COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE GAS & ELECTRIC COMPANY TO ADJUST ITS GAS RATES AND TO INCREASE ITS CHARGES FOR DISCONNECTING SERVICE, RECONNECTING SERVICE AND RETURNED CHECKS	)))))))	CASE NO. 2000-080

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O R D E R

Louisville Gas and Electric Company ("LG&E"), a wholly owned subsidiary of LG&E Energy Corporation ("LG&E Energy"), is an electric and gas utility that purchases, sells, stores, transports and distributes natural gas in Jefferson County and in portions of Bullitt, Green, Hardin, Hart, Henry, Larue, Marion, Meade, Metcalfe, Nelson, Oldham, Shelby, Spencer, Trimble and Washington counties in Kentucky.[1]

BACKGROUND

On February 22, 2000, LG&E filed a letter giving notice of its intent to file an application for approval of an increase in its gas rates to produce additional annual revenues of $27,911,790, an increase of 14.53 percent.[2] On March 30, 2000, LG&E filed its application. LG&E's application includes proposals to establish a Weather Normalization Adjustment Clause ("WNA Clause") and to amend its tariffs to provide

[1] LG&E generates, transmits, distributes and sells electricity in Jefferson County and in portions of Bullitt, Hardin, Henry, Meade, Oldham, Shelby, Spencer and Trimble counties in Kentucky.

[2] The percentage increase reflects LG&E's adjusted annual revenues of $192,157,595, based on the gas cost recovery component in its rates effective February 1, 2000. Updating the revenues to reflect the current gas cost component increases the revenues to $279,640,926, which reduces the stated percentage to 9.98 percent.

gas main extensions differently than that required by 807 KAR 5:022, Section 9(16)(a), (b) and (c). To determine the reasonableness of the request, the Commission suspended the proposed rates for five months from their effective date pursuant to KRS 278.190(2) up to and including September 28, 2000.

On April 21, 2000, LG&E filed an application to increase certain non-recurring charges for both its electric and gas customers.[3] Based upon review of LG&E's applications, the motion of the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), to consolidate LG&E's proceedings and the responses thereto, the Commission ordered the two proceedings consolidated into Case No. 2000-080 and directed that Case No. 2000-137 be closed.

The following parties requested and were granted full intervention: The AG; Kentucky Industrial Utility Customers ("KIUC"); The United States Department of Defense and other Federal Executive Agencies ("DOD"); People Organized and Working for Energy Reform ("POWER"); and Metro Human Needs Alliance ("MHNA"). Initially, Robert L. Madison was granted full intervention; however, the scope of his participation was limited to the electric non-recurring charge issues on a finding that he was not a gas customer and therefore did not meet the regulatory standard for full intervention.

[3] Case No. 2000-137, Application of Louisville Gas and Electric Company to Increase its Charges for Disconnecting and Reconnecting Service and for Returned Checks.

On April 6, 2000, the Commission issued a procedural schedule to investigate LG&E's rate application.[4] The schedule provided for discovery, intervenor testimony, rebuttal testimony by LG&E, a public hearing, and an opportunity for the parties to file post-hearing briefs. LG&E filed its rebuttal testimony on July 26, 2000. LG&E's rebuttal testimony contained revisions to key exhibits that resulted in a requested adjustment of $26,376,773 rather than the originally proposed $27,911,790. KIUC also filed rebuttal testimony on July 26, 2000, which the AG, POWER, and MHNA moved to strike. The Commission overruled the motions to strike KIUC's rebuttal testimony at the public hearing held at the Commission's offices in Frankfort, Kentucky on August 2, 3, and 4, 2000.[5]

At the conclusion of the hearing, the Commission modified the procedural schedule to permit the parties up to and including September 8, 2000 in which to submit briefs. All parties timely filed briefs and the case now stands submitted for a decision.

TEST PERIOD

LG&E proposes the 12-month period ending December 31, 1999 as the test period for determining the reasonableness of the proposed rates. The AG and DOD also utilized this 12-month period. The Commission finds it is reasonable to utilize the 12-month period ending December 31, 1999 as the test period in this proceeding. In utilizing a historic test period, the Commission has given full consideration to appropriate known and measurable changes.

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[4] In its order consolidating Case No. 2000-137 and Case No. 2000-080, the Commission ordered the procedural schedule established in Case No. 2000-080 adopted as the procedural schedule of the consolidated case.

[5] Transcript of Evidence ("T.E."), Vol. I, at 82.

CAPITALIZATION VERSUS RATE BASE

LG&E determined that its adjusted test-year capitalization is $268,202,448, while its adjusted test-period net original cost rate base ("rate base") is $287,909,011.[6] LG&E's proposed increase in revenue results from the application of the overall cost of capital to its adjusted test-period rate base.

LG&E acknowledges that for its combined electric and gas operations, its revenue proposals have historically been based on capitalization rather than on rate base. As this proceeding deals only with its gas operations, LG&E states that it sought guidance from the Commission's decision in Case No. 99-176,[7] the most recent gas-only rate case. LG&E notes that in Case No. 99-176, the AG recommended, and the Commission determined, that the revenue increase for Delta Natural Gas Company, Inc. ("Delta") should be based on rate base rather than capitalization. LG&E argues that it was following the most recent applicable precedent when it used rate base instead of capitalization to determine its proposed revenue increase.[8] LG&E contends that the Commission's determination of the return requirement using rate base in Delta's last two general rate cases constitutes a change in Commission policy for calculating the return requirement. LG&E claims there was nothing extraordinary about the latest Delta rate case that would have necessitated changing the Commission's policy of using

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[6] Williams Direct Testimony, Exhibit 2, page 1 of 2, and Exhibit 3, page 1 of 2.

[7] Case No. 99-176, An Adjustment of the Rates of Delta Natural Gas Company, Inc., Final Order dated December 27, 1999.

[8] LG&E's Response to the Commission's April 28, 2000 Order, Item 42(a).

capitalization.[9] LG&E repeatedly states that it is unaware of any other jurisdiction using capitalization to determine the return requirement.[10] LG&E also notes that, for a combined electric and gas utility, the capital structure cannot be directly separated between the two operations, while a separate rate base is calculated for both electric and gas operations.[11] In its rebuttal testimony and brief, LG&E extensively criticizes the AG for advocating that the return requirement be determined using capitalization. LG&E repeatedly notes that the AG supported using the rate base in the two previous Delta general rate cases.[12]

The AG recommends that LG&E's revenue requirement be calculated by applying the overall cost of capital found reasonable to LG&E's investment that is used and useful in providing service to the ratepayers. The AG contends that this investment has been financed by investor-supplied capital, which is composed of debt, preferred stock, and equity.[13] Thus, the AG bases his revenue requirement recommendation on LG&E's capitalization rather than on its rate base. The AG states that when a utility's capitalization exceeds its rate base, this generally indicates that a portion of the capitalization has been used to finance non-regulated, non-utility, or "below-the-line"

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[9] The Commission does not have a "policy" of using capitalization. The Commission, as it is statutorily mandated to do, reviews each application filed to determine which method more accurately reflects the investment that is used and useful in providing service to the ratepayers.

[10] Seelye Rebuttal Testimony at 5-6.

[11] LG&E's Response to the Commission's May 25, 2000 Order, Item 8(c).

[12] <u>See</u> Seelye Rebuttal Testimony at 3-10 and LG&E's Post-Hearing Brief at 39-44.

[13] Henkes Direct Testimony at 7.

assets. The AG further asserts that when a utility's rate base exceeds its capitalization, portions of the rate base may have been financed with funds from sources other than debt, preferred stock, and common equity. Such a situation could also indicate that the inclusion of rate base items determined by formulas, such as the cash working capital allowance, do not actually exist.[14] The AG states that the use of LG&E's gas capitalization is consistent with the Commission's recent decision in Case No. 98-426.[15] The AG further claims that it would be inconsistent and inappropriate to determine that LG&E's electric return requirement should be based on capitalization and then, within a few months, to determine that LG&E's gas return requirement should be based on rate base.[16] Finally, the AG contends that it is doubtful LG&E would have urged the Commission to adhere to the decision in the Delta case to base the revenue requirement on rate base, in light of the Commission's traditional approach of using capitalization in LG&E general rate cases, if LG&E's gas capitalization had been larger than its gas rate base.[17]

The DOD determined its recommended revenue increase for LG&E using rate base, but took no position on whether the revenue requirements should be calculated using rate base or capitalization.[18]

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[14] Id. at 7-8.

[15] Case No. 98-426, Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of its Rates and Service, Final Order dated January 7, 2000 and Rehearing Order dated June 1, 2000.

[16] Henkes Direct Testimony at 9.

[17] AG's Post-Hearing Brief at 1-2.

[18] T.E., Volume II, August 3, 2000, at 251-252.

As noted previously, the Commission has determined the revenue requirements for LG&E using capitalization rather than rate base. This was true for LG&E's last combined electric and gas general rate case, Case No. 90-158,[19] as well as the recent electric rate complaint case, Case No. 98-426. However, if justification exists, the Commission will consider using an approach different from that previously used. LG&E has based its argument supporting the use of rate base on the Commission's decision in Delta's recent gas rate case. Accordingly, it is appropriate here to analyze the Delta case and to determine whether the reasoning in that case applies here.

In Case No. 99-176, the Commission determined that Delta's rate base was $91,997,648 and its capitalization was $92,996,779.[20] Delta's revenue requirement was determined by applying the overall cost of capital to the rate base. There is no discussion in that Order explaining why rate base was utilized. However, the Commission notes that the rate base was the lower of the two valuations of Delta. The Commission has also reviewed Delta's previous general rate case, Case No. 97-066.[21] The Commission determined that Delta's rate base was $65,445,709 and its capitalization was $65,949,247.[22] As in Case No. 99-176, Delta's revenue requirement was determined by applying the overall cost of capital to the rate base, and there is no

[19] Case No. 90-158, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, final Order dated December 21, 1990.

[20] Case No. 99-176, December 27, 1999 Order at 10 and 12.

[21] Case No. 97-066, An Adjustment of General Rates of Delta Natural Gas Company, Inc., final Order dated December 8, 1997 and rehearing Order dated May 1, 1998.

[22] Case No. 97-066, December 8, 1997 Order at 7-8. In the May 1, 1998 Rehearing Order, page 2, rate base was revised to $66,751,309.

discussion explaining why rate base was utilized. In the December 8, 1997 Order, the rate base was the lower of the two valuations of Delta. In the May 1, 1998 Order, the revenue requirements were still determined using rate base, even though it was slightly higher than capitalization.

Delta is a Kentucky corporation that purchases, sells, stores, transports, and distributes natural gas to approximately 38,000 customers in 23 Kentucky counties. It has a wholly owned subsidiary that provides gas storage services to Delta.[23] LG&E is a Kentucky corporation that is engaged in the electric and gas businesses. LG&E's gas business purchases, sells, stores, transports, and distributes natural gas to approximately 293,000 customers in 16 Kentucky counties. LG&E has no subsidiaries, but is one of two regulated utilities owned by LG&E Energy.

After reviewing Delta's two previous rate cases and comparing Delta and LG&E, the Commission rejects LG&E's arguments that our decisions in the Delta cases constitute "applicable precedent" and a change in Commission policy for calculating the revenue requirements for a utility. Since it has been 10 years since LG&E's last general rate case for gas operations, and since this is the first time it has filed a separate gas case, it is understandable that LG&E would review recent gas case decisions. But it is equally valid to review past Commission decisions involving the other combined electric and gas utility under our jurisdiction, The Union Light, Heat and Power Company.[24]

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[23] Case No. 99-176, December 27, 1999 Order at 3-4.

[24] LG&E had stated that such a comparison was not relevant to the issue of whether to use rate base or capitalization in calculating revenue increases. See LG&E's Response to the Commission's April 28, 2000 Order, Item 42(b).

Both reviews must, however, be considered in light of the Commission's previous determinations of LG&E's revenue requirements.

When determining the valuation of a utility to be used in calculating revenue requirements, the Commission is guided by KRS 278.290(1), which states in part:

> In fixing the value of any property under this subsection, the commission shall give due consideration to the history and development of the utility and its property, original cost, cost of reproduction as a going concern, capital structure, and other elements of value recognized by the law of the land for rate-making purposes.

The Commission has previously found that LG&E's revenue requirement should be determined by using capitalization rather than rate base. However, this does not preclude the Commission from determining that the revenue requirement in this proceeding should be based on rate base, if evidence is presented to support such a finding. In this proceeding, LG&E has not provided any evidence to justify the use of its rate base to determine revenue requirements, other than stating this was the approach used in the Delta proceeding and in other jurisdictions. LG&E also has not provided any evidence explaining why the circumstances faced by Delta in its previous rate cases are relevant to LG&E's situation.

As we acknowledged in Case No. 98-426, while rate base and capitalization theoretically should be equal, it is rare that this happens.[25] Because rate base and capitalization are rarely equal, the Commission promulgated 807 KAR 5:001, Section 10(6)(i), which requires a utility to file a reconciliation of its rate base and capitalization used for determining revenue requirements in a historic test-year rate application. This

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[25] Case No. 98-426, June 1, 2000 Order, at 3.

reconciliation should identify the reasons for the difference between the two valuation approaches. LG&E provided reconciliations for both its total company and its gas operations. While no party to this proceeding has challenged LG&E's reconciliations, the Commission did question LG&E about the reconciliations and sought clarifications of the information provided.[26] LG&E's reconciliations do not identify and explain the reasons for the differences between rate base and capitalization, but instead classify its balance sheet as one of the following: rate base, capitalization, non-rate base assets and liabilities, or Commission adjustments to rate base. Of particular concern in the gas operations reconciliation is the inclusion of an "Electric/Gas Adjustment" which, LG&E states, results from the use of different allocation percentages when determining separate electric and gas balance sheets.[27] This "Electric/Gas Adjustment" is nearly double the amount of the difference between the gas rate base and gas capitalization. Consequently, LG&E's reconciliations of rate base and capitalization provide little information as to why the difference between gas rate base and gas capitalization is $19,706,563.[28]

LG&E's statement that this is the only jurisdiction using capitalization to determine revenue requirements is of no relevance. The Commission is not restricted by the approaches other regulatory commissions have employed to determine revenue

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[26] See LG&E's Response to the Commission's April 28, 2000 Order, Item 35; and LG&E's Response to the Commission's May 25, 2000 Order, Item 3.

[27] LG&E's Response to the Commission's May 25, 2000 Order, Item 3(c).

[28] Rate base of $287,909,011 minus capitalization of $268,202,448 equals $19,706,563.

requirements. We also note that LG&E has produced no evidence that supports this conclusion.

The Commission observes that, while LG&E does calculate a separate rate base for both the electric and gas operations, it maintains the balance sheet accounts on a combined basis.[29] While many of the balance sheet accounts can be identified as pertaining to either electric or gas operations, LG&E must allocate several accounts that are common to both operations. Thus, the implication that LG&E's gas rate base is composed exclusively of directly assigned, gas-only account balances is misleading.

The Commission finds that LG&E's gas revenue requirement should be determined by applying the overall cost of capital to the gas capitalization. The capitalization of the utility is a better measure of the real cost of providing service since it is the cost of debt and equity that is reflected in the financial statements of the utility. To impute the operating income requirements based on an inflated rate base in effect establishes a cost of doing business that is non-existent to the utility. LG&E's arguments that Commission decisions in recent Delta rate cases constitute applicable precedent and a change in policy are not persuasive. The Commission is inclined to agree with the AG's observation that when rate base exceeds capitalization, this indicates that portions of rate base have been financed with funds from sources other than debt, preferred stock, and common equity. We also agree with the AG that, given the decision in Case No. 98-426 and the absence of evidence to justify the use of rate base, it is inappropriate to determine LG&E's gas revenue requirement using rate base.

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[29] LG&E's Response to the Commission's May 25, 2000 Order, Item 3(c).

COMMON UTILITY STUDY

LG&E conducts an annual common utility study each November that determines the ratio to be used to allocate its common utility plant to its electric and gas operations. Although conducted in November of each year, the study is not concluded and the results reported to LG&E's management until the following spring. During the test year, LG&E applied the results from the 1998 Common Utility Study ("1998 Study"), which caused common utility plant to be allocated 75 percent to electric and 25 percent to gas. The 1998 Study was performed during November 1998 and submitted to management in January 1999.[30] LG&E performed its 1999 Common Utility Study ("1999 Study") during November 1999 and submitted the results to management in April 2000. The 1999 Study indicated that common utility plant should be allocated 77 percent to electric and 23 percent to gas.[31]

In its application, LG&E used the 1998 Study when calculating its gas rate base. LG&E contends that it is appropriate to use the 1998 Study because the results from the 1999 Study were not known and measurable when the case was filed.[32] LG&E states its belief that the use of the 1998 Study is more appropriate because it contains the information actually used to allocate common utility plant during the test year.[33] LG&E also argues that the results of the annual studies vary from year to year and that there is no reason to believe that the 1999 Study is a better predictor of financial results than the

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[30] LG&E's Response to the Commission's March 15, 2000 Order, Item 35.

[31] LG&E's Response to the Commission's April 28, 2000 Order, Item 74.

[32] Id.

[33] LG&E's Post-Hearing Brief at 5-6.

1998 Study.[34] In its rebuttal testimony and brief, LG&E criticizes the AG for advocating the use of the 1999 Study results, stating that if the 1999 Study is used, other common utility expense allocation factors that were changed at the beginning of 2000 should also be recognized.[35] LG&E further notes that the 1998 Study was used to allocate the common utility plant in Case No. 98-426, and argues that it would be inconsistent for the AG to advocate the use of the 1999 Study while at the same time opposing LG&E's proposal to determine its revenue requirements using rate base.[36]

The AG recommends that the results of the 1999 Study be used for rate-making purposes in this case. The AG argues that the common utility allocation factor of 23 percent to gas should be used because it is a known and measurable number, it results from the most recent common utility study, and it is based on 1999 actual accounting data.[37]

The Commission agrees with the arguments put forth by the AG. The results of the 1999 Study are known and measurable, reflect the most recent version of a recurring analysis of allocation factors, and are based on actual accounting data that corresponds with the test period. The Commission also agrees with LG&E that, consistent with the use of the 1999 Study, the updated allocation factors for the common operating expenses should also be reflected in the determination of LG&E's

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[34] LG&E's Response to the Commission's May 25, 2000 Order, Item 24.

[35] Williams Rebuttal Testimony at 2-4; Seelye Rebuttal Testimony at 11; and LG&E's Post-Hearing Brief at 5-6.

[36] Seelye Rebuttal Testimony at 12-13.

[37] Henkes Direct Testimony at 11-13.

gas operating expenses.[38] The Commission reminds LG&E that the purpose of its annual common utility study should be to establish the appropriate allocation factor used to allocate the common utility plant to its electric and gas operations. The Commission rejects LG&E's contention that the 1998 Study should be used in this proceeding because it was used in Case No. 98-426. The test period in Case No. 98-426 was the 12 months ending December 31, 1998; in this case it is the 12 months ending December 31, 1999. There also is no relevance in LG&E's argument connecting the use of the 1999 Study to support its proposal to determine revenue requirements using rate base. Therefore, the Commission will apply the results of the 1999 Study and the updated common operating expense allocation factors when determining the rate base, capitalization, and net operating income of LG&E in this proceeding.

RATE BASE

LG&E proposes an adjusted gas operations rate base of $287,909,011.[39] The AG proposes an adjusted gas operations rate base of $277,961,350.[40] The DOD

[38] For the specific operating expense accounts impacted and the change in allocation factors, see Williams Rebuttal Testimony at 3 and Williams Rebuttal Exhibit 1.

[39] Williams Direct Testimony, Exhibit 3, page 1 of 2. In its rebuttal testimony, LG&E revised its calculations and proposed an adjusted gas operations rate base of $287,894,821. See Williams Rebuttal Testimony, Revised Exhibit 3, page 1 of 2.

[40] Henkes Direct Testimony, Schedule RJH-3. In his brief, the AG revised his calculations and proposed an adjusted gas operations rate base of $277,907,992. See AG's Post-Hearing Brief at 4.

adopts the adjusted gas operations rate base as determined by LG&E.[41] The Commission has reviewed the proposed rate bases and has made the following modifications:

Utility Plant

LG&E has determined that its total gas utility plant in service at the end of the test period was $439,581,248.[42] The AG has determined that the total gas utility plant in service was $436,334,493.[43] The difference in the amounts results from the AG allocating the common utility plant in service and common CWIP using the 1999 Study rather than the 1998 Study. As discussed previously in this Order, the Commission has determined that the 1999 Study should be used in the determination of LG&E's gas operations rate base. Therefore, the Commission will accept the total gas plant in service determined by the AG as the appropriate test-period balance.

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[41] Prisco Direct Testimony, Exhibit TJP-2. However, the DOD used LG&E's rate base "for calculation purposes only" and did not advocate either rate base or capitalization to determine the revenue requirements. The DOD revised its calculations to reflect the pro forma adjustments it supported in its direct testimony, and determined an adjusted gas operations rate base of $287,783,447. See Response to the First Data Request of Commission Staff to the DOD, dated July 5, 2000, Items 1 and 2.

[42] Williams Direct Testimony, Exhibit 3, page 1 of 2. Total gas utility plant in service reflects gas plant in service, gas construction work in progress ("CWIP"), gas stored underground – noncurrent, 25 percent of common utility plant in service, and 25 percent of common CWIP.

[43] Henkes Direct Testimony, Schedule RJH-3.

Prepayments

In determining the gas operations rate base, LG&E and the AG use the 13-month average balance for prepayments.[44] LG&E provided the ratios used to determine the portion of the total company prepayments allocated to gas operations.

The Commission has reviewed these allocation ratios and has rejected the ratios used for the prepaid real estate commissions and prepaid rights-of-way. LG&E allocates prepaid real estate commissions on a service center that is shared by both the electric and gas businesses on a 50-50 basis. The Commission believes that the service center is part of common utility plant that should be allocated in accordance with the 1999 Study. LG&E's test-period allocation of the prepaid rights-of-way reflects the 1998 Study; however, the Commission has determined the 1999 Study should be used. The Commission's determination of prepayments reflects these allocation ratio changes.[45]

The prepaid taxes included in the prepayments reflect the gas portion of the PSC Assessment. The Commission has previously found that the PSC Assessment should be excluded from the calculation of rate base. The Commission stated in Case No. 98-474:

> The classification of the PSC Assessment as a prepayment allows KU to recognize the expense over the entire year, rather than in the month of payment. The Commission is not

[44] The following items were included in both LG&E's and the AG's gas prepayment calculations: prepaid insurance, prepaid taxes, prepaid gas franchises, prepaid real estate commissions, and prepaid rights-of-way. See LG&E Supporting Workpapers, filed April 27, 2000, tab 16.

[45] The Commission has accepted the test-period allocation ratios used for the prepaid insurance and the prepaid gas franchises.

> opposed to the concept of spreading this expenditure over a 12-month period. However, in determining whether the unamortized expense should be included in rate base, we must consider whether the funds were provided by ratepayers prior to or after the prepayment is recorded on the books. The assessment is based on the gross operating revenues of the utility for the prior calendar year, and it is notified of its assessments by July 1 of the following year. Thus, the assessment applies to sales that occurred prior to the recording of the prepayment. The PSC Assessment is included in operating expenses in determining revenue requirements that provide full recovery of this cost. It is inappropriate to also include a return on the unamortized balance in the prepaid accrual simply because for accounting purposes the assessment can be treated as an accrual or a prepaid expense.[46]

While LG&E acknowledges the Commission's traditional treatment of the PSC Assessment, it believes that the PSC Assessment should remain in the prepayments because it is a cash outlay for a prepaid expense and should be treated in the same manner as other prepaid items.[47] The Commission is not persuaded by LG&E's argument. LG&E has not provided any evidence that would refute the Commission's previous decisions. Based on the same reasoning set forth in Case No. 98-474, the Commission finds that the PSC Assessment should be excluded from the 13-month average balance of prepayments included in LG&E's gas rate base.

Cash Working Capital Allowance

LG&E and the AG determine the cash working capital allowance using the 45 day or 1/8th formula methodology, reflecting the impacts of adjustments each proposed

[46] See Case No. 98-474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of its Rates and Service, final Order dated January 7, 2000, at 52 and footnote 134.

[47] LG&E's Post-Hearing Brief at 10.

to gas operation and maintenance expenses. While the Commission finds that approach is reasonable and should be used here, the cash working capital allowance included in the Commission's determination of gas rate base has been adjusted to reflect the accepted pro forma adjustments to operation and maintenance expenses, as discussed later in this Order.

Accumulated Depreciation

LG&E proposes to increase the test-period balance for gas accumulated depreciation of $148,052,866 by $80,513 in conjunction with its proposed adjustment to depreciation expense. The proposed adjustment is to reflect a full year depreciation expense on 1999 net plant additions, in order for the test period to be more representative of ongoing operations. LG&E calculates its proposed adjustment by listing test-period end plant balances by function multiplied by the corresponding depreciation rate.[48] LG&E's test-period balance for gas accumulated depreciation and its proposed depreciation expense adjustment reflect the allocation of depreciation expense on common utility plant and miscellaneous intangible plant, both of which are allocated to gas operations using the 1998 Study.

The AG proposes to adjust the test-period balance for gas accumulated depreciation to $147,012,854, to reflect the use of the 1999 Study, and further to reduce this accumulated depreciation by $467,195[49] in conjunction with its proposed adjustment to depreciation expense. The AG's proposed depreciation expense is composed of two items. First, the AG recalculates LG&E's depreciation expense

[48] LG&E Supporting Workpapers, filed April 27, 2000, tab 2.

[49] Henkes Direct Testimony, Schedule RJH-4.

adjustment so that it reflects the 1999 Study. Second, the AG removes depreciation expense on plant funded by customer advances for construction ("customer advances"). The AG contends that since LG&E is not seeking a return on plant funded by customer advances, it is inappropriate and inconsistent for LG&E to include plant funded by customer advances in the calculation of the depreciation expense adjustment.[50]

LG&E disagrees with the AG's exclusion of plant funded by customer advances from the calculation of depreciation expense. LG&E contends that as the customer advances are refunded over a 10-year period, a corresponding amount of the customer advances is charged off, which effectively means that LG&E pays for that utility plant. Any portion of the customer advance not refunded within the 10-year period is reclassified as a contribution in aid of construction, and that portion of the utility plant is deducted from the balance of utility plant in service. LG&E argues that the AG's proposal would require that depreciation on plant funded by customer advances be held in abeyance until LG&E's refunding obligation had expired. LG&E further argues that the AG's proposal is inconsistent with the proper accounting treatment for customer advances and the Commission's past rate-making treatment.[51]

As the Commission has determined that the 1999 Study should be used in this proceeding, we have restated LG&E's test-period balance for gas accumulated depreciation to $147,012,854. The Commission has also recalculated LG&E's depreciation expense adjustment, applying the 1999 Study to the common utility plant and miscellaneous intangible plant, and the result is a reduction to the test-period

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[50] Id. at 54.

[51] Seelye Rebuttal Testimony at 27-29.

expense of $167,448. Therefore, the Commission will include this reduction in test-period depreciation expense in the balance of accumulated depreciation used to determine LG&E's gas rate base.

However, the Commission agrees with LG&E that the AG's proposal to exclude depreciation expense on plant funded by customer advances is inappropriate. The Commission finds that portion of the AG's proposal to be inconsistent with established accounting and rate-making treatments. We agree with LG&E that such an approach would require the utility to wait until the refunding period is concluded before recovering depreciation expense on utility plant funded by customer advances.

Miscellaneous Long-Term Liabilities

The AG proposes that $6,934,924 in certain long-term deferred credit balances be recognized as reductions to LG&E's gas rate base.[52] The AG argues that these accruals, which are internally funded, represent funds that would be available to LG&E for general working capital purposes. The AG believes these accruals should be treated as reductions to LG&E's gas rate base.[53]

LG&E opposes the AG's proposed adjustment related to these miscellaneous long-term liabilities, noting that such adjustments are contrary to the Commission's long-

[52] The long-term deferred credit balances included in the AG's proposal are related to accumulated Statement of Financial Accounting Standard ("FAS") No. 106 post retirement benefit expense accruals, accumulated internally funded pension expense accruals, FAS No. 112 expense accruals, and workers compensation expense accruals.

[53] Henkes Direct Testimony at 20-22.

standing practice for determining rate base. LG&E also notes that these accruals have nothing to do with the investment in facilities used to provide service to customers.[54]

The Commission is not persuaded by the AG's arguments. The AG has offered no evidence to support this adjustment to rate base and has not explained why, given the nature of these accruals, it is reasonable to assume these internally funded accruals represent funds available for general working capital purposes. Therefore, the Commission rejects the AG's proposal.

Accumulated Deferred Income Taxes ("ADIT")

In the determination of its gas rate base, LG&E has deducted ADIT of $26,352,941.[55] The balance utilized by LG&E included common ADIT reflecting the 1998 Study. The AG has deducted ADIT of $27,235,152.[56] The AG's balance for gas ADIT reflects the use of the 1999 Study for the allocation of common ADIT, and several adjustments. First, the AG proposes to exclude ADIT related to test period over- and under-recovery balances of LG&E's Gas Supply Clause ("GSC") mechanism. Second, the AG proposes to exclude ADIT related to LG&E's Supplemental Executive Retirement Income Plan ("SERP"). Finally, the AG proposes that, if the Commission rejects his recommendation concerning the miscellaneous long-term liabilities, the ADIT balances related to those accruals should be excluded from the rate base calculation.[57]

[54] Seelye Rebuttal Testimony at 14.

[55] This amount reflects gas ADIT of $21,021,338 and gas ADIT associated with FAS 109 of $5,331,603. See Williams Direct Testimony, Exhibit 3, page 1 of 2.

[56] This amount reflects gas ADIT of $21,793,472 and gas ADIT associated with FAS 109 of $5,441,680. See Henkes Direct Testimony, Schedules RJH-3 and RJH-5.

[57] Henkes Direct Testimony at 14-18.

LG&E opposes the AG's adjustments to the gas ADIT balances. LG&E states that the GSC mechanism does not contain provisions for the recovery of taxes or deferred taxes. LG&E contends that if the ADIT associated with the GSC mechanism is excluded from rate base, then this cost would never be recoverable. LG&E notes that such an exclusion is not consistent with the approach used by the Commission to determine rate base.[58] Concerning the proposal to exclude ADIT associated with SERP, LG&E argues that it must pay these taxes associated with the SERP accruals and that because this portion of the ADIT balance relates to SERP does not warrant the AG's proposed exclusion.[59] Concerning the ADIT related to miscellaneous long-term liabilities, LG&E opposes this adjustment for the same reasons given in opposition to the AG's miscellaneous long-term liabilities adjustment.[60]

As noted previously in this Order, the Commission has determined that the 1999 Study should be used in this proceeding, and the adjusted gas ADIT balance reflects this decision. In addition, the Commission agrees with the AG that the gas ADIT associated with LG&E's SERP should be excluded from the rate base calculation. Because LG&E records SERP expenses and related income taxes as "below-the-line" expenses on its income statement, the shareholders of LG&E bear these expenses. It is consistent that the associated ADIT should also be borne by shareholders, and the

[58] Seelye Rebuttal Testimony at 13-14.

[59] LG&E's Post-Hearing Brief at 7-8.

[60] Id. at 8-9.

gas ADIT utilized by the Commission to determine LG&E's gas operations rate base will reflect this exclusion.[61]

However, the Commission is not persuaded by the AG's arguments concerning the remaining proposed adjustments to ADIT. The GSC mechanism currently does not contain a provision addressing the recovery of taxes or deferred taxes. Excluding ADIT associated with the GSC mechanism would deny LG&E the opportunity to earn a return on these deferred taxes. The AG has provided no evidence to support excluding the ADIT related to the GSC or miscellaneous long-term liabilities. The AG has also failed to adequately explain why the Commission should recognize these adjustments when it has not done so previously. Therefore, the Commission rejects these proposed adjustments to the ADIT.

Based upon the previous findings, we have determined the gas rate base for LG&E at December 31, 1999 to be as follows:

Total Utility Plant in Service	$436,334,493
Add:	
Gas Stored Underground	26,664,564
Materials and Supplies	1,371,734
Prepayments	244,443
Cash Working Capital Allowance	4,733,447
Subtotal	$ 33,014,188
Deduct:	
Accumulated Depreciation	146,845,406
Customer Advances	10,444,203
Accumulated Deferred Taxes	26,462,743
Investment Tax Credit (prior law)	29,222
Subtotal	$183,781,574
NET ORIGINAL COST RATE BASE – GAS	$285,567,107

[61] The SERP exclusion will also be reflected when the Commission determines the rate base ratio to be used to determine LG&E's gas operations capitalization.

CAPITALIZATION

LG&E proposes an adjusted gas operations capitalization of $268,202,448.[62] Included in the gas capitalization were adjustments for the Job Development Investment Tax Credit ("JDIC") and the exclusion of the gas portion of LG&E's investment in the African American Venture Capital Fund ("Venture Fund"), an investment not associated with LG&E's Kentucky jurisdiction operations. Both adjustments were allocated by LG&E on a pro rata basis to all components of capitalization.

The AG initially agreed with the adjusted gas operations capitalization proposed by LG&E. However, in order to maintain consistency with the recommendation to reflect the 1999 Study, the AG now proposes an adjusted gas operations capitalization of $266,263,516.[63] Like LG&E, the AG included adjustments for JDIC and the Venture Fund, allocated on a pro rata basis to all components of capitalization.

Both LG&E and the AG determined the gas capitalization by multiplying LG&E's total company capitalization times a ratio calculated by dividing the gas rate base by the total company rate base. This approach is consistent with the approach used by the Commission in previous LG&E rate cases. LG&E's gas capitalization reflects the impacts of the 1998 Study as it was applied to rate base components and the gas portion of the Venture Fund. The AG's revised gas capitalization reflects the impacts of the 1999 Study as it was applied to rate base components, but reflects the 1998 Study when determining the gas portion of the Venture Fund. Neither LG&E nor the AG

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[62] Williams Direct Testimony, Exhibit 2, page 1 of 2.

[63] AG's Response to the First Data Request of Commission Staff to the AG, dated July 5, 2000, Item 3.

reflected the allocation of common JDIC to the gas capitalization.[64] To be consistent in the treatment of common items, the common JDIC should have also been allocated to the gas operations.

Based on the findings herein, the Commission has determined that LG&E's test-period-end gas capitalization should be $266,376,827. The Commission's conclusion reflects the impacts of the 1999 Study as applied to the determination of LG&E's gas rate base, as well as the allocation to gas operations of the common JDIC and Venture Fund. The calculation of the gas capitalization is shown on Appendix C.

REVENUES AND EXPENSES

For the test period, LG&E reports actual net operating income from gas operations of $7,282,920.[65] LG&E proposes a series of adjustments to revenues and expenses to reflect more current and anticipated operating conditions, which results in an adjusted net operating income from gas operations of $7,614,330.[66] The AG proposes his own series of revenue and expense adjustments to arrive at his adjusted net operating income from LG&E's gas operations of $11,258,219.[67] The Commission

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[64] LG&E had indicated that it considered the common JDIC balance, a credit of $97, to be immaterial and did not allocate a portion of it to gas operations JDIC. See LG&E's Response to the Commission's April 28, 2000 Order, Item 43(d). While this amount is immaterial, it was readily identifiable in LG&E's financial reports. See Application, Tab 35, Filing Requirement 6-r, December 1999 Monthly Financial Report, page 10.

[65] Williams Direct Testimony, Exhibit 1, page 1 of 2.

[66] Id. at 2 of 2. Subsequently, LG&E accepted several of the AG's proposed adjustments which increased its adjusted net operating income from gas operations to $8,526,123. See Williams Rebuttal Testimony, Revised Exhibit 1, page 1 of 2.

[67] Henkes Direct Testimony, Schedule RJH-8.

finds that six of the adjustments proposed by LG&E and accepted by the intervenors are reasonable and will be accepted without change: temperature normalization; year-end customer growth; customer switching and billing; the removal of the Muldraugh storage field gas storage losses; the elimination of the LG&E Energy expenses allocated to LG&E's gas operations; and the impact of the post test-period union wage increase upon payroll taxes.[68] The Commission makes the following modifications to the remaining proposed adjustments:

Charges For Miscellaneous Service Fees

On April 21, 2000, LG&E filed a request to increase its fees for disconnecting and reconnecting service and for returned checks for both its electric and gas customers.[69] LG&E proposes to increase the fee for disconnecting and reconnecting service from $14.00 to $23.00 and the fee for returned checks from $4.00 to $10.00. LG&E has provided cost justification for this increase in fees. The changes in these fees result in an additional $38,903 of revenues.

The AG opposes any increase to these fees, citing the increased burden to low-income ratepayers and arguing that increases of this magnitude would violate the Commission's policy of maintaining gradualism and rate continuity when making rate adjustments.[70] MHNA also takes the position that the proposed increases will be an

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[68] Although the DOD proposed an adjustment to LG&E's labor expense, it failed to make a corresponding adjustment to payroll taxes.

[69] Case No. 2000-137, which was consolidated with this proceeding by Order dated May 19, 2000.

[70] Kinloch Direct Testimony at 34.

undue hardship on low-income customers,[71] but neither the AG nor MHNA offers any alternative rates.

The Commission generally recognizes that fees such as these allocate costs to cost causers and are a fair and reasonable component of a gas utility's rate design. However, we also recognize that any increase in utility rates or charges has the potential to create a financial hardship for low-income customers. In this instance, the Commission will approve a fee of $18.50 for disconnecting and reconnecting service and a returned check charge of $7.50 to partially compensate LG&E for its increased costs. This results in an additional $20,892 of revenues. By increasing these charges by one-half of the amount proposed by LG&E the Commission is adhering to the rate-making concepts of continuity and gradualism in order to lessen the impact of these increases on the customers that incur these charges. However, we do so recognizing that the costs not recovered in these charges must then be recovered through LG&E's rates for gas service.

Wages and Salaries

LG&E proposes to increase its wages and salaries expense by $324,268. Under the terms of the 1998 bargaining agreement with the International Brotherhood of Electric Workers, Local 2100, LG&E's union employees will receive a 3.5 percent wage increase on November 13, 2000, which is the basis of LG&E's wage and salary adjustment.[72]

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[71] Valade Direct Testimony at 1.

[72] Williams Direct Testimony at 8.

The DOD argues that because the union wage increase does not go into effect until November 2000, LG&E should be entitled only to the portion of the increase that will be in effect within one year of the test period.[73] For this reason the DOD proposes to reduce LG&E's wages and salaries adjustment by $249,768.

LG&E's proposal to reflect the post test-period union wage increase is consistent with the methodology proposed by LG&E and accepted by this Commission in Case Nos. 8616,[74] 10064,[75] and 90-158. This past methodology recognizes that the contract union wage increase constitutes a known and measurable adjustment. The DOD has not presented any evidence to persuade the Commission to abandon this approach. Accordingly, the Commission finds that LG&E's proposed adjustment should be accepted and has increased salaries and wages expense by $324,268.

401(k) Company Match

LG&E's original proposal was to increase its 401(k) company matching expense by $8,857 to reflect the effect its post test-period union wage increase will have on this expense.[76] The AG proposes to decrease LG&E's 401(k) company matching expense adjustment by $1,820 to correct a mathematical error.[77] LG&E agrees with the AG that there is a mathematical error in its calculation, but LG&E has determined that its 401(k)

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[73] Prisco Direct testimony at 5.

[74] Case No. 8616, General Adjustment in Electric and Gas Rates of Louisville Gas and Electric Company, Final Order dated March 2, 1983.

[75] Case No. 10064, Adjustment of Gas and Electric Rates of Louisville Gas and Electric Company, final Order dated July 1, 1988.

[76] Williams Direct Testimony at 9.

[77] AG's Post-Hearing Brief at 10.

company matching expense adjustment should be reduced to $7,236, which is $200 greater than the AG's proposal.[78] Upon review of LG&E's and the AG's calculations, the Commission finds that LG&E's revised calculation is more accurate and, therefore, has increased test-period 401(k) company matching expense by $7,236.

<u>LG&E's One Utility Program</u>

Subsequent to the test period, LG&E Energy offered its employees a voluntary retirement package entitled One Utility Program. LG&E Energy announced that by the end of April 2000, its One Utility Program would result in the elimination of 250 positions company wide, and estimated that 127 positions would be eliminated from LG&E.[79] LG&E estimated that the One Utility Program would result in estimated net gas savings of $502,390.[80] In computing its net savings LG&E used a 21 percent allocation factor for the annual labor savings, a 25 percent allocation factor for the separation costs, and amortized the separation costs over 3 years.[81]

The DOD proposes to decrease test-period operating expenses by $502,390 to reflect LG&E's estimate of the net savings in the gas operations resulting from the One Utility Program.[82] The AG agrees with the DOD that LG&E's test-period operations should be adjusted to reflect the impact of the One Utility Program; however, the AG

[78] Williams Rebuttal Testimony, Revised Exhibit 1, Schedule G, page 1 of 4.

[79] LG&E's Response to the AG's Second Request for Information dated May 25, 2000, Item 42, page 3 of 3; and LG&E's Response to the Commission's March 15, 2000 Order, Item 37.

[80] LG&E's Response to the Commission's May 25, 2000 Order.

[81] Henkes Direct Testimony, Schedule RJH-16.

[82] Prisco Direct Testimony at 6.

makes several revisions to LG&E's estimate. The AG proposes a net reduction of $838,900[83] by using the same 21 percent allocation factor for both the employee separation costs and the labor savings, and amortizing the separation costs over 5 years.[84]

LG&E claims that the savings from its One Utility Program are not known and measurable at this time, and will likely never be known and measurable. LG&E states that they have not implemented a formal process for tracking the savings and that even if they could be measured, there is uncertainty as to what the savings will actually be.[85] While it was originally anticipated that 250 employees would leave LG&E Energy company wide, LG&E now asserts that it is unable to determine how many employees will leave because the One Utility Program's non-discrimination practices permit an indeterminate number of employees to take advantage of the program. For this reason, LG&E argues that it does not know how many positions it will need to backfill with new hires or temporary employees or the cost of technology that will be required to accomplish the necessary tasks in light of the employee losses.[86]

According to an LG&E witness, the estimated separation costs were recorded in March 2000 and the majority of the employees left as expected in April 2000.[87] The

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[83] Henkes Direct Testimony, Schedule RJH-16.

[84] AG's Brief at 13.

[85] Seelye Rebuttal Testimony at 25.

[86] LG&E's Post-Hearing Brief at 14.

[87] T.E., Vol. I of III, at 202.

Commission finds that the employee reduction that occurred in April 2000 as a result of the One Utility Program will impact LG&E's current and ongoing operations.

LG&E's argument that the impact of its One Utility Program is not known and measurable centers around the claim that company wide there has been an over subscription to the program.[88] As of June 30, 2000 a net of 214 employees have left the employment of LG&E. Of this number 124 are connected to the One Utility Program and the remaining 90 can be attributed to retirements and normal attrition.[89] This shows that the original estimate that the One Utility Program would result in the elimination of 127 positions at LG&E is within a range the Commission finds is reasonable.

Given that the One Utility Program has been implemented and that the number of positions actually eliminated is known, the Commission finds that LG&E's test-period operations should be adjusted. If this adjustment is not made, the savings will not be passed on to consumers until LG&E's next gas rate case. Likewise, if the adjustment is not included, LG&E will realize additional earnings as a result of those employee eliminations. LG&E's estimate of its net savings in the gas operations is reasonable; however, the actual separation costs incurred as of July 2000 of $7,244,901[90] have been substituted for the estimate, which results in a reduction to test-period operating expenses of $673,693.

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[88] Id., Vol. II of III, at 177.

[89] LG&E's Response to the Information Requested During the August 2 through 4, 2000 Hearing, Item 6, page 1 of 2.

[90] Id., page 2 of 2.

Year 2000 Expenses

In accordance with the Commission's decision in Case No. 98-426, LG&E proposes to reduce its operating expenses by $260,710 to reflect a 3-year amortization of the incremental costs associated with preparing its computer systems for the year 2000 ("Y2K Preparedness").[91]

The DOD proposes a reduction to operating expenses of $391,066 to eliminate all of the costs associated with LG&E's Y2K Preparedness on the grounds that they are non-recurring.[92] While the AG does not oppose LG&E's recovery of the cost of the Y2K Preparedness, he does object to the proposed 3-year amortization. Because this case is not subject to a 3-year review, as was established in Case No. 98-426, the AG claims that there is no compelling reason to amortize this expense over 3 years. Given the extraordinary nature of this non-recurring expense and considering the magnitude of the rate increase sought, the AG proposes this expense be amortized over 5 years, which results in a reduction to operating expenses of $312,853.[93]

In Case No. 98-426, the Commission rejected a proposed 5-year amortization period for Y2K Preparedness expenditures, finding that "A three year amortization conforms with generally accepted accounting principles and LG&E's procedures for recovery of information technology investments."[94] Neither the DOD nor the AG has presented any evidence to persuade the Commission that this approach is

[91] Williams Direct Testimony at 10.

[92] Prisco Direct Testimony at 6.

[93] AG's Post-Hearing Brief at 11.

[94] See final Order dated January 7,2000 at 64.

unreasonable. Accordingly, the Commission finds that LG&E's proposed adjustment to reduce operating expenses by $260,710 should be accepted.

Pension Expense

LG&E proposes to increase the allocation of its pension expense to its gas division by $801,704.[95] According to LG&E, the pension expense decreased considerably during the test period due to changes in the actuarial assumptions and the strong performance of the pension asset investments. To normalize pension expense, LG&E uses a mathematical 5-year average of historical pension costs.[96]

The AG states that the Commission has not previously allowed LG&E to normalize its pension expense based on a 5-year historic average. The AG argues that pension expense is not the type of expense for which a historic averaging is appropriate. The AG points to a change in the Union Plan provisions in 1999 that resulted in a decrease of $2.225 million in LG&E's pension expenses. Because 4 of the 5 years fail to reflect such changes in the Union Plan provisions, the AG states that it is inappropriate to utilize a historic averaging normalization. The AG proposes a decrease of $1,903,762 to LG&E's adjustment to reflect the impact of the pro forma test period pension expense calculated by LG&E.[97]

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[95] Williams Direct Testimony, Exhibit 1, Schedule J.

[96] Id. at 10.

[97] AG's Post-Hearing Brief at 10.

According to the DOD, LG&E's pension costs have been decreasing for the past 5 years, and there is no indication that this trend will not continue over the next several years. For these reasons the DOD proposes that LG&E's adjustment be denied.[98]

LG&E claims that its approach reflects the 20-year market trends preceding 1999, as well as the 1999 market performance, while the AG's approach uses only the results of the investments in 1999 and an estimate of the predicted results of 2000. LG&E argues that it is not appropriate to set rates based on an estimate for the year 2000 that is out of sync with the prior 19 years. Because the official 2000 actuarial report will not be available until early 2001, LG&E claims that the AG's proposal is based upon an actuarial estimate that is on three pages of handwritten notes. For these reasons, LG&E proposes the AG's adjustment be denied.[99]

Over the 5-year period of 1995 through 1999 the following events occurred that that would significantly impact LG&E's pension expense:

(1) A net reduction in LG&E's workforce of 410 employees.[100]

(2) The merger between LG&E Energy and KU Energy Corporation.[101]

(3) The Union Plan provisions were revised in 1999.

(4) The actuarial assumptions were changed in 1999.

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[98] Prisco Direct Testimony at 6.

[99] Seelye Rebuttal Testimony at 21.

[100] LG&E's Response to Item 5 of the Information Requested During the August 2 through 4, 2000 Hearing.

[101] Case No. 97-300, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for Approval of Merger, final Order dated September 12, 1997.

(5) The pension assets earned a strong market return in 1999.

Given that the identified events were not reflected in all years, it is unlikely that LG&E's proposal to use a 5-year historical average of these years can be an accurate indicator of LG&E's ongoing expected future levels of pension expense. Likewise, the AG has failed to document that the actuarial estimate of the 2000 pension expense is a reasonable indicator of the future level of LG&E's pension expense. The AG's proposal to use the actuarial estimate also fails to meet the rate-making criteria of known and measurable. For these reasons the Commission finds that the DOD proposal to leave LG&E's pension expense at the test-period level should be accepted.

Advertising/Promotional Expense

LG&E's original proposal was to reduce Account No. 930.1 – General Advertising Expenses and Account No. 913 – Advertising Expenses by $60,634 and $21,526, respectively.[102] LG&E states that 807 KAR 5:016, Section (2)1, provides that a utility will be allowed to recover for rate-making purposes only those advertising expenses that produce a "material benefit" to its ratepayers. For this reason LG&E's adjustment only removes the advertising expenses that it deems to be institutional and promotional in nature.[103]

The AG proposes a decrease of $205,620, which reflects the removal of additional advertising/promotional expenses of $123,460.[104] LG&E agrees with the AG's

[102] Williams Direct Testimony, Exhibit 1, Schedule K.

[103] Id. at 11.

[104] Henkes Direct Testimony, Schedule RJH-19.

proposal to remove $45,139[105] of promotional/advertising expenses identified by the AG that are not the type of expenses the Commission has allowed in the past, and modifies its proposal to remove those expenses.[106]

LG&E does not agree with removing the $47,660 in expenses in Account 912001 that relate to economic development. The only justification LG&E provides for this position is that the Commission has traditionally allowed expenses related to the internal economic development activities. To support this claim, LG&E states that these types of expenses were not removed in Case Nos. 90-158 or 98-426.[107] The AG views these expenses as promotional and not related to the provision of gas service.[108]

The Commission finds that the economic development activities listed in Account 912001 are not specifically Identified as those advertising expenditures that have a "material benefit" for the ratepayers.[109] Furthermore, an LG&E witness testified that the FERC definition of Account 912001 matches the Administrative Regulation definition of advertising that is to be excluded from rate-making.[110] For these reasons the Commission finds that Account 912001 meets the criteria established by 807 KAR 5:016 as advertising expenses that must be excluded for rate-making purposes and has

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[105] Williams Rebuttal Testimony at 6 and 7.

[106] Id. at 6.

[107] Williams Rebuttal Testimony at 7.

[108] AG's Post-Hearing Brief at 16.

[109] See 807 KAR 5:016, Section 3.

[110] T. E., Volume I, at 215.

accepted the AG's adjustment to decrease test-period operating expenses by $205,620, which includes Account 912001.

Manufactured Gas Plant Cleanup Costs

LG&E proposes to increase its test-period operating expenses by $561,612 to reflect the amortization of $1.7 million in costs incurred to cleanup the various contaminates at the manufactured gas plants LG&E formerly owned.[111] Because it was concerned that the potential liability to cleanup the manufactured gas plants might be substantial, LG&E recorded the cleanup costs as a deferred debit in accordance with FAS 71. Now that a rate case has been filed, LG&E claims that it is entitled to amortize these expenditures over a reasonable time. For this reason LG&E proposes to amortize these expenditures over 3 years.[112]

The AG agrees that the $1.7 million expended on the environmental remediation measures are a one-time non-recurring expenditure that LG&E should be allowed to recover, but contends that the issue is the amortization period. The AG argues that it is appropriate to use the time lapse between the last rate case and this current case and the time period over which the expenditures were deferred as a guide to determine the appropriate amortization period. Therefore, the AG proposes to increase LG&E's test-period operating expenses by $210,604[113] to reflect amortizing the cleanup costs over 8 years, the period of time over which the expenditures were deferred.[114]

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[111] Id. at 11.

[112] Seelye Rebuttal Testimony at 22.

[113] Henkes Direct Testimony, Schedule RJH-14.

[114] AG's Post-Hearing Brief at 11.

The DOD agrees with the AG in that LG&E should be allowed to recoup the cleanup costs; however, the DOD recommends that the costs be amortized over 10 years. According to the DOD the contamination of these properties has occurred over an extensive period of time, and the amortization should also be spread over a longer period of time.[115] The DOD proposes to increase LG&E's test-period operating expenses by $168,484 to reflect a 10-year amortization period. [116]

The only justification expressed by LG&E for its proposal of a 3-year amortization period is that it expects to file a rate case in 3 years.[117] The Commission agrees with the AG in that in order to determine a reasonable amortization period for a deferred expenditure it is appropriate to consider the time lapse between the last rate case and this current case and the time period over which the expenditures were deferred. In this instance the cleanup of the manufactured gas plant was started in 1992,[118] so the costs have been accumulated over an 8-year period. The Commission finds that the AG's proposal to amortize the manufactured gas plant cleanup costs over 8 years is reasonable and has increased LG&E's operating expenses by $210,604.

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[115] Prisco Direct Testimony at 6 and 7.

[116] Id., DOD Exhibit TJP-8.

[117] LG&E's Response to Item 88(c) of the Commission's April 28, 2000 Order.

[118] T.E. at 213.

Rate Case Amortization

LG&E proposes to increase test-period expenses by $140,000 to reflect the amortization of its estimated rate case expense of $420,000 over a 3-year period.[119] The AG does not oppose LG&E's estimated rate case expense, but proposes an increase of $84,000[120] in operating expenses to reflect a 5-year amortization period. The AG argues that there is not a 3-year term Alternative Regulation plan in this proceeding requiring LG&E to file a rate case within 3 years, as there was in Case No. 98-426. The AG further argues that other than LG&E's general statement, there is no evidence in the record that would support LG&E's claim that it will file a gas rate case in 2003. What is known, the AG states, is that LG&E's last gas rate case was 10 years ago in 1990.[121] LG&E points to Commission past precedent to support its proposal of a 3-year amortization of rate case expense.[122]

This is the first rate case proceeding in which LG&E has requested recovery of rate case expense; therefore, there is no Commission precedent regarding amortization of rate case expense that is LG&E specific. However, the Commission traditionally recommends that a utility seek rate relief in a timely manner, so that rates will gradually increase over time. Finding that 3 years is generally a reasonable period of time between rate cases, the Commission has allowed rate case expense to be amortized over 3 years.

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[119] Williams Direct Testimony at 11.

[120] Henkes Direct Testimony, Schedule RJH-15.

[121] Id. at 37.

[122] LG&E's Post-Hearing Brief at 22.

Given the amount of capital LG&E is required to expend on its gas main replacement program, the Commission expects that LG&E will need to seek rate relief within a shorter period of time than in the past. The AG has not presented any evidence to persuade the Commission to abandon its approach of amortizing rate case expense over 3 years. For these reasons the Commission finds a 3-year amortization period is appropriate; however, it has modified LG&E's adjustment to reflect the $296,460[123] in the actual rate case cost that has been incurred to date, which results in an increase to operating expenses of $98,820.

Account 925

LG&E proposes no adjustment in Account 925 – Injuries and Damages, however, the AG argues that due to the nature of Account 925, it is difficult to predict the annual level of expense for this account. In support of his argument the AG provides a schedule showing that between the period of 1996 through 1999 Account 925 fluctuated from a low of $608,000 to a high of $1,048,000. For this reason, the AG proposes to decrease the test-period level of Account 925 by $253,706 to reflect a 4-year mathematical average.[124]

LG&E provided information after the hearing showing that Account 925 includes abnormal expense bookings of $291,000 and $113,400 for non-recurring settlement payments, which are related to certain accidents.[125] After reviewing the post-hearing

[123] LG&E's Updated Response to the Commission's March 15, 2000 Order, Item 38, filed September 1, 2000.

[124] Henkes Direct Testimony at 45.

[125] LG&E's Response to Items 9 and 10 of the Information Requested During the August 2 through 4, 2000 Hearing.

information filed by LG&E, the AG states that it is acceptable to decrease Account 925 by $404,400 to reflect the removal of the abnormal amounts.[126]

One method to determine whether an expense level is reasonable is to review the relationship between it and a relevant historical period. As shown by the AG, Account 925 reflects a significant increase in the test-period level when compared to the previous 3 years. LG&E explains that this increase is due to the settlement of an automobile accident and the settlement of a liability claim. Removal of these two abnormal settlement payments from Account 925 results in an adjusted test-period level of $643,883, a level that is reasonable when compared to the 3-year historical amounts. For this reason, the Commission finds that the AG's revised proposal should be accepted and has reduced Account 925 by $404,400.

Account 916

As with Account 925, the AG states that Account 916, miscellaneous sales expenses, also experiences significant fluctuations. The AG argues that LG&E has not provided any information indicating that the test-period level of $53,482 constitutes a trend or that it will be incurred at that level on an ongoing basis in the future. Therefore, the AG recommends that this expense be "normalized" based on the 5-year historic average of 1995 through 1999 for a decrease of $39,588.[127] LG&E argues that the AG offers no evidence that the test-period level of expenses for Account 916 will not be ongoing.[128]

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[126] AG's Post-Hearing Brief at 15.

[127] Id.

[128] Id. at 27.

As shown by the AG, Account 916 has a significant increase in the test-period level when compared to the previous 4 years. In the information provided after the hearing, LG&E states that the increase is due to misclassification of Gas Sales personnel's labor and expenses in Account Nos. 912 and 880. Given the misclassification of expenses, the AG's comparison of the test-period expense level to the historical amounts is incorrect. For this reason the Commission finds that the AG's adjustment should be denied.

Miscellaneous

The AG proposes that LG&E's test-period operating expenses be reduced by $150,673 to remove several miscellaneous expense items.[129] LG&E agrees that $36,101 of the miscellaneous expense items should be removed. However, LG&E disagrees with removing $39,461 of the gas-allocated Electric Power Research Institute ("EPRI") expense and $75,111 for employee moving expenses booked in the test-period.[130]

LG&E claims that in Case No. 98-426 the Commission approved inclusion of $294,381 of the EPRI membership charges to its electric operations, which left $37,591 of the EPRI membership charges allocated to the gas division. Because of the Commission's treatment of the EPRI membership charges in Case No. 98-426, LG&E argues that refusal to allow recovery of the gas allocation in this proceeding will result in the loss of the expenditure for which value is being received.[131] Although the

[129] Henkes Direct Testimony, Schedule RJH 20.

[130] LG&E's Post-Hearing Brief at 22 and 23.

[131] Id. at 23.

Commission has disallowed the recovery of employee moving expenses in the past, LG&E requests the Commission to reconsider this position. According to LG&E if it is not allowed to compensate employees for moving expenses, it would be extremely difficult to hire qualified professional employees from outside the Louisville area.[132]

The AG argues that the work performed by EPRI has nothing to do with the provision of gas service in a regulated environment and that for this reason LG&E should not be allowed to recover the gas allocation of the EPRI dues. The AG states that LG&E failed to provide a reasonable explanation to support rate recovery of its employee moving expense and that the Commission should persist in refusing to allow these expenses.[133]

The Commission is not persuaded by LG&E's arguments. LG&E's EPRI dues and the allocation of those expenses were not separately examined as part of the proceedings in Case No. 98-426, and the Commission was unaware that the EPRI dues allowed in that proceeding were not reflected at 100 percent. However, such an examination has been part of this case, and LG&E has had the burden of proof to demonstrate that its approaches and methodologies are reasonable. Here, it has not carried that burden. LG&E's incorrect allocation of its EPRI dues and its failure to recover 100 percent of those dues is not a valid reason for the Commission to allow recovery from the gas ratepayers for EPRI services that provide no direct benefit to the gas operations.

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[132] Williams Rebuttal Testimony at 8.

[133] AG's Post-Hearing Brief at 17.

LG&E made broad statements regarding its inability to attract and hire qualified professional employees if it is unable to compensate potential employees for their moving expenses. LG&E claims that it has established that the payment of moving expense is necessary to attract qualified employees and states that the expense is recurring. However, at the hearing, an LG&E witness testified that it has not performed an analysis or study to support its statements regarding the payment of moving expenses.[134]

The Commission finds that the AG's proposal to eliminate $150,673 of miscellaneous expense items is reasonable and, therefore, is accepted.

1999 Expense Allocation Factors

LG&E argues that if the Commission decides to update rate base and capital structure to reflect the use of the 1999 Study, then it should update the common expenses.[135] According to LG&E, updating the common expenses would result in an increase in test-period operating expenses of $1,015,929.[136] As previously mentioned, the Commission agrees with LG&E that, consistent with the use of the 1999 Study, the updated allocation factors for the common operating expenses should also be reflected in the determination of LG&E's gas operating expenses. To update LG&E's test-period operating expenses to reflect the 1999 Study percentages, the Commission will increase expenses by $1,015,929.

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[134] T. E., Volume I at 217.

[135] Williams Rebuttal Testimony at 4.

[136] LG&E's Post-Hearing Brief at 25.

Outside Legal Expense

LG&E prepared an analysis of its professional services expenses that identified 26 providers of legal services. On a total company basis, LG&E incurred an expense of $1,087,764.[137] LG&E states that it has historically allocated outside counsel expenses between electric and gas operations using the appropriate allocation percentages. LG&E notes that this approach results in some expenses incurred primarily for electric operations being allocated to gas operations and vice versa.[138] During the test period, LG&E recorded these legal expenses in four different expense accounts[139] and, using the test-period allocation percentages associated with those accounts, allocated $206,437 of the total company outside legal expense to gas operations.[140]

LG&E argues that this allocation approach was used during 1998 and was reflected in the rates set in Case No. 98-426. LG&E believes that it would be unfair to

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[137] LG&E's Response to the Commission's March 15, 2000 Order, Item 26, lines 2 through 29. The total represents a summation of the amounts shown in column (d) of the response.

[138] LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 19.

[139] LG&E's Response to the Commission's March 15, 2000 Order, Item 26, column (h), lines 2 through 29.

[140] Test period allocations provided in LG&E's Response to the Commission's April 28, 2000 Order, Item 49(c). The determination of the test-period allocation to gas operations is as follows:

Account No. 903024	$3,345 x 44%	=	1,472
Account No. 923100	$1,046,959 x 18.9%	=	197,875
Account No. 925002	$37,299 x 18.9%	=	7,050
Account No. 930208	$161 x 25%	=	40
Total			$206,437

use inconsistent methods for allocating these costs in this case.[141] LG&E contends that its allocation methodology for outside legal expenses is appropriate, was approved in Case No. 98-426, and should be approved in this case.[142]

In his brief, the AG notes that LG&E's outside legal expenses included a charge of $1,024 for legal work related to telecommunication activities and suggests that outside legal expenses be reduced by that amount.[143] LG&E has indicated that this charge should have been recorded below the line and not charged to gas operations.[144]

The Commission is not persuaded by LG&E's arguments. LG&E's outside legal expenses and the allocation of those expenses were not separately examined as part of the proceedings in Case No. 98-426. However, such an examination has been part of this case, and LG&E has the burden of proof to demonstrate that its approaches and methodologies are reasonable. If LG&E fails to satisfy its burden of proof, it would be reasonable to expect that the decision reached in this case would not be consistent with what was permitted in a previous case.

As part of its analysis of accounts such as outside legal expenses, the Commission attempts to determine an amount that represents a reasonable, ongoing level of expense to reflect in the utility's rates. When making this determination, the Commission attempts to evaluate whether expenses included in the test period reflect

[141] LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 19.

[142] LG&E's Post-Hearing Brief at 28.

[143] AG's Post-Hearing Brief at 19.

[144] LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 18.

recurring or non-recurring activity. The simple assertion by the utility that the expense level expected in future years would be comparable to the level experienced in the test period is not sufficient.[145]

The Commission has made three separate requests of LG&E for descriptions of the legal services provided by the 26 firms. The responses provided have been overall summaries of the services provided that, in many instances, failed to explain why the services should be charged to LG&E's gas operations.[146] This lack of specifics concerning the outside legal expenses, and LG&E's approach of allocating all outside legal expenses to electric and gas operations, makes it extremely difficult for the Commission to determine a reasonable, ongoing level at which this expense should be included in rates.

Especially troubling to the Commission is LG&E's allocation of all outside legal expenses to electric and gas operations without consideration for determining which of its operations is responsible for the expense. By following this approach during the test period, only 18.9 percent of the legal expenses associated with securing copyright and trademark registrations for a gas safety program mascot were assigned to gas

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[145] LG&E states that it expects that it will incur outside legal expenses in 2000 comparable to the amount incurred during the test period. See LG&E's Response to the Commission's May 25, 2000 Order, Item 11(c). The Commission notes that LG&E provided no analysis supporting its statement.

[146] See LG&E's Response to the Commission's April 28, 2000 Order, Item 49(a); Response to the Commission's May 25, 2000 Order, Item 11(a); and LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 19. The Commission notes that, while not specifically requested, LG&E could have provided copies of the invoices supporting the outside legal expenses when trying to explain the nature of the services provided and how those expenses related to its gas operations.

operations.[147] Likewise, 18.9 percent of the expenses for outside counsel utilized in Case No. 98-426 were allocated to gas operations.[148]

The Commission finds that LG&E's approach of allocating all outside legal expenses, regardless of the nature of those expenses, is not only inappropriate for rate-making purposes, but is also inappropriate accounting. LG&E operates two regulated businesses, the provision of electric service and the provision of gas service. Consequently, LG&E should be examining all expenditures to first determine whether the expense can be directly assigned to either the electric or gas operations. Only after concluding that it is not possible to make a direct assignment should LG&E allocate the expense, using a reasonable methodology, to both the electric and gas operations. Therefore, the Commission finds that LG&E should cease its current accounting practice concerning the treatment of outside legal expenses. LG&E should adopt accounting practices that provide for the direct assignment of outside legal expenses to either electric or gas operations, as appropriate. Only after LG&E has determined that

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[147] Until LG&E provided the information requested at the public hearing, LG&E lead the Commission to believe it had spent $218,874 securing the copyright and trademark registrations. See LG&E's Response to the Commission's April 28, 2000 Order, Item 49(a) and LG&E's Response to the Commission's May 25, 2000 Order, Item 11(a). However, LG&E now states that the total test period expense for this activity was $1,139. See LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 16. LG&E has only provided a general summary of the other additional legal work provided by this firm, with no breakdown of the remaining $217,735. See LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 19.

[148] LG&E's gas operations were allocated $51,500 related to the representation of LG&E in Case No. 98-426 by outside counsel. While LG&E's amended application in that proceeding contained a proposal to freeze gas rates (a proposal that was rejected by the Commission), Case No. 98-426 dealt only with LG&E's electric operations.

an outside legal expense cannot be directly assigned, it should utilize an appropriate allocation methodology and allocate the expense to its electric and gas operations.

Further, the Commission is concerned that LG&E may be treating other types of operating expenses in the same manner as it has the outside legal expenses. We are also concerned that LG&E's affiliation with KU and the "one utility concept" could result in expenses being inappropriately allocated between the two regulated utilities. Therefore, the Commission's decision concerning the appropriate accounting practice for outside legal expenses is also applicable to any other operating expense of LG&E, as well as to any expenses involving LG&E and KU, and any other LG&E affiliate.

After considering LG&E's inappropriate allocation of all outside legal expenses and the lack of specific information concerning the nature of the transactions with 26 firms, the Commission finds that it cannot establish a reasonable, ongoing level of outside legal expenses to include in rates. For the same reasons, the Commission finds that it cannot determine the reasonableness of the amounts reported as outside legal expense for the test period. Therefore, the Commission will exclude the entire amount recognized as outside legal expenses from the determination of LG&E's gas rates. As discussed previously in this Order, the Commission has recognized the updated allocation rates for operating expenses. The adjustment calculated in conjunction with that decision includes the total company outside legal expenses for the test period. The Commission has calculated the adjustment to remove all outside legal expenses from gas operating expenses, using the updated allocation rates, which results in a reduction of $240,079.[149]

Team Incentive Award ("TIA")

In 1999 LG&E's total company TIA was $4,872,652, which is $760,977 greater than the amount included in the 1999 operating expenses.[150] LG&E estimates that the impact that the One Utility Program has upon the 1999 TIA is a reduction of $350,000.[151] At the hearing an AG witness agreed that the test-period TIA should be adjusted to reflect the actual 1999 expense and the impact of the One Utility Program. To be consistent with the labor adjustments to reflect the post test-period union wage increase and the One Utility Program, LG&E's test-period TIA should be adjusted. The Commission has increased the TIA by $44,305 to reflect a 21 percent allocation, the labor allocation factor, of the net impact.

Depreciation Expenses

LG&E proposes to increase depreciation expense by $80,513[152] to reflect a full year of depreciation expense on 1999 net plant additions in order for the test period to

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[149] Using the updated allocation rates provided in Williams Rebuttal Testimony at 3, the determination of the outside legal expense exclusion is as follows:

Account No. 903024	$3,345 x 45%	=	1,505
Account No. 923100	$1,046,959 x 22%	=	230,331
Account No. 925002	$37,299 x 22%	=	8,206
Account No. 930208	$161 x 23%	=	37
Total			$240,079

[150] LG&E's Response to Item 26(a) of the Commission's May 25, 2000 Order.

[151] Id. at Item 26(c).

[152] Williams Direct Testimony, Exhibit 1, Schedule F.

be more representative of ongoing operations.[153] The AG's proposal to decrease depreciation expense by $467,195[154] is composed of two items. First, the AG recalculates LG&E's depreciation expense adjustment so that it reflects the 1999 Study. Second, the AG removes depreciation expense on plant funded by customer advances.[155]

As previously mentioned, the Commission has recalculated LG&E's depreciation expense adjustment, applying the 1999 Study to the common utility plant and miscellaneous intangible plant, thereby reducing the test-period expense by $167,448.

LG&E completed its last depreciation study in May 1990. The study was based on account balances as of December 31, 1988. As recommended by the study's consultant, LG&E performed a review of the depreciation accrual rates in 1995.[156] Given the time that had lapsed since the last complete study, LG&E should strongly consider performing a new depreciation study rather than a review of depreciation accrual rates only as recommended in the May 1990 Study.

Interest Synchronization

LG&E originally proposed to increase its interest expense by $70,520, which resulted in a decrease to income tax expense of $28,464.[157] LG&E applies its weighted

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[153] Id. at 7.

[154] Henkes Direct Testimony, Schedule RJH-4.

[155] Id. at 54.

[156] Application, Tab 31, Filing Requirement 6-R, page S-2, and LG&E's Response to the Commission's April 28, 2000 Order, Item 25(a).

[157] Williams Direct Testimony, Exhibit 1, Schedule R.

cost of debt to the capitalization adjustments for the Job Development Credit, and the African American Venture Capital Fund. According to LG&E, its adjustment reflects the interest synchronization methodology used by the Commission in Case No. 98-426.[158]

LG&E re-examined its interest synchronization methodology and determined that it is the methodology proposed by LG&E in Case No. 98-426 and not the interest methodology approved by the Commission. LG&E made a revision to its interest synchronization methodology to reflect applying its weighted cost of debt to the proposed rate base, which results in an increase to interest expense of $2,161,799[159] and a corresponding decrease to income tax expense of $872,556.[160]

The Commission has recalculated the interest synchronization adjustment for LG&E. Using the capital structure and weighted cost of debt determined reasonable herein, the Commission determines that interest expense should be increased by $1,871,676, which results in a decrease to income tax expense of $755,455.

<u>Other Interest Expense</u>

LG&E originally proposed to decrease income tax expense by $46,651[161] to reflect the exclusion of other interest expense.[162] At the hearing, however, an LG&E witness acknowledged that because of the revision to the interest synchronization

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[158] <u>Id.</u> at 13.

[159] Williams Rebuttal Testimony, Revised Exhibit 1, Schedule R.

[160] LG&E's Post-Hearing Brief at 24.

[161] Williams Direct Testimony, Exhibit 1, Schedule S.

[162] <u>Id.</u> at 13.

methodology, this adjustment should not be made.[163] Therefore, the Commission finds that LG&E's adjustment should be denied.

Income Taxes

LG&E originally proposed an increase in income tax expense of $236,606, reflecting the overall impact its adjustments to revenues and expense would have on income tax expense.[164] During the course of this proceeding LG&E made revisions to several of its adjustments resulting in a revised increase to income tax expense of $282,427.[165]

In a response to a Commission information request, the AG calculated LG&E's pro forma income tax expense by using the test-period actual gas income tax expense as the starting point and then adjusting for three factors: (1) the income tax impact of all of the AG's pro forma revenue and expense adjustments, (2) the interest synchronization deduction, and (3) the removal of all current and deferred income taxes associated with "prior period income tax adjustments." The AG proposes a pro forma income tax expense of $1,977,566, which increases test-period income tax expense by $1,184,905. The AG proposes that the Commission use this methodology in its calculation of LG&E's pro forma income tax expense.[166]

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[163] T.E., Vol. I, at 144.

[164] Williams Direct Testimony, Exhibit 1, page 2 of 2.

[165] Williams Rebuttal Testimony, Revised Exhibit 1, page 2 of 2.

[166] AG's Post-Hearing Brief at 19.

Pro Forma Income Taxes	$ 1,977,566
Less: Actual Income Tax Expense	- 890,568
Increase in Income Taxes	$ 1,184,905

According to LG&E, the prior year tax adjustment is a yearly, not a non-recurring, event. LG&E argues that the prior year adjustments that are included in test-period income tax expense should remain. For this reason, LG&E contends that the AG's adjustment should be denied.[167]

LG&E's reported 1999 income tax expense reflects 12 months of revenue and expenses. If the prior year true ups are included, income tax expense would reflect a period greater than 12 months. For this reason the Commission finds that the AG's methodology excluding the prior period income tax adjustments is reasonable. The Commission has applied the combined federal and state income tax rate of 40.3625 percent to the accepted pro forma adjustment and has eliminated all current and deferred income taxes associated with "prior period income tax adjustments," resulting in an increase to income tax expense of $1,586,386. This adjustment is in addition to the interest synchronization adjustment described previously.

Pro Forma Net Operating Income Summary

The adjusted net operating income for LG&E's gas operations is as follows:

Operating Revenues	$65,941,221
Operating Expenses	56,054,929
ADJUSTED GAS NET OPERATING INCOME	$ 9,886,292

RATE OF RETURN

Capital Structure

LG&E proposes an adjusted end-of-test-period capital structure containing 41.09 percent long-term debt, 7.87 percent short-term debt, 6.25 percent preferred stock, and

[167] LG&E's Post-Hearing Brief at 26.

44.79 percent common equity.[168] LG&E decreased its test-period-end, gas operations' preferred stock and increased its common equity by $205,321, the amount of the discount and expense associated with the preferred stock issues.[169] As discussed previously in this Order, LG&E has allocated adjustments to JDIC and the Venture Fund on a pro rata basis to all components of capitalization. The AG's and DOD's proposed capital structures were the same as that proposed by LG&E.[170]

The Commission agrees with LG&E, the AG, and DOD, and finds LG&E's gas capital structure is as follows:

	Percent
Long-Term Debt	41.09
Short-Term Debt	7.87
Preferred Stock	6.25
Common Equity	44.79
Total Gas Capital	100.00

Cost of Debt and Preferred Stock

LG&E proposes a cost of long-term debt of 5.45 percent and a cost of short-term debt of 6.02 percent. The AG and DOD use the costs of debt proposed by LG&E.[171] These rates reflect the cost of debt as of test-period end.[172] In addition, LG&E adjusted

[168] Williams Direct Testimony, Exhibit 2, page 1 of 2.

[169] Id.

[170] Henkes Direct Testimony, Schedule RJH-2; Prisco Direct Testimony, DOD Exhibit TJP-9.

[171] Weaver Testimony, Exhibit Carl G. K. Weaver Schedule 30; Prisco Direct Testimony, DOD Exhibit TJP-9.

[172] LG&E Supporting Workpapers, filed April 27, 2000, tab 15.

the cost of long-term debt to reflect the exclusion of debt cost associated with its environmental compliance investment, consistent with the Commission's decision in Case No. 98-426.[173] In response to a hearing data request, LG&E provided an update of the cost of long-term debt, short-term debt, and preferred stock as of June 30, 2000.

The Commission finds that it is not appropriate to adjust the cost of long-term debt for LG&E's gas operations to reflect an adjustment that relates solely to its electric operations. The adjustment to the debt cost associated with LG&E's environmental compliance investment relates only to its electric operations. LG&E has offered no compelling evidence to persuade the Commission that the cost of debt applied to its gas operations should reflect an adjustment made for its electric operations.

The Commission also finds it appropriate to recognize the debt cost rates as of June 30, 2000 when determining the overall cost of capital for LG&E's gas operations. The recognition of the updated debt cost rates constitutes a known and measurable adjustment and is more representative of the period the rates established in this Order will be in effect as compared to the test-period-end debt cost rates. However, these debt cost rates will be applied to the test-period-end capital structure. Therefore, the Commission finds the cost of long-term debt to be 5.58 percent and the cost of short-term debt to be 6.75 percent.[174]

LG&E, the AG, and DOD all utilized the test-period-end cost of preferred stock rate of 5.19 percent. Consistent with the approach used in determining the cost of debt,

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[173] Case No. 98-426, June 1, 2000 Order, at 4-5.

[174] LG&E's Response to Information Requested During Hearings Held August 2-4, 2000, filed August 21, 2000, Item 14, page 2 of 2.

the Commission believes it is more appropriate to use the cost of preferred stock as of June 30, 2000, applied to the test-period-end capital structure. Therefore, the Commission finds the cost of preferred stock to be 5.54 percent.[175]

Return on Equity

LG&E estimates its required return on equity using four methods: the discounted cash flow ("DCF") method, the capital asset pricing model ("CAPM"), two risk premium analyses, and a comparable earnings analysis. Based on the results of these methods, LG&E recommends a return on equity range of 11.5 to 12.5 percent with a midpoint of 12.0 percent.

The DCF and CAPM analyses were performed using eight electric companies as proxies for LG&E. LG&E proposed the use of proxy companies for the analysis, rather than its stock price, because it is a subsidiary of LG&E Energy. LG&E's stock is not publicly traded. In addition, PowerGen, plc ("PowerGen") is in the process of acquiring LG&E Energy.[176] LG&E's criteria for selecting a comparison company was inclusion in Value Line's listing of electric utility companies and a bond rating criterion centered on the current bond ratings of LG&E, which is A1 by Moody's and A+ by Standard & Poor's.[177]

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[175] Id.

[176] Rosenberg Direct Testimony at 7.

[177] Id.

In response to a data request, LG&E submitted new cost of equity estimates using a comparison group made up of four gas companies.[178] The gas study results are slightly higher than those for the electric group study. The difference in results is attributed mostly to the length of time between the two studies and to slightly higher recent interest rates. Had LG&E relied on the gas study for its recommended return on equity, the result would have been a range of 11.75 to 12.75 percent.[179] However, LG&E continued to rely on its electric group study, with a return on equity range of 11.5 to 12.5 percent and a midpoint of 12.0 percent.[180]

The AG criticizes LG&E's return on equity estimates on several grounds. The AG contends that LG&E's use of Value Line "Safety Ratings" is an inappropriate tool to select companies with comparable risks as required by Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, (1923); Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944).[181] The AG argues there are problems with LG&E's CAPM analyses, specifically claiming that conceptual errors were made in the application of an arithmetic mean versus a geometric mean in calculating expected market premiums.[182] The AG also argues that implementation errors were made by mismatching current risk free rates

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[178] LG&E's Response to Item 53(d) of the Commission's Order dated April 28, 2000.

[179] T.E., Volume I, at 108.

[180] Rosenberg Rebuttal Testimony at 27.

[181] Weaver Testimony at 17-19.

[182] Id. at 43–47.

with long-term risk premiums and that the mismatch could have been avoided by applying a current risk premium to the current risk free rates.[183]

The AG's analysis differs at a threshold level in that he did not use a similar group of companies as proxies for LG&E in his DCF and CAPM analyses. The AG argues that compliance with *Bluefield* and *Hope* drove the selection of four gas companies as proxies, because their gas businesses were more similar to LG&E's than were those of other companies.[184] LG&E acknowledged that four of the eight electric companies identified in Rosenberg's Direct Testimony, Schedule 1 (Allegheny, FPL Group, CLECO and Idacorp) are not in the gas distribution business and that four of the eight (CH Energy, Constellation, FPL Group, and GPU) have nuclear generation. LG&E also acknowledged that data from these companies was used in its DCF and CAPM analyses.[185]

Responding to the AG's criticisms, LG&E argues that it correctly used an arithmetic mean in its CAPM analysis and provides citations from published sources as additional proof of the correctness of its methods.[186] LG&E contends the methods used in its Risk Premium analysis are correct and that the AG's arguments concerning mismatched risk free rates and risk premiums are without merit.[187]

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[183] Id. at 48.

[184] Id. at 5-7.

[185] T.E., Volume I, at 60-62.

[186] Rosenberg Rebuttal Testimony at 20-23.

[187] Id. at 25-26.

The AG estimated a fair rate of return on common equity for LG&E's gas operations using two versions of a DCF analysis, a CAPM analysis and the bond-yield-plus-risk-premium approach ("Bond-Risk-Premium"). The AG's DCF analyses were performed using a comparison group of four publicly traded gas utilities. The AG did not perform a DCF analysis for LG&E's parent, LG&E Energy, for three reasons. First, LG&E Energy is in the process of merging with PowerGen; therefore, the premium offered by PowerGen is reflected in LG&E Energy's current stock price. Second, LG&E Energy's stock price reflects the consolidated operations of the company, including the electric business of LG&E and KU, the 25-year lease of the Big Rivers Electric Corporation's generating assets, and LG&E Capital Corp., the holding company for LG&E Energy's non-utility investments. Third, the revenue increase that is the subject of this proceeding is only related to the gas operations of LG&E. The AG stated that utilizing consolidated electric and gas company data to determine the rate of return for the gas operations alone would not meet the requirements of *Bluefield* and *Hope*.[188]

The AG selected his comparison group of companies starting with the 34 gas distribution companies listed in the regular and expanded editions of Value Line. All companies that did not have at least 95 percent of their operations in the gas business were eliminated. Next, companies with net plant greater than $900 million were removed because companies of that size would not make a good comparison given LG&E's net gas plant value of $291.45 million. Companies involved in a merger or take-over were also excluded from the comparison group. The last companies

[188] Weaver Testimony at 6-7.

eliminated had recently experienced unusual events or were companies for which the necessary forecast information was not available.

The AG's constant-growth DCF analysis produced eight growth rates ranging from 6.85 percent to 13.95 percent. When the AG excluded the two lowest results, which are lower than some bond rates, and the two highest results, the analysis produces a range of 9.5 to 10.5 percent, with a midpoint of 10.0 percent. The AG's two-stage DCF analysis produces a cost of equity of 11.3 percent. His CAPM analysis produces a range of 9.5 to 10.5 percent, with 10.0 percent as the midpoint. The AG's Bond-Yield-Risk-Premium method produces a range of 10.47 to 11.06 percent with 10.77 percent as the midpoint. Based on these analyses, the AG recommends a rate of return on common equity for LG&E of 10.0 percent.[189]

LG&E argues that there are several problems with the AG's analysis. LG&E contends that the constant growth DCF method is unreliable, using the AG's own analysis to support this view. LG&E cites the fact that half of the DCF results were eliminated from consideration because they were below bond yields or too high to be relied upon by investors. LG&E argues that the second stage growth used by the AG in the two-stage DCF method understates the estimated growth significantly and therefore casts doubt on the results. LG&E also disagrees with the inputs that the AG uses in his CAPM analysis, stating that because of the inputs utilized, the results understate the required return. LG&E also states that none of the AG's 36 CAPM calculation results falls within the AG's recommended range of 9.5 to 10.5 percent.[190] Nine of the results

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[189] Id. at 41-42.

[190] Rosenberg Rebuttal Testimony at 8-9. However, referring to Schedule 25 in Weaver Testimony, 6 of the 36 CAPM results do fall within the recommended range.

fall below the recent cost of debt while 18 of the estimates are above the CAPM recommended range. LG&E adds that the smaller size of the companies included in the AG's comparison group requires a size premium, thus increasing the AG's calculated cost of equity. LG&E also takes issue with the inputs used in the AG's Risk Premium Analysis. LG&E contends that the AG's use of the Composite Treasury yield reflects the yield on all Treasury bonds with a maturity over 10 years, which differs from the yield on 10-year Treasury bonds alone. LG&E states that use of the Composite Treasury yield understates its cost of equity by 40 basis points.[191]

The AG correctly points to several serious problems regarding LG&E's proxy group of comparison companies. One of the criteria for using a group of companies as a proxy is for that group to resemble as nearly as possible the company in question. The Commission finds it is inappropriate to include electric companies in the proxy group since this case involves only LG&E's gas operations. In addition, some of the electric companies selected have nuclear generation in their portfolios, which further differentiates the proxy group from LG&E's gas operations. Finally, it is likewise inappropriate to include electric companies with no regulated interests in natural gas distribution in the proxy group. For these reasons, the makeup of its proxy group invalidates many of LG&E's cost of equity calculations.

The Commission agrees in part with LG&E's critique of the AG's cost of equity estimates. The AG's DCF estimations are wide-ranging and not all are reasonable enough to be applicable to LG&E's cost of equity. The AG's CAPM analysis also has wide-ranging results, some of which are similar to the low results the AG removes from

[191] Rosenberg Rebuttal Testimony at 14-16.

consideration in his DCF analysis because they are near bond rates. Also, the gas companies included in AG's proxy group are small enough to warrant the addition of a size premium, which is not included in any of the AG's analyses.

After reviewing the evidence of record and considering the infirmities in both LG&E's and the AG's analyses, the Commission finds that a reasonable return on equity falls somewhere between the levels recommended by the parties. A further issue in consideration of an appropriate return on equity is that LG&E's proposed WNA Clause is being approved by this Order. The Commission believes the WNA Clause will work to stabilize revenues over time and decrease the risk to LG&E's shareholders. Based on all these factors, the Commission finds that LG&E's return on equity should fall within a range of 10.75 to 11.75 percent, with a midpoint of 11.25 percent.

Rate of Return Summary

Applying the rates of 5.58 percent for long-term debt, 6.75 percent for short-term debt, 5.54 percent for preferred stock, and 11.25 percent for common equity to the capital structure produces an overall cost of capital of 8.21 percent, which we find to be fair, just, and reasonable. This cost of capital produces a rate of return on LG&E's gas rate base of 7.66 percent, which the Commission finds is fair, just, and reasonable.

REVENUE REQUIREMENTS

The Commission has determined, based upon a gas capitalization of $266,376,827 and an overall cost of capital of 8.21 percent, that the net operating income found reasonable for LG&E's gas operations is $21,869,537. LG&E's pro forma net operating income for the test period is $9,886,292. Thus, LG&E needs additional annual operating income of $11,983,245. After the provision for bad debts, the PSC

Assessment, and state and federal taxes, there is a revenue deficiency of $20,193,449, which is the amount of additional revenue granted herein. The net operating income found reasonable for LG&E's gas operations will allow it the opportunity to pay its operating expenses and fixed costs and have a reasonable amount for equity growth.

The calculation of the overall revenue deficiency is as follows:

Net Operating Income Found Reasonable	$21,869,537
Pro Forma Net Operating Income	9,886,292
Net Operating Income Deficiency	11,983,245
Gross Up Revenue Factor[192]	.5934224
Overall Revenue Deficiency	$20,193,449

The additional revenue granted will provide a rate of return on the gas rate base of 7.66 percent and an overall return on total gas capitalization of 8.21 percent. The $20,193,449 increase represents an increase of 7.26 percent over the normalized gross operating revenues.[193]

The rates and charges in Appendix A are designed to produce gross operating revenues, based on the adjusted test year, of $299,834,375. The gas operating revenues reflect the most recent gas cost adjustment approved in Case No. 90-158-MM.[194]

[192] The gross up revenue factor recognizes the impact the overall revenue deficiency will have on the provision for bad debts, the PSC Assessment, state income taxes, and federal taxes. The Commission's calculation of the gross up factor follows the same approach as LG&E provided in Williams Direct Testimony, Exhibit 1, Schedule T. The Commission used the same rates as LG&E did, with the exception that the Commission's calculation reflects the most recent PSC Assessment rate of 1.9510.

[193] The normalized operating revenues reflect the impact of LG&E's most recent gas cost adjustment.

[194] Case No. 90-158-MM, The Notice of Purchased Gas Adjustment Filing of Louisville Gas and Electric Company, final Order dated July 18, 2000.

The Commission notes that it has been nearly 10 years since LG&E's last gas rate case. While LG&E is comprised of the regulated businesses of electric service and gas service, it had not been calculating or monitoring the separate rates of return on rate base and common equity until 1998.[195] An analysis prepared by LG&E shows that since 1996 its rates of return on rate base and common equity for gas operations have been decreasing and were at levels that could not be considered reasonable.[196] The existence of these low rates of return on gas operations came to the Commission's attention in Case No. 98-426. In the January 7, 2000 Order in that case, the Commission stated: "It is the responsibility of LG&E to take the appropriate steps to address that problem by some means other than relying on a subsidy from its electric operations."[197] The present case represents LG&E's response to address its low rates of return on gas operations. LG&E states that it is now monitoring the achieved rates of return for its electric and gas operations separately.[198] The Commission expects LG&E to utilize this monitoring as a means to identify when it needs to take corrective action concerning the rates of return for its gas operations. The Commission reemphasizes its concern that one segment of LG&E's operations 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

[195] LG&E's Response to the Commission's March 15, 2000 Order, Item 33; and LG&E's Response to the Commission's May 25, 2000 Order, Item 5(b).

[196] LG&E's Response to the Commission's March 15, 2000 Order, Item 33; and LG&E's Response to the Commission's April 28, 2000 Order, Item 39(c).

[197] Case No. 98-426, January 7, 2000 Order, at 36.

[198] LG&E's Response to the Commission's May 25, 2000 Order, Item 5(b).

service. When corrective action is indicated, whether the earned returns are deficient or excessive, the Commission also expects LG&E promptly to initiate the appropriate proceeding to address the situation.

PRICING AND TARIFF ISSUES

Cost-of-Service Study

LG&E presented an embedded class cost-of-service study for the 12 months ended December 31, 1999 adjusted for known and measurable changes to the test year operating results.[199] 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. Generally, LG&E's cost-of-service study indicates that, at present rates, all class rates of return are below reasonably expected returns with the exception of the firm transportation class.[200] A cost-of-service study may also be used as a guide in developing an appropriate rate design for each customer class. LG&E used the results of the cost-of-service study to design rates to better achieve a balance in its class rates of return while affording recognition to the marketplace, customer acceptance and gradualism.

LG&E's cost-of-service study incorporates the "zero-intercept" methodology to classify distribution mains into customer and demand components.[201] The theory behind the zero-intercept methodology is that a linear relationship exists between the unit cost of distribution mains and the capacity of the main proportionate to its diameter.

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[199] Seelye Direct Testimony, Exhibit 1 and 2.

[200] Seelye Direct Testimony, Table 1.

[201] Seelye Direct Testimony at 14-17.

Upon establishing this linear relationship, it can be determined, theoretically, where the cost component of mains is invariant to the size of the main. Another methodology LG&E could have employed is the "minimum system," but this methodology is generally considered to be more subjective than the zero-intercept approach. As it has stated in numerous orders over the last decade, the Commission believes that the zero-intercept methodology is the more acceptable way to divide distribution main costs into demand-related and customer-related components. Moreover, the Commission is convinced that the zero-intercept methodology is statistically more sound and less subjective than the minimum system method, in which a minimum size main must arbitrarily be chosen in order to determine the customer-related component. As pointed out in KIUC's brief, the minimum system approach would significantly assign greater costs to the residential class and away from other classes.[202]

The AG identified a number of problems with LG&E's study, which in his opinion renders the results of the study unusable.[203] Therefore, the AG developed an alternative cost-of-service study using LG&E's study and making or substituting proposed solutions for the problems identified.

The first problem identified by the AG was the use of two duplicate allocator names that caused incorrect allocations of selected operating expenses. The second problem was identified as an inappropriate allocation choice for removing promotional advertising expense from the cost-of-service study. The third problem was identified as the appropriate means to allocate forfeited discounts and miscellaneous service

[202] KIUC's Brief at 9.

[203] Brown Kinloch Direct Testimony at 7.

revenues. The allocation of customer service expenses was identified as a fourth problem. The last concern identified by the AG was the appropriate way to allocate fixed storage and transportation costs.

In its rebuttal testimony, LG&E agreed with the AG on the duplicate allocator names, the introduction of a better removal of promotional advertising expense, and the more appropriate forfeited discount allcator.[204] The remaining issues of fixed storage costs, customer service expenses, and miscellaneous service revenues are discussed below.

Fixed Storage Cost. The issue of the appropriate allocator for fixed storage cost generally revolves around the need to constantly maintain LG&E's gas distribution system in balance within the defined physical tolerances of the industry. In its cost-of-service study, LG&E allocates no fixed storage costs to interruptible transportation customers. As noted by the AG, this is the first LG&E case wherein transportation customers have been served under a tariff that permits transportation services without requiring back-up gas service. The AG contends that to promote equity and fairness among all classes of service, it is necessary to allocate at least a small portion of the fixed storage cost to these interruptible transportation customers. The AG argues that while interruptible customers should not pay as much as firm customers, it is not reasonable that interruptible customers should pay none of the fixed storage costs. The AG further argues that the construction of the storage assets preceded the introduction of the transportation class of service and therefore was intended to serve all classes of service. The AG proposes an allocation of fixed storage costs with 50 percent based

[204] Seeyle Rebuttal Testimony at 32-48.

upon the class relationship of annual throughput and 50 percent based upon the class relationship of storage demand.[205]

LG&E counters that the interruptible transportation class is served on a firm commitment basis, but only to the extent that deliveries to the system are equal to the volumes consumed, i.e. balanced within the class or the system. In its brief LG&E lists several reasons why it did not allocate fixed storage costs to the transportation and other interruptible classes.[206] These include the exclusion of storage services from the tariffs or contracts for this class, the interruptible nature of the service, and the inability to use the storage fields during the spring and summer months due to maintenance and injections[207] and due to withdrawals during the winter months. In addition, there are balancing and penalty provisions currently in place for these customers, such as utilization charges, monthly cash-out provisions and operational flow orders that provide LG&E the ability to maintain overall system balance.

The issue of allocating fixed storage cost can be summarized as one of shifting costs to the interruptible transportation customers and special contract customers and away from firm service customers. LG&E cautions that shifting costs to these interruptible customers will likely increase the chance of these customers physically bypassing the distribution system with the consequence that the remaining customers would be required to bear the fixed costs previously borne by the interruptible customers.

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[205] Brown Kinloch Testimony, Exhibit DHBK-3.

[206] LG&E's Post-Hearing Brief at 46-47.

[207] T.E., Volume 1, at 301-302.

Having given consideration to both the arguments and the counter-arguments, the Commission finds that the AG has not offered persuasive evidence that a modified allocation of fixed storage cost based on a weighted analysis of 50 percent storage demand and 50 percent annual throughput is reasonable. We conclude that, while LG&E's approach may not be perfect, its arguments against allocating fixed storage costs to interruptible customers are persuasive and reasonable. Therefore, we accept LG&E's position on the allocation of fixed storage costs.

<u>Customer Service.</u> During his review of the case, the AG noted that in comparison to LG&E's previous gas rate case, the relationship of customer service and sales expenses had dramatically changed.[208] Upon a closer examination of these expenditures, the AG surmised that a shift had been made in LG&E's customer service and sales departments to emphasize the efforts necessary to retain and attract large volume customers. In allocating these costs to the various classes, the AG assigned more employees to the commercial and industrial customers than were in fact actually supporting these customer classes. In its rebuttal testimony, LG&E asserts that the AG misinterprets the information provided during the investigation through both undercounting and overcounting.[209]

The issue of how to allocate customer service and sales expenses is best described as a shift of costs to commercial and industrial customers and away from residential customers. Having given consideration to both the arguments and the counter-arguments, the Commission is not persuaded that a modified allocation of

[208] Brown Kinloch Direct Testimony at 12-13.

[209] Seelye Rebuttal Testimony at 40-44.

customer service and sales expenses is needed at this time. The residential class rate of return is still substantially below the system average.

Miscellaneous Service Revenue. The AG proposes to modify the allocation of miscellaneous service revenue on the same basis as that used for forfeited discount revenues.[210] The impact of this change is to shift more revenues to residential customers, thus lowering their cost of service. On the other hand, LG&E allocates miscellaneous service revenues based on total sales revenue. LG&E, in response to information requests during the hearing, provided an analysis of items included in the test-year miscellaneous service revenues.[211] LG&E's analysis supports the allocation of a greater portion of these revenues to the commercial and industrial classes. LG&E's methodology reflects this allocation; therefore, the Commission finds that the AG's proposed modification should be denied.

Conclusion. The Commission finds the cost-of-service study as modified by LG&E to be reasonable. It provides a means of measuring individual class rates of return and can be used as a guide in developing appropriate revenue allocations and rate design.

Revenue Allocation

LG&E's cost-of-service study reflects a rate of return for the residential class, Rate RGS, considerably below the total company rate of return.[212] For this reason, LG&E proposes a larger percentage increase for Rate RGS than for its other rate

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[210] Brown Kinloch Testimony at 11.

[211] LG&E's Response to Information Requested During Hearings, Item 23.

[212] Seelye Direct Testimony at 19.

classes. However, the increase proposed by LG&E for the residential class is less than the increase supported by the results of its cost-of-service study. Its proposed rates, LG&E asserts, establish a reasonable balance between the result of its cost-of-service study and the realities of the current marketplace. LG&E is also proposing increases for commercial and industrial customers served on rate schedules CGS, IGS, and G-6, but it proposes no increase to its special contract customers. According to LG&E, even though its cost-of-service study shows the special contract customer class to have a relatively low rate of return, the pricing for these customers must reflect competitive considerations such as physical by-pass.[213]

The AG opposes LG&E's proposed revenue allocation and states that all customer classes should be assigned part of the proposed increase. The AG sponsors an alternative cost-of-service study and argues that it shows that all rate classes fall well short of the 8.40 percent overall rate of return requested by LG&E.[214] Although the results of his cost-of-service study support widely varying percentage increases among LG&E's customer classes, the AG proposes relatively equal percentage increases of 4.5 to 6.5 percent for all rate classes except special contracts, which he proposes to increase by 8.4 percent.[215] The AG argues that other rate classes should not subsidize special contract customers even if there is a danger of these customers leaving the system. He contends that if special contract customers don't cover their expenses and

[213] Seelye Direct Testimony at 27.

[214] Brown Kinloch Direct Testimony at 20.

[215] Id. at 25.

make a contribution to fixed costs the value of continuing to serve those customers is questionable.[216]

In evaluating this issue, the Commission is cognizant of the major changes the natural gas industry has undergone in recent years. As a result of these changes, large volume end-users, mainly industrial customers, have sought out their own gas supplies at prices lower than the local distribution company's ("LDC's") price for its system supply gas. Some of these customers that have large volumes and that are located relatively close to an interstate pipeline may bypass an LDC to avoid paying the LDC for transportation services. The Commission agrees with LG&E on the importance of retaining special contract customers as long as those customers are making a contribution to fixed costs.

LG&E has demonstrated that its special contract class is contributing to the system's fixed costs even though the class's rate of return is significantly lower than the total system return proposed by LG&E. As we have found several times in reviewing gas or electric utility special contracts or economic development rate proposals, if rates are sufficient to cover variable costs plus make a contribution to fixed costs, the system as a whole and the remaining customers benefit. In the absence of the special contract/large volume customers' contribution, the remaining customers' rates would require a further increase sufficient to cover those fixed costs. Recognizing that competition, in addition to cost of service, plays a role in revenue allocation, the Commission finds it reasonable to allocate none of the increase awarded herein to the

[216] Id. at 23.

special contract class. However, the Commission will continue to monitor LG&E's special contract filings and advises LG&E that the prices contained therein will continue to be subject to extensive review.

LG&E proposes to allocate the revenue increase so as to move in the direction of fully allocated cost recovery while minimizing the rate impact for all customer classes. The allocation of the revenue increase granted herein generally follows LG&E's allocation proposal, allowing for the difference between the amount requested and the amount awarded. The rates set out in Appendix A, which increase LG&E's revenues by 7.26 percent, will produce the additional revenues granted herein while generally moving rates toward their actual cost of service.

Rate Design

LG&E proposes to increase its customer charge for residential customers, Rate RGS, from $4.48 to $9.00. To avoid undue disruption for its customers, LG&E proposes to achieve this increase in steps over 3 years, starting with a $7.00 customer charge for the first year following the decision in this proceeding. After one year, the charge would go to $8.00 and then to $9.00 a year later.[217] The distribution cost component would also be adjusted downward each year so that the total class revenue remains neutral for the 3 years.

The AG proposes to increase the customer charge by a percentage equal to the overall percentage revenue increase granted LG&E. The AG's recommended revenue increase of approximately 8 percent would produce a customer charge of $4.84.[218] The

[217] Seelye Direct Testimony at 31-34.

[218] Brown Kinloch Direct Testimony at 32.

AG and MHNA both point out the adverse impact that rate increases can have on low-income customers.

LG&E also proposes to increase its customer charges for rates CGS and IGS to more accurately reflect the cost to serve the commercial and industrial customers served on those rate schedules.[219] The present charge is $8.96 for both rate schedules. LG&E proposes to establish a two-tier customer charge based on meter capacity. Customers with a meter capacity less than 5,000 cubic feet per hour would have a customer charge of $16.50 per month, and those with meter capacity equal to or greater than 5,000 cubic feet per hour would have a customer charge of $117.00 per month. LG&E also proposes to increase its customer charge from $20.00 to $150.00 for Rate G6 customers.[220] The AG proposes the same percentage of revenue approach for determining the customer charges for Rate CGS and IGS as he did for rate RGS. The AG did not make a recommendation on LG&E's customer charge proposal for Rate G6.

The Commission believes that a reasonable increase in LG&E's residential customer charge is warranted, given the relatively low level of the current charge and recognizing that it has not been increased for approximately 10 years. However, an increase to $9.00, even using the phased-in approach proposed by LG&E, does not comport with the principles of gradualism and rate continuity. On the other hand, the AG offers no persuasive evidence for limiting the increase to the overall percentage increase in revenues awarded herein. His modified cost-of-service study, when

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[219] Seelye Direct Testimony at 35.

[220] Id. at 35-36.

presented in a manner similar to LG&E's cost-of-service study, indicates the residential customer charge should be significantly increased. The AG recommended the Commission rely on the allocation recommendations in the 1989 NARUC Gas Distribution Rate Design Manual. This would result in fewer types of costs being classified as customer-related costs; however, it would also shift costs from the residential class. Such cost shifting is inappropriate given the residential class's consistently low rate of return. After thorough consideration of the issue, the Commission finds that an increase to $7.00 is reasonable as it moves LG&E's customer charge toward the cost to serve its residential customers in a gradual manner.

The Commission finds that the cost justification offered by LG&E in support of the proposed two-tier customer charge for commercial and industrial rate classes is reasonable. We are not persuaded to adopt the AG's percentage of revenue approach for these customer classes any more than we are persuaded to adopt this approach for the residential class. The Commission finds that the proposed customer charges of $16.50 and $117.00 for Rates CGS and IGS are reasonable and appropriate and should be approved. We further find that the proposed charge of $150.00 for Rate G6 is reasonable and should be approved.

WNA Clause

LG&E proposes a WNA Clause applicable to Rate RGS and Rate CGS for an experimental period of three years to adjust for the effects that weather has on its earnings and return on equity.[221] The proposed WNA Clause will adjust billing-cycle residential and commercial gas sales for normal temperatures on a real-time basis.

[221] Seelye Direct Testimony at 37.

LG&E argues that, although a temperature normalization adjustment is historically allowed in rate cases, the absence of a WNA Clause subjects it to drastic fluctuations in earnings and return on equity due to temperature variations. LG&E's mechanism is modeled after Columbia Gas of Kentucky's WNA Clause, which was approved by the Commission in Case No. 97-299.[222]

The Commission finds that LG&E's proposed WNA Clause is reasonable and should be approved. We further find that LG&E should be required to file an annual report on the operation of its WNA Clause after each heating season. The annual report shall be filed by June 30th of the summer following the heating season and shall be filed in the format set out in Appendix B to this Order.

Transportation Services Tariff Modifications

Rate TS – Transportation Service. LG&E proposes to broaden the availability of this tariff to 50 Mcf per day, or 50,000 annually, in order to allow more customers the opportunity to transport their own gas.[223] The "Receipts and Deliveries" section of the tariff will be replaced by a Cash-Out Provision that will more closely control imbalances on the system. LG&E also proposes to make pooling service available under this tariff to correspond to a similar service already available under Tariff FT.[224]

Rate FT – Firm Transportation Service. LG&E proposes to change the manner in which it determines its Cash-Out price to reflect a market based price. LG&E's price

[222] Case No. 97-299, Application of Columbia Gas of Kentucky, Inc., For Authority to Permanently Adopt a Weather Normalization Adjustment Mechanism, final Order dated December 1, 1997.

[223] Murphy Direct Testimony at 9.

[224] Id. at 12.

will be based on the monthly average of the daily mid-point prices posted in Gas Daily for CNG-South Point for the month during which the imbalance occurred. LG&E states that this change will better reflect the market price at the time the imbalance occurred. LG&E also proposes to modify its penalty for violation of an Operational Flow Order from $15.00 per Mcf to $15.00 per Mcf plus the market price for gas on the day of the OFO.[225]

The intervenors do not offer any objection to the proposed tariff changes for either Rate TS or Rate FT. The Commission finds that the proposed changes are reasonable and should be approved.

Line Extensions

LG&E requests Commission approval to reduce the extension of mains to new customers from 100 feet per customer to 80 feet. LG&E failed to justify its request other than claiming savings would result to LG&E if it extends the mains 80 feet in lieu of 100 feet. All the gas utilities in Kentucky provide up to 100 feet of main to new customers, while some provide up to 200 feet. In addition, 807 KAR 5:022, Section 9(16), requires a gas utility to provide up to 100 feet to an existing distribution main without charge for a prospective customer. KRS Chapter 13A does not provide for such cavalier treatment of policies duly promulgated in administrative regulations. LG&E's request to permanently deviate from 807 KAR 5:022, Section 9(16), should be denied.

GAS MAIN REPLACEMENTS

Since 1996, LG&E has been engaged in an extensive gas main replacement project. Between 1996 and 1999, LG&E has replaced approximately 123 miles of its

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[225] Id. at 15.

existing mains, and it plans to replace an additional 45 miles during 2000.[226] LG&E estimated that the annual cost of this project has been between $8 and $9 million, with the work in 2000 estimated to cost $11 million.[227] The capital investment associated with this project has contributed to the erosion of LG&E's earnings from its gas operations during those years.

The Commission commends LG&E for its efforts to maintain and improve the safety and reliability of its gas distribution system. We also encourage LG&E to continue this project, as the safety and reliability of its gas distribution system is of paramount importance. These efforts should provide overall benefits to both its customers and shareholders through enhanced operating efficiencies and lowered costs.

The Commission also recognizes the impact such capital investment has on LG&E's financial condition. When preparing for its next general gas rate case, LG&E may wish to consider filing a historic test period and requesting the recognition of pro forma adjustments for known and measurable changes or filing a fully forecasted test period.[228] If LG&E believes some additional measures are needed to address the impact of this capital investment on its earnings, the Commission encourages LG&E to consider and offer well-reasoned proposals to address this issue.

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[226] Farrar Direct Testimony at 5, 11, and 12.

[227] T. E., Volume I, August 2, 2000, at 39, and LG&E's Response to the Commission's April 28, 2000 Order, Item 19.

[228] See 807 KAR 5:001, Section 10(7) and (8).

SUMMARY

The Commission, after consideration of all matters of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A are the fair, just, and reasonable rates for LG&E to charge for service rendered on and after the date of this Order.

2. The rates proposed by LG&E would produce revenue in excess of that found reasonable herein and should be denied.

3. LG&E's request to reduce its standard extension of existing distribution main to new customers and to deviate from the requirements of 807 KAR 5:022, Section 9(16), Extension of Services, should be denied.

4. LG&E's proposed WNA Clause is reasonable and should be approved.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A are approved for service rendered by LG&E on and after the date of this Order.

2. The rates proposed by LG&E are denied.

3. LG&E shall, within 30 days of the date of this Order, file its revised tariff sheets setting out the rates approved herein.

4. LG&E's proposed tariff changes to Rates TS and FT are approved.

5. LG&E's proposed WNA Clause is approved, subject to the reporting requirements outlined in Appendix B.

6. LG&E's request to deviate from the requirements of 807 KAR 5:022, Section 9(16), Extension of Services, is denied.

7. As of the date of this Order, LG&E shall cease its current accounting practice concerning the treatment of outside legal expenses. LG&E shall adopt accounting practices that provide for the direct assignment of outside legal expenses to either electric or gas operations, as appropriate. Only after LG&E has determined that an outside legal expense cannot be directly assigned shall it utilize an appropriate allocation methodology and allocate the expense to electric and gas operations. LG&E shall also make this change in accounting practice for any other expense category, as well as expenses involving LG&E and KU or any other LG&E affiliate, that has been previously treated as outside legal expenses.

Done at Frankfort, Kentucky, this 27th day of September, 2000.

By the Commission

ATTEST:

Thomas M. Dorman

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2000-080 DATED SEPTEMBER 27, 2000

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

GAS SERVICE

The Gas Supply Cost component in the following rates has been adjusted to incorporate all changes through Case No. 90-158-MM.

RGS
Residential Gas Service

RATE:

Customer Charge:

$7.00 Per Delivery Point Per Month

Charge Per 100 Cubic Feet:

Distribution Cost Component	13.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge Per 100 Cubic Feet	68.149 ¢

Summer Air Conditioning Service Under Gas Rate RGS

RATE:

The rate for "Summer Air Conditioning Consumption," as described in the manner hereinafter prescribed, shall be as follows:

Charge Per 100 Cubic Feet:

Distribution Cost Component	8.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge Per 100 Cubic Feet	63.149 ¢

CGS
Firm Commercial Gas Service

RATE:

Customer Charge:

If all of the Customer's meters have a capacity <5000 CF/HR	$16.50 Per Delivery Point Per Month
If any of the Customer's meters have a capacity ≥5000 CF/HR	$117.00 Per Delivery Point Per Month

Charge Per 100 Cubic Feet:

On Peak:

Distribution Cost Component	13.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge Per 100 Cubic Feet	68.149 ¢

Off Peak:

Distribution Cost Component	8.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge For 100 Cubic Feet	63.149 ¢

CGS
Summer Air Conditioning Service

RATE

Charge Per 100 Cubic Feet

Distribution Cost Component	8.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge For 100 Cubic Feet	63.149 ¢

CGS
Gas Transportation Rider

RATE:

Charge Per 100 Cubic Feet

Distribution Cost Component	13.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge For 100 Cubic Feet	68.149 ¢

IGS
Firm Industrial Gas Servcie

RATE:

Customer Charge:

If all of the Customer's meters have a capacity <5000 CF/HR	$16.50 Per Delivery Point Per Month
If any of the Customer's meters have a capacity $\geq$5000 CF/HR	$117.00 Per Delivery Point Per Month

Charge Per 100 Cubic Feet:

On Peak:

Distribution Cost Component	13.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge Per 100 Cubic Feet	68.149 ¢

Off Peak:

Distribution Cost Component	8.457 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge For 100 Cubic Feet	63.149 ¢

G-6
Seasonal Off-Peak Gas Rate

RATE:

Customer Charge $150.00 Per Delivery Point Per Month

Charge Per 100 Cubic Feet:

Distribution Cost Component	6.855 ¢
Gas Supply Cost Component	54.692 ¢
Total Charge Per 100 Cubic Feet	61.547 ¢

RATE TS
Gas Transportation Service/Standby

RATE:

Administrative Charge $90.00 Per Delivery Point Per Month

	CGS	IGS	G-6
Distribution Charge Per Mcf	$1.3801	$1.3801	$.6855
Pipeline Supplier's Demand Component	.6357	.6357	.6357
Total	$2.0158	$2.0158	$1.3212

RATE RBS
Reserved Balancing Service

RATE:

Monthly Demand Charges	$5.9900
Monthly Balancing Charges	3.6500
Total	$9.6400

ELECTRIC AND GAS
Miscellaneous Service Fees

RATE:

Disconnecting and Reconnecting Service	$18.50
Returned Checks	7.50

APPENDIX B

APPENDIX TO AN ORDER OF THE KENUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2000-080 DATED SEPTEMBER 27, 2000

Louisville Gas and Electric Company shall include the following financial and statistical data in its Annual Report to the Commission on the Weather Normalization Adjustment ("WNA") program:

1. Number of WNA Customers (By Class)
2. Amount of WNA Revenue (By Class)
3. Mcf Volume Adjustment Resulting From WNA (By Class)
4. Average WNA Revenue Per Customer (By Class)
5. Amount of WNA Revenue (Total Company)
6. Mcf Volume Adjustment Resulting From WNA (Total Company)
7. WNA Impact on Earnings for Reporting Period
8. Actual Number of Heating Degree Days
9. Normal Number of Heating Degree Days
10. Variation of Actual Temperatures From Normal Temperatures (%)
11. Number of Customer Inquiries About WNA Program
12. Number of Customer Complaints About WNA Program

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2000-080 DATED SEPTEMBER 27, 2000

Determination of LG&E's
Gas Operations Capitalization

The determination of LG&E's gas capitalization reflects the allocation of the total company capitalization using a factor based on LG&E's actual test-period gas rate base compared to the total company rate base.

	Gas Rate Base at 12/31/99	Total Co. Rate Base at 12/31/99
Total Utility Plant in Service	$436,334,493	$3,065,838,688
Add:		
Gas Stored Underground	26,664,564	26,664,564
Fuel Inventory	0	17,008,480
Materials and Supplies	1,371,734	33,214,842
Prepayments	244,443	1,566,650
Cash Working Capital Allowance	4,698,540	46,562,526
Subtotal	$ 32,979,281	$ 125,017,062
Deduct:		
Accumulated Depreciation	147,012,854	1,215,031,862
Customer Advances	10,444,203	11,104,354
Accumulated Deferred Taxes	26,462,743	313,854,416
Investment Tax Credit (prior law)	29,222	101,728
Subtotal	$183,949,022	$1,540,092,360
NET ORIGINAL COST RATE BASE	$285,364,752	$1,650,763,390
Percentage of Gas Rate Base to Total Company Rate Base		17.29%

The allocation of Common Utility Plant and associated balances and Prepayments for the gas rate base is consistent with the approach described in the Order. As the allocation only impacts the electric and gas rate base calculations, the total company amounts are not effected.
The balance for Prepayment for both the gas and total company rate bases does not include the PSC Assessment.
The balance for Accumulated Deferred Taxes for both the gas and total company rate bases reflects the exclusion of SERP-related deferred taxes. The SERP-related deferred taxes have been found to be a "below the line" item.
The total company amounts are taken from LG&E's Application, Tab 35, Filing Requirement 6-r, December 1999 Monthly Financial Report, pages 5, 7-10, and 14 and LG&E's Supporting Workpapers filed April 27, 2000, tab 16.

APPENDIX C (continued)

Allocation of Total Company Capitalization to Gas Operations

Component Of Capitalization	Restated Test Period Balances	Total Co. Capital Structure	Test Period Gas Capitalization	Net Capitalization Adjustments	Adjuste Gas Capitaliza
Long-Term Debt	626,800,000	41.09%	108,373,720	1,068,488	109,442,2
Short-Term Debt	120,097,458	7.87%	20,764,850	204,648	20,969,4
Preferred Stock	95,327,847	6.25%	16,482,185	162,522	16,644,7
Common Equity	683,376,017	44.79%	118,155,713	1,164,701	119,320,4
Total Debt, Preferred Stock, and Common Equity	1,525,601,322	100.00%	263,776,468	2,600,359	266,376,8
JDIC	67,151,221		2,659,265	(2,659,265)	
Total Capitalization	1,592,752,543		266,435,733	(58,906)	266,376,8

The Total Company Restated Test Period Balances reflect LG&E's reclassification of certain stock discount and expense items from Common Equity to Preferred Stock.
Long-Term Debt, Short-Term Debt, Preferred Stock, and Common Equity were allocated to Gas Operations by applying the Gas Rate Base percentage of 17.29% to the Total Company Restated Test Period Balances. Gas JDIC was not allocated using the 17.29% allocation factor, but rather reflects actual gas JDIC plus 23% of LG&E's common JDIC balance.
All Net Capitalization Adjustments were allocated to the components of capitalization on a pro rata basis. The calculation of the Net Capitalization Adjustments is on the following page of this Appendix.

APPENDIX C (continued)

Calculation of Net Capitalization Adjustments

Component Of Capitalization	Other Investments	JDIC	T
Long-Term Debt	(24,204)	1,092,692	1,0
Short-Term Debt	(4,636)	209,284	2
Preferred Stock	(3,682)	166,204	1
Common Equity	(26,384)	1,191,085	1,1
Totals	(58,906)	2,659,265	2,6

Notes:
The Other Investments is made up of LG&E's investment in the African American Venture Capital Fund, which the Commission has treated as a common investment and allocated 23% of the total $256,112, or $58,906, to Gas. This treatment is consistent with the Commission's decision in Case No. 98-426.
The JDIC treatment is consistent with previous Commission decisions.