

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

LOUISVILLE GAS AND ELECTRIC COMPANY S )  
ANNUAL EARNINGS SHARING MECHANISM ) CASE NO. 2002-00071  
FILING FOR CALENDAR YEAR 2001 )

O R D E R

On March 1, 2002, Louisville Gas and Electric Company ( LG&E ) filed its second annual Earnings Sharing Mechanism ( ESM ) calculations. LG&E s current ESM filing covers its financial results from the 2001 calendar year. LG&E determined that its rate of return on common equity for calendar year 2001 was 10.28 percent,<sup>1</sup> which is below the lower limit of the deadband in the ESM mechanism. Based on the results for calendar year 2001, LG&E calculated that it needed to collect \$966,721 from ratepayers during the period April 2002 through March 2003.<sup>2</sup> LG&E began collecting

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<sup>1</sup> Application, Form 1c.

<sup>2</sup> In the March 1, 2002 filing, LG&E determined that \$1,020,588 needed to be collected from ratepayers. On April 22, 2002, LG&E filed calculations reflecting the balancing adjustment for the 2000 ESM mechanism. In the April 22, 2002 filing, LG&E reflected the impact of combining the balancing adjustment for 2000 with the 2001 ESM mechanism calculations. This results in the total to be collected from ratepayers of \$966,721. See Annual Earnings Sharing Mechanism Balancing Adjustment, Form 1a.

the \$966,721 through a monthly ESM factor applied to bills rendered on and after April 1, 2002.<sup>3</sup>

The Attorney General, by and through his Office of Rate Intervention ( AG ), and the Kentucky Industrial Utility Customers, Inc. ( KIUC ) sought and were granted intervention in this proceeding.

An informal conference was held on May 23, 2002 at the Commission s offices in Frankfort, Kentucky to discuss the issues in this case. During the informal conference a procedural schedule was developed, which provided that direct testimony from any party would be filed on June 4, 2002 and response testimony would be filed on June 11, 2002. In the event no direct testimony was filed, the case would stand submitted on the existing record and any briefs would be filed electronically on June 10, 2002 and physically on June 11, 2002. No direct testimony was filed, LG&E and KIUC filed briefs on June 11, 2002, and the case is ready for decision.

#### BACKGROUND

LG&E s ESM was established as part of the Commission s Order in Case No. 1998-00426.<sup>4</sup> Under the ESM mechanism, a deadband was established in the range of 100 basis points above and 100 basis points below the 11.5 percent rate of return on common equity authorized in that case. When the rate of return on common

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<sup>3</sup> Annual Earnings Sharing Mechanism Balancing Adjustment filed April 22, 2002, Form 1a. The ESM Factor included in the March 1, 2002 filing provided for a monthly collection of approximately \$85,049. This amount was collected for only 1 month. After adjusting the ESM Factor for the 2000 ESM balancing adjustment, the monthly collection was reduced to approximately \$80,152 (\$881,672 divided by 11 months).

<sup>4</sup> Case No. 1998-00426, 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.

equity achieved in a calendar year is above the deadband, LG&E must return to ratepayers 40 percent of the amount by which its actual earnings exceed its earnings at the upper limit of the deadband. When the rate of return on common equity achieved in a calendar year is below the deadband, LG&E is permitted to collect from ratepayers 40 percent of the amount by which its actual earnings fall below its earnings at the lower limit of the deadband.

LG&E filed its first annual ESM calculations on March 1, 2001.<sup>5</sup> That filing included a calculation of LG&E's rate of return on common equity achieved for year 2000 using its year-end capitalization. Utilizing year-end capitalization, LG&E determined that it had exceeded the ESM deadband and should return to ratepayers \$617,609. During that proceeding, KIUC objected to LG&E's use of year-end capitalization and argued that average capitalization should have been used. KIUC contended that the use of year-end capitalization overstated the revenue requirements used in the ESM calculations and understated the credit due to LG&E's ratepayers by \$3,000,000.<sup>6</sup> The dispute was resolved as part of a comprehensive settlement agreement ( Global Settlement ) entered into by LG&E, KIUC, and the AG, and approved by the Commission on December 3, 2001.<sup>7</sup> Under the Global Settlement, the

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<sup>5</sup> Case No. 2001-00054, The Annual Earnings Sharing Mechanism Filing of Louisville Gas and Electric Company.

<sup>6</sup> See Case No. 2001-00054, final Order dated December 3, 2001, at 3.

<sup>7</sup> The Global Settlement resolved five cases then pending before the Commission to which KIUC, the AG, and LG&E or the Kentucky Utilities Company ( KU ) were parties. The five cases concerned the calculations under the ESM mechanism, approval of new depreciation rates, and the accounting for and ESM recognition of the 2001 Workforce Transition Separation Program ( Workforce Reduction ) at LG&E and KU.

parties agreed that the ESM calculations for calendar year 2000 would be based on LG&E's as-filed year-end capitalization, with calendar years 2001 and 2002 based on monthly average capitalization.<sup>8</sup>

In its March 1, 2002 filing, LG&E used the monthly average capitalization in its ESM calculations for year 2001. As applied by LG&E, the monthly average capitalization approach to determining capitalization used a 13-month average, consisting of the months of December 2000 through and including December 2001. In performing these calculations, LG&E adjusted its actual monthly capitalization totals to reflect two items that had also been addressed as part of the Global Settlement. First, depreciation expense for the 12 months of 2001 was adjusted retroactively to January 2001 to reflect the reduction in expense agreed to in the Global Settlement. Second, the March 2001 write-off of Workforce Reduction costs was reversed and adjustments were included to retroactively reflect the Workforce Reduction costs as a deferred debit for LG&E. The adjustments showed the deferred debit as if it had been on LG&E's books for the last 9 months of 2001. The adjustments also included the monthly amortizations of the deferred debit and the monthly credit to ratepayers of the Value Delivery Surcredit for the last 9 months of 2001.<sup>9</sup>

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<sup>8</sup> See Case No. 2001-00054, final Order dated December 3, 2001, at 7.

<sup>9</sup> See Case No. 2001-00169, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for an Order Approving Proposed Deferred Debits and Declaring the Amortization of the Deferred Debits to be Included in Earnings Sharing Mechanism Calculations, final Order dated December 3, 2001, at 8. Under the Value Delivery Surcredit, 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. The Value Delivery Surcredit will continue in effect until March 2006.

KIUC argues that no provision of the Global Settlement specifically authorized LG&E to adjust its monthly capitalization to retroactively reflect the Workforce Reduction deferred debit as if it were booked in March 2001, when in fact the deferred debit was not booked until December 2001. KIUC also argues that no provision of the Global Settlement authorized LG&E to make adjustments to reflect the Value Delivery Surcredit and the amortization of the Workforce Reduction deferred debit as if they were booked in the months of April through December 2001 when in fact these accounting entries were not booked until December 2001.<sup>10</sup> KIUC contends that while the Global Settlement expressly states that LG&E's new depreciation rates would be used for accounting and rate-making purposes effective January 1, 2001, there is no comparable provision in the Global Settlement authorizing the retroactive recognition of the Workforce Reduction adjustments.<sup>11</sup>

KIUC's position is that the Global Settlement did not authorize LG&E to establish the Workforce Reduction deferred debit retroactively to March 2001 for accounting and financial reporting purposes. KIUC notes that LG&E did not actually establish the deferred debit in March 2001, did not restate its financial statements for the first, second, or third quarters of 2001,<sup>12</sup> and did not seek authorization in its application in Case No. 2001-00169 to establish the Workforce Reduction deferred debit retroactive to March 2001.<sup>13</sup> Based on these arguments, KIUC concludes that LG&E's calendar year

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<sup>10</sup> Brief of KIUC at 1-2.

<sup>11</sup> Id. at 4.

<sup>12</sup> Id. at 5.

<sup>13</sup> Id. at 6.

2001 adjusted net operating income and rate of return on common equity fell within the ESM deadband and no amounts should be collected from LG&E's ratepayers.<sup>14</sup>

LG&E argues that its capitalization balances included in the ESM calculations properly reflect the impact of all revenue and expense adjustments mandated by the Global Settlement and comply with the terms of that agreement.<sup>15</sup> LG&E notes that the Commission's December 3, 2001 Order in Case No. 2001-00169 made it clear that it was always LG&E's intent to include the amortization of the Workforce Reduction deferred debits as an expense when determining the net operating income for ESM purposes.<sup>16</sup> LG&E contends that in directing it to establish the Workforce Reduction deferred debits and to amortize that deferred debit effective April 1, 2001, the Global Settlement implicitly required a reversal of the Workforce Reduction-related expense LG&E had recorded for accounting and ESM purposes in March 2001, as it could not concurrently expense and amortize the same costs. LG&E believes that the Commission's December 3, 2001 Order in Case No. 2001-00169 confirmed LG&E's intent to reflect the amortization of the Workforce Reduction deferred debit as of April 1, 2001 and to include the amortization as an expense when determining the net operating income for ESM purposes.<sup>17</sup>

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<sup>14</sup> Id., Attachment 1, LG&E Recalculation of ESM Band.

<sup>15</sup> Joint Brief of LG&E and KU at 2.

<sup>16</sup> Id. at 3.

<sup>17</sup> Id. at 5.

## ANALYSIS

The dispute in this case arises from the timing of certain Workforce Reduction accounting adjustments made by LG&E for purposes of calculating its year 2001 ESM. LG&E asserts that the accounting adjustments were to be booked retroactively to March and April 2001, whereas KIUC asserts that the adjustments were to be booked in December 2001. Both LG&E and KIUC rely upon differing interpretations of provisions in the Global Settlement to support their respective positions. The other party to this case, the AG, has expressed no opinion on the issues raised in this dispute.

The starting point for the Commission's review is the January 7, 2000 Order establishing LG&E's ESM in Case No. 1998-00426. In setting the parameters for the ESM, the Commission determined that only limited adjustments should be made to LG&E's actual financial results. Specifically, the Commission stated:

To ensure that the ESM plan does not become cumbersome and the annual reviews do not result in lengthy and costly rate cases, only limited rate-making adjustments will be required.<sup>18</sup>

On rehearing in that case, the Commission further found that, LG&E should use actual revenues, rather than estimated revenues, in the derivation of its future ESM factors, and that the issue of allowing future ESM adjustments to reflect subsequent Commission Orders will be deferred until such time as future cases are docketed.<sup>19</sup> Thus, LG&E's ESM was to reflect its actual financial results, except for those

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<sup>18</sup> Case No. 1998-00426, Order dated January 7, 2000, at 49.

<sup>19</sup> Case No. 1998-00426, Order dated June 1, 2000, at 13-14.

adjustments that had received the Commission's prior approval. With these parameters in mind, the Commission turns to the Global Settlement.

The Commission has reviewed the language contained in the Global Settlement and our December 3, 2001 Order approving the Global Settlement in its entirety. The Global Settlement expressly states in Section 1.2 that the agreed-to depreciation rates will be used for accounting and rate-making purposes effective January 1, 2001. However, the Global Settlement contains no similar provision authorizing a retroactive date for establishing the Workforce Reduction deferred debit, the amortization of that deferred debit, or the payment of the Value Delivery Surcredit. While Section 2.2 of the Global Settlement does state that, "The deferred debits . . . shall be amortized over a sixty month period beginning April 1, 2001," it further states that LG&E will reflect the 2001 amortization of the deferred debits in the financial statements of LG&E during the fourth quarter of 2001.<sup>20</sup> In addition, the amortization expense for the deferred debit is stated as a fixed amount for 2001, representing a 9-month amortization total, and the Global Settlement contains no references to LG&E booking a monthly amount during 2001.<sup>21</sup>

LG&E argues that its intent in agreeing to the Global Settlement was to include the amortization of the deferred debit as an expense when determining its net operating income for ESM purposes. LG&E's brief repeatedly cites as support for this intent the Commission's statement in the December 3, 2001 Order in Case No. 2001-00169, at

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<sup>20</sup> See Case No. 2001-00169, December 3, 2001 Order, Appendix A at 5, Section 2.2.

<sup>21</sup> Id.



page 5, that, 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 income for ESM purposes. However, what the Commission was stating in that Order was LG&E's intent as expressed in its June 1, 2001 application filed in Case No. 2001-00169. At that time, LG&E's intent was also to continue filing its ESM calculations based on its year-end capitalization.

As a result of LG&E's subsequent negotiations with KIUC and the AG, there are significant differences between what LG&E had proposed in that application and what it agreed to as expressed in the Global Settlement, which is dated October 31, 2001 and was approved by the Commission on December 3, 2001. For example, the amortization of the Workforce Reduction deferred debits was extended from 48 to 60 months, a Workforce Reduction Surcredit was established, and the ESM calculations would subsequently be based on average capitalization rather than year-end capitalization. While the record is clear as to LG&E's intent when it filed its June 1, 2001 application in Case No. 2001-00069, there is no credible evidence to support LG&E's current argument that its intent in agreeing to the Global Settlement was to adjust its monthly capitalization retroactively to April 1, 2001.

Based on a review of the expressed provisions in the Global Settlement, the Commission finds that the Global Settlement does not authorize LG&E to adjust its monthly capitalization to retroactively reflect the Workforce Reduction. While LG&E is authorized to retroactively adjust its depreciation rates for accounting and ratemaking purposes, there is no such authorization for the Workforce Reduction adjustments.

Thus, the Workforce Reduction-related adjustments are properly recognized beginning in December 2001, when LG&E recorded the actual accounting entries.

While the Global Settlement only authorizes LG&E to recognize the Workforce Reduction adjustments prospectively from their date of entry in December 2001, the deferred debits are to be amortized over a 60-month period beginning April 1, 2001. Thus, the Global Settlement, Section 2.2, authorizes LG&E to record on its books in December 2001 a total of 9 months of amortizations to reflect the amortization period beginning April 1, 2001.

The Commission also finds that KIUC's proposed ESM calculation<sup>22</sup> utilizing a December 2001 beginning date for the Workforce Reduction adjustments appears reasonable. Using this calculation, LG&E's adjusted net operating income for 2001 fell within the ESM deadband. The adjusted net operating income of \$105,744,065 as calculated by KIUC reflects a rate of return on common equity of 10.95 percent.<sup>23</sup> Since LG&E's authorized return on common equity is 11.5 percent, an achieved return of 10.95 percent falls within the 10.5 to 12.5 percent deadband. Consequently, this calculation indicates that LG&E should not be recovering any amounts from its ratepayers in conjunction with its ESM calculations for 2001 and that all monies already collected through the ESM factor since April 2002 should be refunded. However, since

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<sup>22</sup> Brief of KIUC, Attachment 1, LG&E Recalculation of ESM Band.

<sup>23</sup> Dividing the adjusted net operating income of \$105,744,065 by the electric capitalization of \$1,325,437,378 results in a rate of return on capital of 7.98 percent. Of this total, 2.53 percent reflects the cost rates for debt, accounts receivable financing, and preferred stock. Dividing the remaining 5.45 percent (7.98 minus 2.53) by the common equity capital structure percentage of 49.78 percent results in the rate of return on common equity of 10.95 percent.

KIUC's calculations were filed as an attachment to its brief, the Commission will direct LG&E to refile its ESM calculations for year 2001 based on the findings herein rejecting the proposed retroactive adjustments for the Workforce Reduction.

#### SUMMARY

1. The calendar year 2001 ESM calculations as filed by LG&E on March 1, 2002 include adjustments to retroactively reflect the Workforce Reduction. Those adjustments are not authorized by the provisions of the Global Settlement and should be rejected.

2. LG&E should refile its calendar year 2001 ESM calculations to reflect the exclusion of its proposed retroactive adjustments for the Workforce Reduction and the inclusion of any refunds for amounts collected through the ESM factor since April 1, 2002.

IT IS THEREFORE ORDERED that:

1. Within 10 days of the date of this Order, LG&E shall file its calendar year 2001 ESM calculations excluding any adjustments to retroactively reflect its Workforce Reduction prior to December 2001. LG&E shall also file its calculations of any refund owed to its ratepayers due to collections through the ESM factor in effect since April 1, 2002.

2. Within 10 days of the date of this Order, LG&E shall file the necessary revisions to its tariffs reflecting the recalculation of its ESM as required by the findings herein.

Done at Frankfort, Kentucky, this 16<sup>th</sup> day of October, 2002.

By the Commission

ATTEST:

A handwritten signature in black ink, appearing to read "Thomas H. [unclear]", written over a horizontal line.

Executive Director