RECEIVED

DEC 03 2008

PUBLIC SERVICE
COMMISSION

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY UTILITIES	)	Case No. 2008-00251
COMPANY, INC. FOR AN ADJUSTMENT	)	C/W
OF BASE RATES	)	Case No. 2007-00565

ATTORNEY GENERAL'S RESPONSES TO DISCOVERY
REQUESTS OF COMMISSION STAFF

Comes now the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention, and states as follows for his responses to the discovery requests of the Commission Staff.

Respectfully submitted,

JACK CONWAY
ATTORNEY GENERAL

Lawrence W. Cook

DENNIS G. HOWARD, II
LAWRENCE W. COOK
PAUL D. ADAMS
ASSISTANT ATTORNEYS GENERAL
1024 CAPITAL CENTER DRIVE,
SUITE 200
FRANKFORT KY 40601-8204
(502) 696-5453
FAX: (502) 573-8315

Certificate of Service and Filing

Counsel certifies that the responses set forth herein are true and accurate to the best of his knowledge, information, and belief formed after a reasonable inquiry. Counsel further certifies that an original and ten photocopies of the foregoing were served and filed by hand delivery to Beth O'Donnell, Executive Director, Public Service Commission, 211 Sower Boulevard, Frankfort, Kentucky 40601; furthermore, it was served by mailing a true and correct copy of the same, first class postage prepaid, to:

Lonnie E. Bellar
Vice President - State Regulation
E.ON U.S. Services, Inc.
220 W. Main St.
Louisville, KY 40202

Hon. Allyson K. Sturgeon
Attorney at Law
E.ON U.S. Services, Inc.
220 W. Main St.
Louisville, KY 40202

Hon. Kendrick R. Riggs
Hon. W. Duncan Crosby, III
Attorneys at Law
Stoll Keenon Ogden, PLLC
2000 PNC Plaza
500 W. Jefferson St.
Louisville, KY 40202-2828

Hon. Michael L. Kurtz
Attorney at Law
Boehm, Kurtz & Lowry
36 E. 7th Street
Ste. 1510
Cincinnati, OH 45202

Hon. David C. Brown, Esq.
Stites & Harbison, PLLC
1800 Providian Ctr.
400 W. Market St.
Louisville, KY 40202

Joe F. Childers
Getty & Childers
1900 Lexington Financial Center
250 W. Main St.
Lexington, KY 40507

Honorable Willis L. Wilson
Lexington-Fayette Urban County Government
Department of Law
200 East Main Street
Lexington, KY 40507

this 3rd day of December, 2008

Assistant Attorney General

WITNESS RESPONSIBLE:
Robert J. Henkes/Glenn A. Watkins

1. Refer to the Henkes Electric Testimony, page 21, and the Prepared Direct Testimony and Schedules of Glenn A. Watkins ("Watkins Testimony"), pages 3 and 10-13, regarding the electric weatherization adjustment proposed by Kentucky Utilities Company ("KU").
   a. Mr. Henkes refers to the recommendations made by Mr. Watkins with regard to eliminating KU's proposed adjustment. Exactly where in the Watkins Testimony does Mr. Watkins make this recommendation?
   b. Mr. Watkins refers to "[t]he vast majority of other states." Identify the states of which Mr. Watkins is aware that accept, or have accepted in the past, some form of electric weather normalization adjustment.
   c. On pages 10-13 of his testimony, Mr. Watkins discusses his disagreement with various aspects of KU's adjustment and his analysis of the test year sales and how they were impacted by temperatures. Mr. Watkins also computes a weather normalization adjustment, the details of which are shown on Schedule GAW_2. Explain whether Mr. Watkins is proposing that the Commission adopt his calculated weather normalization adjustment. If not, explain why he has included such an adjustment in his testimony.

RESPONSE:

a. Please see page 3, lines 11-15 and page 4, lines 21-23 of Mr. Watkins testimony.
b. Mr. Watkins is not aware of any states that utilize weather normalization for electric revenue requirement purposes. With this said, Mr. Watkins is aware that Pennsylvania uses a forecasted test year concept and several small utilities rely on budgeted amounts for forecasts. These budgets may or may not reflect "normal weather." Mr. Watkins is also aware of Mr. Seelye's testimony on page 49 in which he states that Connecticut, North Carolina, Washington, D.C., Indiana, Georgia, and Kansas have recognized electric temperature normalization adjustments.
c. Mr. Watkins' primary recommendation is to not recognize weather normalization for electric ratemaking. To the extent the Commission disagrees with this recommendation, an alternative to Mr. Seelye's weather normalization adjustment is presented.

WITNESS RESPONSIBLE:
Glenn A. Watkins

2. Refer to the discussion at the top of page 10 of the Watkins Testimony.
   a. Mr. Watkins states that because daily usage varies significantly between weekdays and weekends and holidays, he has reflected this in his analysis of daily observations. Explain in detail how Mr. Watkins reflected the variation in daily observations in his analysis.
   b. Mr. Watkins states that he expressed daily kWh usage on a per-customer basis for the residential class in order to prevent any skewness in the regression model but used a total class basis for the commercial and industrial classes. Provide a detailed discussion of how using daily kWh usage per customer prevents skewness in the regression model.

RESPONSE:

a. Mr. Watkins utilized a binary or "dummy" variable for weekend days (Saturday and Sunday) and holidays (July 4th and Labor Day). Please see Attorney General's Response to Kentucky Utilities Request No. 11 for each classes "dummy" variable coefficient.
b. This is due to customer growth during the period of evaluation as well as other differences in number of billed customers. In other words, if total class KWH were used a dependent variable, and the number of customers vary from the forecast period, a skewness (inaccuracy) will result.

WITNESS RESPONSIBLE:
Robert J. Henkes
PAGE 1 of 1

3. Refer to the Henkes Testimony, pages 27-28, regarding the proposed rate-making treatment of KU's net MISO costs.
   a. Explain in detail why Mr. Henkes believes that KU's post-test year net MISO costs should not be deferred until KU's next base rate case.
   b. Explain why Mr. Henkes favors rate-making recognition of amounts based on various estimates which, to some extent, depend on activity in the MISO market through the year 2014, and which will result in MISO exit fee credits in the first quarter of the year 2015, or 8 years beyond the end of the test year in this case.

RESPONSE:

Upon further reflection on this issue, Mr. Henkes believes that it would be more appropriate to defer the customer refunds for the post-test year MISO Exit Fee credits and MISO Schedule 10 rate collections until KU's next base rate case. Mr. Henkes therefore agrees that his proposed MISO cost adjustment on his Schedule RJH-13 should be withdrawn. This would decrease the AG's recommended pro forma test year after-tax operating income by approximately $619,000 and would reduce the AG's recommended rate decrease by approximately $996,000. See the attached revised Schedules RJH-1, RJH-4, and RJH-13.

WITNESS RESPONSIBLE:
Robert J. Henkes

4. Refer to the Henkes Testimony, pages 33-34, regarding his proposed adjustment to remove a portion of KU's test year legal fees.
   a. Identify all specific test year legal fees reported by KU which Mr. Henkes considers inappropriate for rate recovery.
   b. During the course of Mr. Henkes's review of KU's test year operating expense wherein he identified the "abnormally high" legal expenses, did Mr. Henkes identify any other expenses that were, in his opinion, abnormally high or low relative to previous years? If so, identify those expenses and explain why Mr. Henkes did not propose "normalization adjustments" to those accounts.

RESPONSE:

a. Mr. Henkes considered the overall annual legal expense levels for the 5 year period 2004 through the test year. That would be more appropriate than reviewing every single legal expense reported by KU. Legal expenses can fluctuate significantly from year to year depending on the number and magnitude of legal issues that can materialize each year. This has also been the case for KU during the last 5 years. Given those circumstances, it would be more appropriate to set rates based on a normalized expense level rather than the expense level that happens to be booked in the test year. Mr. Henkes has determined his recommended normalized expense level by averaging the inflation-adjusted legal expenses booked by the Company in the most recent 5 years.
b. Yes. Mr. Henkes considered the overall Outside Services expense account of which the Company's legal expenses are a part. Based on his analysis of the overall Outside Services expenses shown for the 5-year period 2004 through the test year[1], Mr. Henkes determined that the test year overall Outside Services expense account also appears to be abnormally high compared to historic expense levels. Specifically, Mr. Henkes determined that the test year overall Outside Services expense level of approximately $10.7 million is $2 million (almost 24%) higher than the approximate $8.7 million average CPI-U adjusted overall Outside Services expenses for 2004 through the test year. The largest portion of this approximate $2 million expense difference is caused by the very high legal expenses included in the test year overall Outside Services expenses. Mr. Henkes chose to only recommend an adjustment for the abnormally high legal expenses.

[1] Mr. Henkes reviewed the response to AG-1-59 in performing this analysis.

WITNESS RESPONSIBLE:
Robert J. Henkes

5. Refer to the Henkes Testimony, pages 36-38, regarding his proposed adjustment to remove a portion of KU's annual dues to the Edison Electric Institute ("EEI"). Mr. Henkes discusses the adjustment made in KU's last rate case in which 45.35 percent of KU's dues was removed based on that percentage of EEI's activities being related to various types of lobbying activities. The information provided in this case, which is not prepared in the same manner as in previous years, indicates that 16.15 percent of KU's 2007 EEI dues was spent on lobbying activities. With this background, explain Mr. Henkes's reasoning for basing his proposed adjustment on the percentage used 5 years ago in KU's previous rate case.

RESPONSE:

In the prior rate case, the Commission ruled that the EEI dues dedicated to the NARUC functional expense categories of Legislative Advocacy, Regulatory Advocacy and Public Relations should be excluded for ratemaking purposes. These disallowed functional categories amounted to 45.35% of the total EEI dues. In the current case, the Company has indicated that EEI no longer presents its activities in accordance with these same NARUC functional expense categories, but that EEI has determined that 16.15% of EEI dues are spent on lobbying activities. On page 37 of his testimony, Mr. Henkes states in this regard:

"It is not known whether EEI's determination of what represents lobbying activities is as inclusive as, and exactly similar to, NARUC's classification of EEI's legislative and regulatory advocacy and public relations activities. I have therefore relied on the same 43.35% EEI lobbying expense ratio as established by the Commission in the prior case in my determination of the EEI dues to be excluded for ratemaking purposes in the current case."

WITNESS RESPONSIBLE:
Dr. J. Randall Woolridge

6. Refer to the Direct Testimony of Dr. J. Randall Woolridge ("Woolridge Testimony"), page 9, and Exhibit JRW-2. Provide a copy of the most recent published company analysis from Value Line for each of the companies in the proxy groups.

RESPONSE:

See attached DVD.

WITNESS RESPONSIBLE:
Dr. J. Randall Woolridge
PAGE 1 of 1

7. Refer to the Woolridge Testimony, pages 29 – 30, and Exhibit JRW-6, page 3 of 5.
   a. Explain how taking the collective average of 5-year and 10-year historical growth rates for Earnings Per Share ("EPS"), Dividends Per Share ("DPS"), and Book Value Per Share ("BVPS") series' mean and median values provides a meaningful estimate of dividend growth as used in the Discounted Cash Flow ("DCF") model.
   b. Explain the pros and cons of using each of the data series of EPS, DPS, and BVPS individually for calculating the dividend growth to be used in the DCF model.
   c. Several of the companies in the proxy group have negative growth rates in the chart. Part of the rationale for including these companies in the proxy group was that each had paid dividends for the last 3 years.
      (1) Explain why it is valid to have these companies included in this particular analysis.
      (2) To the extent possible, provide KU's EPS, DPS, and BVPS 5-year and 10-year growth rates and describe how they compare to those of the companies listed in the proxy group.

RESPONSE:

a. Dr. Woolridge's objective is to find the central tendency for the figures shown. Means and medians are measures of central tendency for an array of numbers. Due to the presence of outliers, Dr. Woolridge is using both the means and medians. Growth over five- and ten- year periods are commonly provided to investors by Value Line and other investor information sources as indicators of historic growth.
b. According to the DCF model, DPS, EPS, and BVPS should all have the same rate of growth. Over short-term periods of time, these growth rates may differ, Dr. Woolridge is attempting to gauge an overall long-term rate of growth for all three. EPS is the most volatile, but it gets the most attention in the financial press. BVPS and DPS tend to be more stable over time.
c. (1) Investors have access to historic information and growth rates, and presumably take both positive and negative growth rates into consideration in forming expectations of the future.

   (2) Dr. Woolridge does not have that data. He relied on the data for the proxy group.

WITNESS RESPONSIBLE:
Dr. J. Randall Woolridge
PAGE 1 of 1

8. Refer to the Woolridge Testimony, page 30, and Exhibit JRW-6, page 4 of 5.

   a. Explain why using internal growth, which also includes non-regulated revenue returns, as a proxy for dividend growth does not introduce a certain amount of circularity into the calculation and, therefore, should be unacceptable.

   b. Explain why it is valid to use the calculated internal growth rate as a meaningful estimate of dividend growth as used in the DCF model.

RESPONSE:

a. To minimize the impact of unregulated revenues on growth and risk, Dr. Woolridge has used a screen that requires regulated revenue of at least 75%.

b. As stated in Dr. Woolridge's testimony, a very important factor in stock valuation is the growth associated with the reinvestment of earnings and the earned returns on these reinvested earnings since this provides the basis to increase dividends in the future.

WITNESS RESPONSIBLE:
Dr. J. Randall Woolridge

9. Refer to the Woolridge Testimony, page 42. Provide legible copies of the referenced Derrig and Orr (2003), Fernandez (2007) and Song (2007) articles.

RESPONSE:

See attached DVD.

10. Refer to the Woolridge Testimony, pages 42-51, and Exhibit JRW-7, page 3 of 5.
   a. For each article listed in the chart for which a low and high range is provided, explain whether EPS or DPS measures serve as the basis for the listed equity risk premium.
   b. Regarding the three survey articles, explain whether the assumptions and definitions of risk and return underlying the estimates in each of the studies are consistent, and whether there is any weighting of more recent periods or events relative to more distant events.
   c. Explain which, if any, of the estimates are in real terms and which are in nominal terms.
   d. Explain why it is valid to use a geometric mean to calculate the equity risk premium and, if it is valid, why it is reasonable to average those projections with those calculated using an arithmetic mean.
   e. Several of the equity risk premium estimates appear to be low and may not be valid for the purpose at hand. There are ten studies with estimates ranging from 1.96 percent to 3.5 percent. Explain why an investor would undertake the risk of investing in stocks with such low premiums.

RESPONSE:

a. The approach used in each study is provided in the column labeled 'Methodology.' If dividends and/or earnings are used in determining the risk premium, it is noted. The Residual Income approach is an earnings-based approach.

b. In the surveys, the CFOs and Financial Forecasters were simply asked for the expected stock return in excess of the return on bonds over the next ten years. The survey of academics asked the same question, except over thirty years. There was no weighting of returns by time period.

c. All are in nominal terms.

d. See discussion below:

There is an upward bias to the arithmetic mean. Consider the following example. Assume that you have a stock (that pays no dividend) that is selling for $100 today, increases to $200 in one year, and then falls back to $100 in two years. The table below shows the prices and returns.

Time Period	**Stock Price**	**Annual Return**
0	$100	
1	$200	100%
2	$100	-50%

The arithmetic mean return is simply (100% + (-50%))/2 = 25% per year. The geometric mean return is $((2 * .50)^{(1/2)}) - 1 = 0\%$ per year. Therefore, the arithmetic mean return suggests that your stock has appreciated at an annual rate of 25%, while the geometric mean return indicates an annual return of 0%. Since after two years, your stock is still only worth $100, the geometric mean return is the appropriate return measure. For this reason, when stock returns and earnings growth rates are reported in the financial press, they are generally reported using the geometric mean. This is because of the upward bias of the arithmetic mean. As further evidence of the appropriate mean return measure, the U.S. Securities and Exchange Commission requires equity mutual funds to report historic return performance using geometric mean and not arithmetic mean returns.[2]

e. Some of the equity risk premium estimates are low, and some are high. Dr. Woolridge has used the results of all the studies that he can locate. The lower equity risk premiums simply reflect what many have argued for some time – the equity risk premium has declined.

[2] U.S. Securities and Exchange Commission, Form N-1A.

WITNESS RESPONSIBLE:
Dr. J. Randall Woolridge
PAGE 1 of 1

11. Refer to the Woolridge Testimony, page 45. Provide a legible copy of the Ibbotson and Chen article cited in footnote 16.

RESPONSE:

See attached DVD.

WITNESS RESPONSIBLE:
Glenn A. Watkins
PAGE 1 of 1

12. Refer to the Watkins Testimony, Schedule GAW_4, pages 21-28, which list the cost-of-service study allocators. State where in the Watkins cost-of-service study these allocators are used.

RESPONSE:

The allocator "amounts" are contained on pages 21-24 of Schedule GAW-4. The class allocator percentages are provided on pages 25-28 of Schedule GAW-4. The allocators were then used to allocate individual rate base and expense amounts on pages 1-20 of Schedule GAW-4. The "Allocator" column was inadvertently not printed. Attached is a revised Schedule GAW-4 that includes an allocator identification.

WITNESS RESPONSIBLE:
Glenn A. Watkins

13. Provide an electronic version of the Watkins cost-of-service study with the formulas intact.

RESPONSE:

See Attorney General's response to Kentucky Utilities Request No. 11.