

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

KENTUCKY UTILITIES COMPANY S ANNUAL	)	
EARNINGS SHARING MECHANISM FILING FOR	)	CASE NO.
CALENDAR YEAR 2001	)	2002-00072

O R D E R

On March 1, 2002, Kentucky Utilities Company ( KU ) filed its second annual Earnings Sharing Mechanism ( ESM ) calculations. KU s current ESM filing covers its financial results from the 2001 calendar year. KU determined that its rate of return on common equity for calendar year 2001 was 12.46 percent,<sup>1</sup> which is within the deadband in the ESM mechanism. Based on the results for calendar year 2001, KU would not collect from or return to ratepayers any funds.

The Attorney General, by and through his Office of Rate Intervention ( AG ), the Kentucky Industrial Utility Customers, Inc. ( KIUC ), and the Lexington-Fayette Urban County Government ( LFUCG ) 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

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

existing record and any briefs would be filed electronically on June 10, 2002 and physically on June 11, 2002. No direct testimony was filed, KU and KIUC filed briefs on June 11, 2002, and the case is ready for decision.

### BACKGROUND

KU's ESM was established as part of the Commission's Orders in Case No. 1998-00474.<sup>2</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 equity achieved in a calendar year is above the deadband, KU 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, KU 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.

KU filed its first annual ESM calculations on March 1, 2001.<sup>3</sup> That filing included a calculation of KU's rate of return on common equity achieved for year 2000 using its year-end capitalization. Utilizing year-end capitalization, KU determined that its actual net operating income was within the deadband and no rate adjustments were necessary. During that proceeding, KIUC objected to KU's use of year-end

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<sup>2</sup> Case No. 1998-00474, 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.

<sup>3</sup> Case No. 2001-00055, The Annual Earnings Sharing Mechanism Filing of Kentucky Utilities Company.

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, but acknowledged that the ESM results for KU would have not changed.<sup>4</sup> The dispute was resolved as part of a comprehensive settlement agreement ( Global Settlement ) entered into by KU, KIUC, and the AG, and approved by the Commission on December 3, 2001.<sup>5</sup> Under the Global Settlement, the parties agreed that the ESM calculations for calendar year 2000 would be based on KU s as-filed year-end capitalization, with calendar years 2001 and 2002 based on monthly average capitalization.<sup>6</sup>

In its March 1, 2002 filing, KU used the monthly average capitalization in its ESM calculations for year 2001. As applied by KU, 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, KU 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

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<sup>4</sup> See Case No. 2001-00055, final Order dated December 3, 2001, at 3.

<sup>5</sup> The Global Settlement resolved five cases pending before the Commission to which KIUC, the AG, and KU or the Louisville Gas and Electric Company ( LG&E ) 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 KU and LG&E.

<sup>6</sup> See Case No. 2001-00055, final Order dated December 3, 2001, at 7.

write-off of Workforce Reduction costs was reversed and adjustments were included to retroactively reflect the Workforce Reduction costs as a deferred debit for KU. The adjustments showed the deferred debit as if it had been on KU's books for the last 9 months of 2001. The adjustments also included the monthly amortization of the deferred debit and the monthly return to ratepayers of the Value Delivery Surcredit for the last 9 months of 2001.<sup>7</sup>

KIUC argues that no provision of the Global Settlement specifically authorized KU to adjust its 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 KU 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>8</sup> KIUC contends that while the Global Settlement expressly states that KU's new depreciation rates would be used for accounting and rate-making purposes effective January 1, 2001, there is no comparable provision in the

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<sup>7</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.

<sup>8</sup> Brief of KIUC at 1-2.

Global Settlement authorizing the retroactive recognition of the Workforce Reduction adjustments.<sup>9</sup>

KIUC's position is that the Global Settlement did not authorize KU to establish the Workforce Reduction deferred debit retroactively to March 2001 for accounting and financial reporting purposes. KIUC notes that KU 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>10</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>11</sup> Based on these arguments, KIUC concludes that KU's calendar year 2001 adjusted net operating income and rate of return on common equity was above the upper limit of the deadband. Following the ESM mechanism, KIUC determined that KU should return \$1,378,077 to ratepayers.<sup>12</sup>

KU 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 document.<sup>13</sup> KU notes that the Commission's December 3, 2001 Order in Case No. 2001-00169 made it clear that it was always KU's intent to include the amortization of the Workforce Reduction deferred

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<sup>9</sup> Id. at 4.

<sup>10</sup> Id. at 5.

<sup>11</sup> Id. at 6.

<sup>12</sup> Id., Attachment 1, KU Recalculation of ESM Band.

<sup>13</sup> Joint Brief of LG&E and KU at 2.

debits as an expense when determining the net operating income for ESM purposes.<sup>14</sup> KU 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 KU had recorded for accounting and ESM purposes in March 2001, as it could not concurrently expense and amortize the same costs. KU believes that the Commission's December 3, 2001 Order in Case No. 2001-00169 confirmed KU'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>15</sup>

#### ANALYSIS

The dispute in this case arises from the timing of certain Workforce Reduction accounting adjustments made by KU for purposes of calculating its year 2001 ESM. KU 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 KU and KIUC rely upon differing interpretations of provisions in the Global Settlement to support their respective positions. The other parties to this case, the AG and LFUCG, have 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 KU's ESM in Case No. 1998-00474. In setting the parameters for the ESM,

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<sup>14</sup> Id. at 3.

<sup>15</sup> Id. at 5.

the Commission determined that only limited adjustments should be made to KU'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>16</sup>

On rehearing in that case, the Commission further found that, KU 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>17</sup> Thus, KU's ESM was to reflect its actual financial results, except for those 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 KU will reflect the 2001

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<sup>16</sup> Case No. 1998-00474, Order dated January 7, 2000, at 46.

<sup>17</sup> Case No. 1998-00474, Order dated June 1, 2000, at 14.

amortization of the deferred debits in the financial statements of KU during the fourth quarter of 2001.<sup>18</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 KU booking a monthly amount during 2001.<sup>19</sup>

KU 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. KU'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 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 KU's intent as expressed in its June 1, 2001 application filed in Case No. 2001-00169. At that time, KU's intent was also to continue filing its ESM calculations based on its year-end capitalization."

As a result of KU's subsequent negotiations with KIUC and the AG, there are significant differences between what KU 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, that amortization of the Workforce Reduction deferred debits was extended from 48 to 60 months, a Workforce Reduction Surcredit was established, and the ESM calculations

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<sup>18</sup> See Case No. 2001-00169, December 3, 2001 Order, Appendix A at 5, Section 2.2.

<sup>19</sup> Id.



would subsequently be based on average capitalization rather than year-end capitalization. While the record is clear as to KU's intent when it filed its June 1, 2001 application in Case No. 2001-00169, there is no credible evidence to support KU'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 KU to adjust its monthly capitalization to retroactively reflect the Workforce Reduction. While KU is authorized to retroactively adjust its depreciation rates for accounting and rate-making 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 KU recorded the actual accounting entries.

While the Global Settlement only authorizes KU 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 KU 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 ESM calculation<sup>20</sup> utilizing a December 2001 beginning date for the Workforce Reduction adjustments appears reasonable. Using this calculation, KU's adjusted net operating income for 2001 was above the upper limit of the ESM deadband. The adjusted net operating income of \$99,540,725

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<sup>20</sup> Brief of KIUC, Attachment 1, KU Recalculation of ESM Band.

as calculated by KIUC reflects a rate of return on common equity of 12.83 percent.<sup>21</sup> Since KU's authorized return on common equity is 11.5 percent, an achieved return of 12.83 percent falls above the 10.5 to 12.5 percentage deadband. Consequently, this calculation indicates that KU should be refunding amounts to its ratepayers in conjunction with its ESM calculations for 2001. However, since KIUC's calculations were filed as an attachment to its brief, the Commission will direct KU 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 KU 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. KU 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 an ESM factor refunding amounts to its ratepayers during the months remaining between the first billing cycle after the date of this Order and the end of March 2003.

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<sup>21</sup> Dividing the adjusted net operating income of \$99,540,725 by the electric capitalization of \$1,002,130,028 results in a rate of return on capital of 9.93 percent. Of this total, 2.24 percent reflects the cost rates for debt, accounts receivable financing, and preferred stock. Dividing the remaining 7.69 percent (9.93 minus 2.24) by the common equity capital structure percentage of 59.92 percent results in the rate of return on common equity of 12.83 percent.

IT IS THEREFORE ORDERED that:

1. Within 10 days of the date of this Order, KU shall file its calendar year 2001 ESM calculations excluding any adjustments to retroactively reflect its Workforce Reduction prior to December 2001. KU shall also file its calculations of any refund owed to its ratepayers through an ESM factor to be applied to the months remaining between the first billing cycle after the date of this Order and the end of March 2003.

2. Within 10 days of the date of this Order, KU 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