

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

|   |   |            |
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| AN EXAMINATION BY THE PUBLIC SERVICE    | ) |            |
| COMMISSION OF THE ENVIRONMENTAL         | ) |            |
| SURCHARGE MECHANISM OF KENTUCKY         | ) |            |
| UTILITIES COMPANY FOR THE SIX-MONTH     | ) | CASE NO.   |
| BILLING PERIODS ENDING JULY 31, 2003,   | ) | 2006-00129 |
| JANUARY 31, 2004, JANUARY 31, 2005,     | ) |            |
| JULY 31, 2005, AND JANUARY 31, 2006 AND | ) |            |
| FOR THE TWO-YEAR BILLING PERIOD ENDING  | ) |            |
| JULY 31, 2004                           | ) |            |

O R D E R

On April 25, 2006, the Commission initiated five 6-month reviews and two 2-year reviews of Kentucky Utilities Company's ("KU") environmental surcharge as billed to customers for the following periods: the 6-month periods February 1, 2003 to July 31, 2003; August 1, 2003 to January 31, 2004; August 1, 2004 to January 31, 2005; February 1, 2005 to July 31, 2005; August 1, 2005 to January 31, 2006; and the 2-year period August 1, 2002 to July 31, 2004.<sup>1</sup> At the request of KU, the Commission's May 22, 2006 Order expanded the 6-month period to include the billing months of February 1, 2006 to April 30, 2006 and the 2-year period to include the billing months of August 1, 2004 to April 30, 2005.<sup>2</sup> Pursuant to KRS 278.183(3), the Commission must review, at

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<sup>1</sup> KU's surcharge is billed on a 2-month lag. Thus surcharge billings for February 2003 recover costs incurred in December 2002, and every subsequent monthly surcharge billing under review recovers costs incurred 2 months prior to billing.

<sup>2</sup> The expansion of the billing months under review permit future 6-month and 2-year review periods to be synchronized with the same periods for KU's affiliated company, Louisville Gas and Electric Company ("LG&E"). The benefits and advantages of this synchronization are discussed in the May 22, 2006 Order.

6-month intervals, the past operations of the environmental surcharge; disallow any surcharge amounts that are not just and reasonable; and reconcile past surcharge collections with actual costs recoverable. At 2-year intervals, the Commission must review and evaluate the past operations of the environmental surcharge, disallow improper expenses and, to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of the utility.

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. The Commission issued a procedural schedule on April 25, 2006 that provided for discovery, the filing of prepared testimony, an informal conference, and a public hearing. KU filed prepared direct testimony and responded to requests for information. The intervenors filed requests for information and KIUC submitted testimony. On August 24, 2006, KU, the AG, and KIUC filed a joint motion requesting that the Commission cancel the public hearing, as the parties were willing to waive their right to a hearing and submit the case for decision based on the existing record on the condition that they were allowed to file simultaneous briefs no later than September 28, 2006. The Commission granted the joint motion on August 28, 2006 and the parties filed simultaneous briefs on September 28, 2006.

On November 21, 2006, KU filed a motion requesting approval to file corrections to its previously filed direct testimony, a data response, and its September 28, 2006 brief. KU stated that in October 2006 it had discovered errors in the methodology used to determine its over- or under-recovery of surcharge revenues. KU also requested that an informal conference be scheduled for November 29, 2006 to discuss the proposed

corrections. At the November 29, 2006 informal conference, an abbreviated procedural schedule was developed to afford the parties the opportunity to conduct discovery on the corrected testimony and responses. The agreed procedural schedule also provided that KU, the AG, and KIUC would have the opportunity to indicate whether this case could be submitted for decision based on the existing record without a hearing or whether a hearing would be requested. The Commission's December 5, 2006 Order granted KU's motion to file the corrections and approved the procedural schedule. On December 12, 2006, KU, the AG, and KIUC filed a joint motion again requesting the Commission to decide all issues in this proceeding on the existing record.

#### SURCHARGE ADJUSTMENT

The April 25, 2006 Order initiating this case indicated that since each of the six periods under review in this proceeding may have resulted in over- or under-recoveries, the Commission would entertain proposals to adopt one adjustment factor to net all over- or under-recoveries. KU determined that it had a net under-recovery of its environmental costs for all the periods, including the months included in the expansion, of \$1,597,499.<sup>3</sup> KU proposed that the net under-recovery be collected from customers

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<sup>3</sup> November 21, 2006 Motion for Leave to File Corrected Evidence and Brief and Motion for Informal Conference ("November 21, 2006 Motion") at 1-3. KU had originally determined that its net under-recovery was \$158,247, See Conroy Direct Testimony at 3, filed June 19, 2006. KU revised this amount to a net under-recovery of \$254,652, See Amended Conroy Direct Testimony at 3, filed June 21, 2006. The revision resulted from the discovery of an error in the calculation of deferred taxes for one of the environmental compliance projects. The final revision to the net under-recovery determination included in the November 21, 2006 motion resulted from an error in how the monthly surcharge true-up adjustment were recognized in the calculation of the net under-recovery. KU discovered the error when it reviewed the methodology for calculating the under-recovery position as part of its on-going process improvement initiative.

over a 4-month period by increasing the total jurisdictional environmental surcharge revenue requirement by \$399,375 per month for the first 3 months and \$399,374 for the fourth month beginning in the first billing month following the Commission's decision in this proceeding.<sup>4</sup> Neither the AG nor KIUC expressed an opinion on the amount of the net under-recovery or KU's proposal on collecting the under-recovery from ratepayers.

The Commission has reviewed and finds reasonable KU's calculation of a net under-recovery of \$1,597,499 for the billing periods covered in this proceeding. The Commission also finds reasonable KU's proposal to increase the total jurisdictional environmental surcharge revenue requirement in each of the first 4 billing months following the date of this Order, with the increase in the first 3 months being \$399,375 and the increase in the fourth month being \$399,374.

During the processing of this review, the Commission has observed that KU has submitted in its monthly surcharge filings several revisions to previous monthly filings which corrected errors or omissions. In addition, KU sought brief delays in responding to the April 25, 2006 initial data request and filed the November 21, 2006 Motion to correct an error in the calculation of the net under-recovery. During this case, KU was asked to describe the processes employed to collect and assemble the information submitted with the monthly surcharge filings and to describe the internal controls employed to ensure the accuracy of that information. KU responded by describing a process it began in late 2004 to document the surcharge process for developing the monthly filings and to identify and resolve internal issues related to the preparation of

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<sup>4</sup> November 21, 2006 Motion, Corrected Conroy Direct Testimony at 5.

the monthly surcharge filings.<sup>5</sup> The Commission believes KU has undertaken constructive action to address this issue and encourages KU to continue its efforts to provide the most accurate and timely information available in the monthly surcharge filings.

### SURCHARGE ROLL-IN

KU proposed that it was appropriate in this case to incorporate surcharge amounts found just and reasonable for the 2-year billing period, as expanded to April 2005, into existing base rates. KU recommended that this “roll-in” be in the amount of \$23,731,313.<sup>6</sup> KU determined the roll-in amount using the base-current methodology. The proposed roll-in will require the recalculation of the Base Environmental Surcharge Factor (“BESF”) component of KU’s surcharge mechanism.<sup>7</sup> Using the base revenues for the 12 months ending February 2006,<sup>8</sup> KU determined a BESF of 3.21 percent. KU noted that in order to be consistent with the Commission’s previous decision in Case

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<sup>5</sup> Response to the Commission Staff’s First Data Request dated April 25, 2006, Item 20. The error identified in the November 21, 2006 Motion was discovered as part of KU’s ongoing process review.

<sup>6</sup> Conroy Direct Testimony at 6 and Response to the Commission Staff’s First Data Request dated April 25, 2006, Item 12.

<sup>7</sup> The surcharge mechanism uses the following formula to calculate the surcharge factor:  $MESF = CESF - BESF$ . MESF is the Monthly Billed Environmental Surcharge Factor. CESF is the Current Period Environmental Surcharge Factor and reflects the environmental costs for the current expense month. The BESF reflects the portion of total eligible environmental surcharge revenue requirement that has been rolled into base rates.

<sup>8</sup> This period corresponds with the last 12 months included in the surcharge review periods.

No. 2003-00068,<sup>9</sup> the BESF to be included in its surcharge mechanism would need to be calculated using base revenues for the 12-month period ending with the month preceding the month in which the Commission approved the roll-in. Neither the AG nor KIUC expressed an opinion on the proposed roll-in amount or how the BESF should be recalculated to reflect the roll-in.

The Commission has reviewed and finds it reasonable that \$23,731,313 from the surcharge should be rolled into existing base rates. The Commission also finds that KU should make a final determination of the BESF in a manner consistent with the Commission's May 4, 2004 Order in Case No. 2003-00068 and submit its calculation of the BESF along with the first monthly surcharge filing submitted after the date of this Order.

#### ALLOCATION OF ROLL-IN

KU proposed two different methodologies for use in allocating the \$23,731,313 roll-in amount to its various customer classes. The first methodology would allocate the roll-in amount to the classes of service on the basis of base-rate revenues. KU contended that this "Revenues Methodology" is the approach that has been followed in previous cases where surcharge amounts have been rolled into existing base rates.<sup>10</sup>

The alternative methodology starts with the roll-in amount allocated to the customer classes under the Revenues Methodology, and then adjusts the amount by

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<sup>9</sup> Case No. 2003-00068, An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Utilities Company for the Six-Month Billing Periods Ending January 31, 2001, July 31, 2001, January 31, 2002, and January 31, 2003 and for the Two-Year Billing Periods Ending July 31, 2000 and July 31, 2002, rehearing Order dated May 4, 2004.

<sup>10</sup> Seelye Direct Testimony at 2.

either credit or charge depending on whether a class rate of return fell outside a range of plus or minus 100 basis points<sup>11</sup> around the overall rates of return for KU determined in KU's last general rate case, Case No. 2003-00434.<sup>12</sup> If this alternative methodology were adopted in this case, KU stated that, consistent with the Commission's decision in Case No. 2003-00068, the allocations would be revised to reflect the base rates for the most recent 12-month period.<sup>13</sup>

KU also proposed a change in how the roll-in amount would be incorporated into the unit charges. In previous cases where there had been a surcharge roll-in, the amounts allocated to each rate class were assigned to all components of base rates<sup>14</sup> on a pro-rata basis. KU recommended that in rate schedules consisting of a customer charge and energy charge, the roll-in amount should be allocated exclusively to the energy charge. In rate schedules consisting of a customer charge, energy charge, and demand charge, KU recommended that the roll-in amount be allocated exclusively to the demand charge. Lighting rates would be handled in the same manner as previous cases, on a charge per fixture basis.<sup>15</sup> KU proposed that this change should be

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<sup>11</sup> Customer class rates of return above the 100 basis point range would be credited while customer class rates of return below the 100 basis point range would be charged. However, no rate class would receive less than 25 percent of the roll-in amount as determined under the Revenues Methodology for that class. See Seelye Direct Testimony at 10-11.

<sup>12</sup> Case No. 2003-00434, An Adjustment of the Electric Rates, Terms, and Conditions of Kentucky Utilities Company, final Order dated June 30, 2004.

<sup>13</sup> Seelye Direct Testimony at 13-14.

<sup>14</sup> As used in this discussion, the components of base rates are the customer charge, the energy charge, and the demand charge, as applicable.

<sup>15</sup> Seelye Direct Testimony at 14.

adopted regardless of whether the Revenue Methodology or the alternative methodology was used to allocate the roll-in amounts to the rate classes.<sup>16</sup>

In support of the alternative methodology, KU noted this approach would allocate the roll-in amount in a way that gave some recognition to the inter-class rate subsidies that currently exist in KU's rates. KU observed that the roll-in proceeding provided the opportunity for the Commission to move rates closer to the cost of providing service, which would be consistent with the principles of gradualism, rate continuity, and cost of service. KU stated that given the various class rates of return established in Case No. 2003-00434, it would be reasonable for the Commission to address the subsidy issue when transferring environmental surcharge revenue requirements into base rates.<sup>17</sup>

KIUC recommended that the alternative methodology be utilized to allocate the roll-in amount to the customer classes and supported KU's proposal for incorporating the applicable roll-in amounts to the components of base rates. KIUC argued that there is more than sufficient, uncontested, cost-of-service study evidence in this proceeding to demonstrate that class subsidies exist in KU's current rates.<sup>18</sup> KIUC contended that when changing base rates, through a roll-in or otherwise, the new rates must be fair, just, and reasonable.<sup>19</sup> Thus, KIUC reasoned that this fact requires the use of the alternative methodology offered by KU. KIUC noted that a comparison of average customer bills under the two methodologies did not produce significantly different

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<sup>16</sup> Joint Brief of KU and LG&E at 14.

<sup>17</sup> Seelye Direct Testimony at 2, 3, and 5.

<sup>18</sup> KIUC Brief at 6-9.

<sup>19</sup> Id. at 14.



results.<sup>20</sup> KIUC stated that the current proceeding was unlike Case No. 2004-00426,<sup>21</sup> where KIUC had recommended multiple different environmental surcharges on different customer classes in order to address the class inequities embedded in the base rates. In this case KIUC argued,

This case is fundamentally different from the prior one. Here we are not attempting to address base rate cost-of-service inequities through the surcharge; we are attempting to address base rate inequities through base rates. There is no legal or policy roadblock to making base rates more reasonable (e.g., bringing them closer to cost-of-service) in a proceeding whose explicit purpose is to change base rates.<sup>22</sup>

KIUC also contended that the class subsidy issue needed to be addressed in this proceeding since KU has shifted a large amount of its cost recovery away from traditional rate cases.<sup>23</sup> On November 13, 2006, KIUC filed a motion to supplement the record to include environmental surcharge rate increase information that had been provided by KU in Case No. 2006-00206.<sup>24</sup>

The AG recommended that the Revenues Methodology be utilized to allocate the roll-in amounts to the customer classes, but expressed no opinion on KU's proposal on

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<sup>20</sup> Id. at 17-18.

<sup>21</sup> Case No. 2004-00426, The Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct Flue Gas Desulfurization Systems and Approval of Its 2004 Compliance Plan for Recovery by Environmental Surcharge.

<sup>22</sup> KIUC Brief at 20.

<sup>23</sup> Id. at 21.

<sup>24</sup> Case No. 2006-00206, The Application of Kentucky Utilities Company for a Certificate of Public Convenience and Necessity to Construct a Selective Catalytic Reduction System and Approval of Its 2006 Compliance Plan for Recovery by Environmental Surcharge.

how to incorporate the roll-in in the base rate components. The AG argued that the alternative methodology must be rejected because KRS 278.183 does not authorize the use of the 2-year roll-in of surcharge amounts into base rates to address rate class subsidies or to create changes in the allocated class contribution to revenue requirements approved in the general rate case. The AG noted that KRS 278.183 is a cost recovery statute designed to allow the utility to recover environmental compliance costs outside of a general rate case. The AG further noted that KRS 278.183 is a statute replete with specifics, but the correction of purported class subsidies in base rates is not established as an issue to be considered by the Commission. The AG advocated that the Commission should continue to use the Revenues Methodology, which is consistent with the Commission's previous decisions involving the roll-in of the surcharge.<sup>25</sup>

As we noted at the beginning of this Order, KRS 278.183(3) provides that every 2 years the Commission shall review and evaluate the operation of the surcharge, shall disallow improper expenses, and to the extent appropriate, incorporate surcharge amounts found just and reasonable into existing base rates. Consequently, the explicit purpose of this proceeding is the review of the operation of KU's environmental surcharge. The potential that a portion of the surcharge may be rolled into existing base rates is a possible outcome of this proceeding, not its focus.

In the June 20, 2005 Order in Case No. 2004-00426, the Commission stated that it was not persuaded that an environmental surcharge proceeding was an appropriate

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<sup>25</sup> Comments and Brief of the AG at 2, 3, and 6.

venue to address discrepancies in the rate design of KU's base rates.<sup>26</sup> The Commission finds nothing in this record to persuade us that an environmental surcharge review constitutes an appropriate venue either. Regardless of how KIUC wishes to characterize this proceeding, it is still attempting to utilize the surcharge as a means to correct perceived rate class inequities in base rates. The appropriate venue to correct such perceived inequities is a general rate case, not an environmental surcharge review.

The contention that KU is shifting more of its cost recovery to the environmental surcharge and away from traditional rate cases is of no relevance. KRS 278.183 is a cost recovery statute that affords qualifying utilities the option of seeking the recovery of certain environmental compliance costs associated with the production of electricity from the burning of coal through a surcharge rather than a general rate case proceeding. With the changes in environmental compliance regulations over the past decade, it is no surprise KU would avail itself of this option.

Therefore, the Commission finds that the roll-in of \$23,731,313 should be allocated to the various rate classes using the Revenues Methodology. This approach is consistent with previous surcharge review cases where there has been a roll-in of the surcharge into existing base rates. The Commission makes no finding on the accuracy or reasonableness of the various cost-of-service analyses submitted in this record, but notes that we are not persuaded that such issues are appropriate in a surcharge review proceeding. Having determined that the Revenues Methodology is the appropriate

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<sup>26</sup> Case No. 2004-00426, June 20, 2005 Order at 30.

approach to be utilized, the Commission finds that KIUC's motion to supplement the record should be denied.

The Commission also finds that KU's proposal concerning the assignment of the roll-in amounts to either the energy charge or demand charge, as previously described, is reasonable and should be approved.

#### RATE OF RETURN

In Case No. 2000-00439,<sup>27</sup> the Commission found that KU's debt portion of its overall rate of return on capital should be reviewed and re-established during each 6-month review case. The rate of return on common equity ("ROE") would remain unchanged unless the ROE reflected in KU's Earnings Sharing Mechanism ("ESM") was changed or discontinued. If either event occurred, the surcharge ROE would be reviewed during the subsequent 2-year surcharge review. KU's ESM was discontinued under the terms of a settlement agreement in Case No. 2003-00434. The current 2-year review is the first since the ESM was discontinued.

KU stated that it believed the 10.50 percent ROE established in Case No. 2004-00426 was the reasonable rate of return for environmental surcharge purposes. KU provided the outstanding balances for its long-term debt, short-term debt, and common equity as of February 28, 2006, the last billing month of the review periods. It also provided the blended interest rates for the long-term debt and short-term debt as of

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<sup>27</sup> Case No. 2000-00439, 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.

February 28, 2006.<sup>28</sup> Using this information, KU calculated an overall rate of return on capital, before income tax gross-up, of 7.84 percent.<sup>29</sup> KU also provided the overall rate of return on capital reflecting the tax gross-up approach approved in Case No. 2004-00426.<sup>30</sup>

The Commission has reviewed KU's determination of the overall rate of return on capital and finds 7.84 percent to be reasonable. The Commission has also reviewed the determination of the tax gross-up factor and finds that it is consistent with the approach approved in Case No. 2004-00426. Therefore, the Commission finds that the weighted average cost of capital of 7.84 percent and the income tax gross-up factor of 61.5558 should be used in all KU monthly environmental surcharge filings subsequent to the date of this Order. In addition, the Commission finds that the ROE used in the determination of the overall rate of return on capital should be examined as part of the 2-year surcharge review proceeding.

IT IS THEREFORE ORDERED that:

1. KU shall include a \$339,375 monthly increase in its jurisdictional environmental revenue requirement determined in the first 3 billing months following the date of this Order and \$399,374 in the fourth month following the date of this Order, as discussed herein.

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<sup>28</sup> Response to the Commission Staff's First Data Request dated April 25, 2006, Item 17.

<sup>29</sup> Id.

<sup>30</sup> Id. and Response to the Commission Staff's Second Data Request dated June 29, 2006, Item 7. In the response, KU determined that the income tax gross-up factor was 61.5558 which would produce a tax grossed-up weighted average cost of capital of 11.52 percent.

2. KU shall roll into its existing base rates \$23,731,313 in environmental surcharge amounts found to be just and reasonable herein. The roll-in shall be allocated to the customer classes using the Revenues Methodology. The assignment of the roll-in amount to base rate components shall be as described herein.

3. KU shall calculate a revised BESF in a manner consistent with the Commission's Order in Case No. 2003-00068. KU shall utilize the revised BESF in its first monthly surcharge filing submitted after the date of this Order and include all supporting calculations and workpapers used to determine the revised BESF.

4. KU shall use an overall rate of return on capital of 7.84 percent and a tax gross-up factor of 61.5558 in all monthly environmental surcharge filings subsequent to the date of this Order.

5. The ROE utilized in the determination of the overall rate of return shall be examined as part of future 2-year surcharge review proceedings.

6. KIUC's November 13, 2006 motion to supplement the record is denied.

Done at Frankfort, Kentucky, this 31<sup>st</sup> day of January, 2007.

By the Commission

ATTEST:



Executive Director