

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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| THE ANNUAL EARNINGS SHARING MECHANISM |) | |
| FILING OF LOUISVILLE GAS AND ELECTRIC |) | CASE NO. |
| COMPANY |) | 2001-054 |

and

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| THE ANNUAL EARNINGS SHARING MECHANISM |) | CASE NO. |
| FILING OF KENTUCKY UTILITIES COMPANY |) | 2001-055 |

and

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| APPLICATION OF KENTUCKY UTILITIES |) | |
| COMPANY FOR AN ORDER APPROVING REVISED |) | CASE NO. |
| DEPRECIATION RATES |) | 2001-140 |

and

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| APPLICATION OF LOUISVILLE GAS AND |) | |
| ELECTRIC COMPANY FOR AN ORDER |) | CASE NO. |
| APPROVING REVISED DEPRECIATION RATES |) | 2001-141 |

and

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| JOINT APPLICATION OF LOUISVILLE GAS AND |) | |
| ELECTRIC COMPANY AND KENTUCKY UTILITIES |) | |
| COMPANY FOR AN ORDER APPROVING |) | |
| PROPOSED DEFERRED DEBITS AND DECLARING |) | CASE NO. |
| THE AMORTIZATION OF THE DEFERRED DEBITS |) | 2001-169 |
| TO BE INCLUDED IN EARNINGS SHARING |) | |
| MECHANISM CALCULATIONS |) | |

O R D E R

On October 31, 2001, the Louisville Gas and Electric Company ("LG&E") and the Kentucky Utilities Company ("KU") filed a motion requesting the Commission to approve

a Settlement Agreement that is intended to operate as a full and complete resolution of the five pending cases listed in the above caption. LG&E and KU, along with the Office of the Attorney General (“AG”), and the Kentucky Industrial Utility Customers, Inc. (“KIUC”), are parties to the unanimous Settlement Agreement.¹ None of the parties requested a hearing on the motion to adopt the Settlement Agreement.

SUMMARY OF ISSUES IN CAPTIONED CASES

Case Nos. 2001-054 and 2001-055 Earnings Sharing Mechanism (“ESM”)

On March 1, 2001, LG&E and KU filed their first annual ESM calculations. In both filings, the rate of return on equity earned was determined using year-end capitalization. This approach was consistent with the approach used to determine LG&E’s and KU’s revenue sufficiencies in Case Nos. 98-426² and 98-474.³ Using this approach, LG&E determined that its actual net operating income exceeded the prescribed deadband. Under the LG&E ESM, the customers’ portion of the excess

¹ The International Brotherhood of Electrical Workers Local Union 2100 (“IBEW”) was granted intervention in Case No. 2001-169 on August 14, 2001. On October 19, 2001, the IBEW filed a letter requesting to withdraw from that case and the request was granted on October 31, 2001.

² 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.

³ 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.

earnings totaled \$617,609⁴ and LG&E began crediting bills for one-twelfth of that amount in April 2001. KU determined that its actual net operating income was within the deadband, and no rate adjustments were necessary.

On June 13, 2001, KIUC filed its objection to the use of year-end capitalization for the ESM calculations. KIUC argues that average capitalization should have been used, and claims that the use of year-end capitalization has overstated the revenue requirements used in the ESM calculations. KIUC contends that the use of average capitalization understates the credit due to LG&E customers by \$3,000,000, but would not have changed the ESM results for KU.⁵ LG&E and KU responded to KIUC's objection by arguing that their ESM calculations were correct and consistent with the approach described in the Commission's January 7, 2000 Orders in Case Nos. 98-426 and 98-474.⁶

Case Nos. 2001-140 and 2001-141
Revised Depreciation Rates

On May 16, 2001, KU and LG&E filed applications seeking Commission approval of new depreciation rates. KU and LG&E had conducted depreciation studies based on

⁴ Case No. 2001-054, Response to the Commission Staff's 1st Data Request dated April 5, 2001, Item 3. LG&E initially determined that the credit amount should be \$435,457, and began crediting that amount on customer bills in April 2001. The \$617,609 reflected a revision to LG&E's March 1, 2001 calculations. The revised credit began appearing on customer bills in May 2001.

⁵ Case Nos. 2001-054 and 2001-055, Objections of KIUC filed June 13, 2001, at 1.

⁶ Case Nos. 2001-054 and 2001-055, Response of KU and LG&E to Objections of KIUC filed July 19, 2001, at 1-5.

utility plant in service as of December 31, 1999.⁷ As a result of the depreciation studies, KU's total system annual depreciation expense would be reduced by \$6,103,404,⁸ while LG&E's annual electric and gas depreciation expense would be increased by \$897,286.⁹ While KU and LG&E had intended to begin using the new depreciation rates in their respective environmental surcharge calculations beginning with the March 2001 expense month, the Commission prohibited the use of the new depreciation rates until those rates were reviewed and approved by the Commission.¹⁰ A procedural schedule was established and extensive discovery was conducted on the two depreciation studies.

Case No. 2001-169

Accounting Deferral and ESM Recognition for Workforce Reduction

On June 1, 2001, LG&E and KU filed a joint application seeking Commission approval of certain accounting and ESM recognition of the expenses associated with their 2001 Workforce Transition Separation Program ("Workforce Reduction"). LG&E

⁷ KU's last depreciation study was based on utility plant in service as of December 31, 1992. LG&E's last depreciation study was based on utility plant in service as of December 31, 1988.

⁸ Case No. 2001-140, Depreciation Accrued Rate Study for KU, Appendix E, page 2 of 2.

⁹ Case No. 2001-141, Depreciation Accrued Rate Study for LG&E, Appendix E, page 4 of 4.

¹⁰ See Case No. 2000-386, The Application of Louisville Gas and Electric Company for Approval of an Amended Compliance Plan for Purposes of Recovering the Costs of New and Additional Pollution Control Facilities and to Amend Its Environmental Cost Recovery Surcharge Tariff, final Order dated April 18, 2001, Ordering paragraph number 11; and Case No. 2000-439, The Application of Kentucky Utilities Company for Approval of an Amended Compliance Plan for Purposes of Recovering the Costs of New and Additional Pollution Control Facilities and to Amend Its Environmental Surcharge Tariff, final Order dated April 18, 2001, Ordering paragraph number 12.

and KU seek to create deferred debits for the expenses incurred to implement the Workforce Reduction. For electric operations, LG&E and KU propose to reflect the amortizations of the deferred debits as of April 1, 2001 and include the amortizations as expenses when determining their net operating incomes for ESM purposes. The amortizations will be done over 4 years on a straight-line basis. Electric expense savings resulting from the Workforce Reduction would be reflected in the ESM calculations for year 2001 and thereafter. For gas operations, LG&E proposes to delay amortizing the deferred debit until its next gas base rate case. The impact of Workforce Reduction expense savings would also be addressed in the next gas base rate case.

LG&E and KU initiated the Workforce Reduction at the beginning of 2001. As of June 1, 2001, employees of LG&E and KU who had elected to voluntarily separate their employment totaled 1,142,¹¹ with 964 employees actually exercising their election to retire.¹² Due to voluntary employee rescissions, LG&E and KU currently expect 938 employees to exercise the election to retire by the end of 2001.¹³ In addition, LG&E and KU expect to rehire or “backfill” 108 positions and LG&E is obligated under an agreement with the IBEW to hire 180 bargaining unit employees over the next 4 years.¹⁴ The total estimated expense associated with the Workforce Reduction for LG&E and KU

¹¹ Application at 3.

¹² Response to the Commission Staff’s 1st Data Request dated August 29, 2001, Item 2(c). Included in the 971 total original retirements were 7 retirements from LG&E Energy Corp.

¹³ Id.

¹⁴ Application at 4.

is \$208,173,408,¹⁵ less approximately \$7,200,000 to reflect the rescissions. LG&E and KU plan to adjust the actual expenses and the deferred debits to be recorded and amortized at December 31, 2001, when the actual number of rescissions is known.¹⁶

At the end of the first quarter in 2001, LG&E recorded an estimated Workforce Reduction expense for electric and gas operations of \$144,385,494.¹⁷ KU recorded an estimated Workforce Reduction expense of \$63,787,914 for total company operations, with \$56,267,319 allocated to Kentucky retail operations.¹⁸ As proposed by LG&E and KU, these expense entries would be reversed and the estimated amounts capitalized and recorded as deferred debits. The deferred debits related to electric operations would be amortized on a straight-line basis over a period running from April 2001 through March 2005.

A procedural schedule was established for this case and extensive discovery was conducted.

SETTLEMENT AGREEMENT

At the request of LG&E and KU, an informal conference was held at the Commission's offices on August 28, 2001 to discuss the issues raised in the above-

¹⁵ Application Exhibit B-1. Sum of "Total Accrual March 2001" for LG&E and KU.

¹⁶ Response to the Commission Staff's 1st Data Request dated August 29, 2001, Item 5.

¹⁷ Application Exhibit B-2. Of LG&E's total, \$114,569,153 is associated with electric operations and \$29,816,341 is associated with gas operations.

¹⁸ Application Exhibits B-1 and E. Applying a jurisdictional allocation factor of 88.21 percent, KU's Kentucky jurisdictional portion of the total company expense is \$56,267,319. The remaining \$7,520,595 is applicable to KU's non-Kentucky jurisdictional operations.

captioned cases and explore the potential for resolving some or all of those issues through a settlement. Additional informal conferences were held on September 28, 2001 and October 18, 2001, and a number of conference calls were held among the parties. Those discussions resulted in the filing of a Settlement Agreement on October 31, 2001. The Settlement Agreement, a copy of which is attached hereto as Appendix A, is intended to resolve all issues raised and outstanding in the five captioned cases.

Impact on Case Nos. 2001-054 and 2001-055
ESM

Article 3.0 of the Settlement Agreement resolves KIUC's objection to the use of year-end capitalization in LG&E's and KU's ESM calculations. For calendar year 2000 operations, the ESM calculations will be made using year-end capitalization which is the methodology used by LG&E and KU in these two cases. For years 2001 and 2002, the ESM calculations will be made using monthly average capitalization.

Impact on Case Nos. 2001-140 and 2001-141
Revised Depreciation Rates

Article 1.0 of the Settlement Agreement results in further revisions to the depreciation rates for KU and LG&E. The depreciation rates for steam production plant have been adjusted to an average life of 48 years.¹⁹ KU's annual depreciation expense will be reduced by \$12,774,957, while LG&E's annual electric and gas depreciation expenses will be reduced by a total of \$5,284,413. The revised depreciation rates will be used for accounting and rate-making purposes for all of 2001, with the exception that

¹⁹ There is a specific exception for LG&E's Trimble County Unit No. 1, which will be at 44 years.

the revised depreciation rates will only be applied prospectively in the environmental surcharge calculations. For environmental surcharge calculations, the revised depreciation rates will be used beginning with the first monthly surcharge filings after the approval of the Settlement Agreement. KU and LG&E have committed to perform a new depreciation study no later than calendar year 2004 based on utility plant in service as of December 31, 2003. When completed, this study will be filed with the Commission.

Impact on Case No. 2001-169
Accounting Deferral and ESM Recognition for Workforce Reduction

Article 2.0 of the Settlement Agreement provides for the amortization of the Workforce Reduction expenses and also guarantees that ratepayers will receive a share of the expected savings directly. The deferred debits originally proposed by LG&E and KU will be established, subject to a final adjustment to reflect actual expenses as of December 31, 2001. The deferred debits will be amortized over a 60-month period beginning April 1, 2001 and ending March 31, 2006. The amortization for the first 10 months will not be on a straight-line basis, so that the monthly amortization does not exceed the expected savings and to allow for any adjustments to the deferred debit balances. The unamortized balance for the deferred debits as of February 1, 2002 will be amortized on a straight-line basis for the remaining 50 months.

In addition, the parties have agreed to a surcredit mechanism, designated as the "Value Delivery Surcredit," which is similar to the Merger Surcredit which has been reflected in LG&E's and KU's rates since the merger of their respective holding companies. Under the Value Delivery Surcredit mechanism, the estimated savings from the Workforce Reduction are netted against the monthly amortization of the deferred

debits. The net savings are then shared 40 percent to ratepayers and 60 percent to shareholders, which is the same sharing ratio used in the ESM calculations. The ratepayers' portion of the net savings will be shown as a Value Delivery Surcredit on monthly bills. This surcredit will become effective for billing with the first full monthly billing cycle that occurs no later than 45 days after the Commission approves the Settlement Agreement, but no earlier than December 1, 2001, and will continue in effect until March 2006. When the ESM calculations are performed for electric operations, the effects of the Value Delivery Surcredit will be removed from the calculations, just as the Merger Surcredit has been. For LG&E's gas operations, the net savings will be included as an adjustment in any gas rate case reviewed for LG&E through March 2006.

During the 60 months the Value Delivery Surcredit will be in effect, LG&E's electric customers will receive \$19,800,000 in bill credits; LG&E's gas customers will receive \$5,100,000; and KU's Kentucky jurisdictional customers will receive \$9,600,000.

ANALYSIS

The Commission has reviewed the Settlement Agreement and finds that it constitutes a reasonable resolution of the five captioned cases. All customers will benefit from the guaranteed credits totaling \$34,500,000 in savings resulting from the Value Delivery Surcredit. For electric customers, there is the potential for additional earnings sharing through the ESM due to the use of average capitalization and lowered depreciation expense. Therefore, the Commission will approve the October 31, 2001 Settlement Agreement in its entirety.

LG&E and KU have included as an attachment to the Settlement Agreement a draft version of the Value Delivery Surcredit tariff. The Commission finds the draft to be reasonable, subject to being modified to clearly reflect that the surcredit will be allocated to customers on percentage-of-revenue basis. LG&E and KU should file revised tariffs within 5 days of the date of this Order and file further tariffs by January 21, 2002 to reflect the year-end adjustments to the deferred debits.

The Commission notes that Section 2.6 of the Settlement Agreement provides that if LG&E or KU determine that they need to hire additional employees or retain additional contractors for the purposes of continuing to maintain safety, customer service, and reliability at presently existing levels, the expenses for these additional employees and contractors will be treated as normal operating costs and included in the ESM calculations, subject to Commission review. LG&E and KU have national reputations for not only their low electric rates but also their superior quality of service. The Commission recognizes that the Workforce Reduction has been implemented to further reduce operating expenses, but such savings will not truly benefit customers if one of the unintended effects is a reduction in the quality of service. The Commission has reviewed this issue with LG&E and KU and it appears that their service quality will be maintained through increased reliance on outside contractors, backfilling some positions, and increasing bargaining unit employees. The Commission will closely monitor LG&E's and KU's service quality, particularly restoration times following storms, and will expect LG&E and KU to address any deterioration or deficiencies in a prompt and comprehensive manner.

In conjunction with our approval of the Settlement Agreement, the Commission finds it necessary to establish a monitoring mechanism to track employment and contractor levels. LG&E and KU should file an annual schedule that details the numbers of additional employees hired and the number of additional contractors utilized. The schedule should compare the reporting period's levels with the levels in effect as of December 31, 2001, and detail the additional expenses incurred for each group. The schedule should be filed as part of the annual ESM calculation filing which is due on March 1 of each year. If the ESM is not continued in some form after 2002, the schedule should be filed with LG&E's and KU's annual financial reports. If this information indicates that LG&E or KU have incurred significantly increased costs for increasing numbers of employees or contractors, the Commission will then consider opening a formal investigation to determine whether such increased costs should be included in the ESM calculations.

IT IS THEREFORE ORDERED that:

1. The October 31, 2001 Settlement Agreement among LG&E, KU, the AG, and KIUC is approved in its entirety as a reasonable resolution of all issues raised or outstanding in Case Nos. 2001-054, 2001-055, 2001-140, 2001-141, and 2001-169.
2. LG&E and KU shall file on March 1, 2002, and each year thereafter, the schedule reflecting the number and cost for employees and contractors as more fully described in the above findings.
3. LG&E and KU shall file revised tariffs within 5 days of the date of this Order and shall file further tariffs by January 21, 2002 to reflect the year-end adjustments to the deferred debits.

4. A copy of this Order shall be included in Case Nos. 2001-054, 2001-055, 2001-140, 2001-141, and 2001-169 and those cases are hereby closed.

Done at Frankfort, Kentucky, this 3rd day of December, 2001.

By the Commission

ATTEST:


Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE

KENTUCKY PUBLIC SERVICE COMMISSION

IN CASE NOS. 2001-054, 2001-055, 2001-140, 2001-141, 2001-169

DATED DECEMBER 3, 2001