61] Conroy KU at 8. *See* KU Response to the Commission Staff Request for Information Question No. 17.
[62] Conroy LG&E at 9. *See* LG&E Response to the Commission Staff Request for Information, Question No. 16.

based upon the currently allowed 10.50% rate of return on common equity for the environmental surcharge, are reasonable if not conservative.

The 10.50% rate of return was approved by the Commission in Case Nos. 2004-00421 and 2004-00426 on June 20, 2005, and became effective with the July 2005 billing month. Since the Commission's Orders on June 20, 2005, long-term interest rates have increased, as evidenced by the performance of 10- and 20-year Treasury bonds, A-rated utility bonds, and Aaa-rated corporate bonds for the period January 2005 through May 2006.[63] The Value Line Quarterly Economic Review forecasts that these increases in long-term interest rates will continue.[64]

The authorized 10.50% rate of return on common equity is also consistent with recently authorized returns by this Commission and across the country. The April 5, 2006, issue of Regulatory Research Associates Regulatory Focus shows that the average rate of return on common equity authorized for electric and gas utilities during the first quarter of 2006 averaged 10.4% and 10.6%, respectively.[65]

Thus, the Companies conclude it would be reasonable, and somewhat conservative, to maintain prospectively the current authorized rate of return on common equity of 10.50% for ECR purposes.

VI. LG&E'S ELIMINATION OF EXPENSE REDUCTION FROM PRIOR CASE

One change in the calculation of the recoverable operating expenses under the Post 1995 Compliance Plan for LG&E is necessary. In the determination of the revenue requirement

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[63] *See* KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 11, Attachment 1; LG&E Response to Information Requested in Appendix B of Commission's Order Dated April 25,2006, No. 10, Attachment 1.

[64] *See* KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 11, Attachment 2; LG&E Response to Information Requested in Appendix B of Commission's Order Dated April 25,2006, No. 10, Attachment 2.

[65] *See* KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 11, Attachment 3; LG&E Response to Information Requested in Appendix B of Commission's Order Dated April 25,2006, No. 10, Attachment 3.

established in the September 4, 2003 Order in Case No. 2002-00147, the Commission ordered LG&E to exclude from environmental operating expenses, expenses of $271,119 associated with operators, the cost of which was included in LG&E's base rates at the time of the Order.[66] Since that time, LG&E has implemented new base rates, effective for service rendered on and after July 1, 2004, as approved by the Commission in its June 30, 2004 Order in Case No. 2003-00433.[67] LG&E's revenue requirements in that case did not include labor expense associated with the four employees, and LG&E's current base rates do not include labor expense associated with the four employees.[68] Therefore, there is no double recovery of this expense, and LG&E is eliminating the monthly exclusion for all expense months following the date of the Commission's Order establishing LG&E's new base rates.[69]

During the billing periods from September 2004 through the present, LG&E continued to calculate its monthly environmental surcharge calculations in compliance with the Commission's Order in Case No. 2002-00147 by reducing operating and maintenance expenses by a monthly amount of $22,593.[70]

This proceeding presents the first opportunity to remedy the operation of LG&E's environmental surcharge, as this is the first review of the operation of the surcharge for the periods impacted.[71] LG&E's under-recovery position includes the impact of eliminating the expense exclusion ordered by the Commission and LG&E proposes that eliminating this exclusion be approved for all months from July 2004 to present and continuing.[72] Upon issuance of an Order in this proceeding, LG&E proposes to eliminate this expense reduction from the

[66] Conroy LG&E at 4.
[67] Conroy LG&E at 4.
[68] Conroy LG&E at 4.
[69] Conroy LG&E at 4.
[70] Conroy LG&E at 5.
[71] Conroy LG&E at 5.
[72] Conroy LG&E at 5.

monthly ECR filings and will include an adjustment for the period from March 2006 to the month preceding the Commission order in this proceeding in the appropriate six-month review periods in the future.[73]

VII. KU'S EMISSION ALLOWANCES IN BASE RATES

KU's current base rates were established by the Commission in its Order dated June 30, 2004 in Case No. 2003-00434 based upon its analysis of KU's revenue requirement found justifiable by the record and an electric revenue requirement recommended pursuant to a partial settlement and stipulation.[74] As part of the partial settlement and stipulation and as approved by the Commission's Order, KU's 1994 environmental compliance plan was removed from recovery through the environmental surcharge filings and recovered through base rates.[75] KU's rate base at September 30, 2003 included $69,415 in emission allowances inventory.[76] Therefore, KU's current base rates include a return on the jurisdictional portion of those allowances.

Upon the effective date of the roll-in, KU will continue to calculate a return on total environmental compliance rate base in its monthly filing forms.[77] The resulting revenue requirement will be reduced by the portion of ECR-related revenue collected through base rates as a result of the roll-in.[78] However, if KU does not continue to reduce its environmental rate base by the emission allowance inventory included in base rates, then KU will be including a calculated return on those allowances in its monthly environmental revenue requirement, and the monthly reduction resulting from the roll-in will not include an amount associated with that

[73] Conroy LG&E at 5.
[74] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.
[75] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.
[76] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.
[77] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.
[78] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.

return.[79] Thus, the return on the allowance inventory balance of $69,415 is not reflected in KU's BESF.[80]

VIII. CONCLUSION

For the foregoing reasons stated in this brief and in their testimony, Kentucky Utilities Company and Louisville Gas and Electric Company request the Public Service Commission to enter orders that grant the Companies the following relief:

a. Approving KU's proposed increase to its Environmental Surcharge Revenue Requirement of $63,663 in the first four billing months following the Commission's decision in this proceeding, and likewise approving LG&E's proposed increase to its Environmental Surcharge Revenue Requirement of $662,267 in the first four billing months following the Commission's decision in this proceeding;

b. Finding environmental surcharge amounts for the two-year billing period ending April 2005 to be just and reasonable;

c. Finding that LG&E should eliminate the expense reduction ordered in Case No. 2002-00147 from its monthly ECR filings beginning with the expense month of July 1, 2004;

d. Approving $23,731,313 (KU) and $8,669,729 (LG&E) to be the amounts to be incorporated into base electric rates for bills rendered on and after the second full billing month following the month in which an order is received in these cases;

e. The Commission should decide as a matter of policy whether the Environmental Surcharge mechanism should be used to address the inter-class rate subsidies that currently exist in the Companies' base rates and based on that decision approve either the use of allocating the roll-in amount on the basis of class base rate revenues or a methodology that allocates the roll-in

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[79] KU Response to Information Requested in Appendix B of Commission's Order Dated April 25, 2006, No. 13.
[80] KU Response to Second Data Request of Commission Staff, Dated June 29, 2006, No. 6(a).

amount in a way that gives some recognition to the inter-class rate subsidies that currently exist in base rates; but whichever roll-in methodology is approved by the Commission, no part of the roll-in amount should be recovered through the customer charges of the rates.

f. Resetting the Companies' Base Environmental Surcharge Factors to amounts based on the roll-in amounts and base revenues from the most recent 12-month period available following the Commission's Order in these proceedings; and

g. Establishing the rate of return for KU's Post-1994 Plan to be 11.52%, and the rate of return for LG&E's Post-1995 Plan to be 11.23%.

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Respectfully submitted,

W. Duncan Crosby III

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

Elizabeth L. Cocanougher
Senior Corporate Attorney
E.ON U.S. LLC
220 West Main Street
Louisville, Kentucky 40202
Telephone: (502) 627-4850

Counsel for Kentucky Utilities Company
and Louisville Gas and Electric Company