

## **INDIRECT COST ALLOCATION METHODOLOGY AND PROCEDURES**

In May 2002, the PUC issued its Focused Management and Operations Audit Report on PPL Electric and PPL Gas Utilities Corporation's utility subsidiaries. As part of that report, the PUC recommended a change to the 2002 PPL Corporation method of allocating indirect costs from PPL Service Co. (Service Co.) and PPL Corp. (PPL). The allocation method used through December 31, 2002 was a single factor allocation method using Invested Capital to determine the portion of indirect costs to be allocated to subsidiaries of PPL. Additionally, this method also determined if any of the indirect costs should not be allocated to a particular subsidiary or subsidiaries if the subsidiary or subsidiaries did not receive a benefit from the processes incurring those costs. The PUC, however, indicated that a single factor indirect cost allocation method was not appropriate, although the PUC did agree that excluding certain subsidiaries from certain indirect cost allocations was appropriate.

In its audit, the PUC recommended that support costs be allocated using a three-factor methodology. The PUC recommended that the three-factor methodology should contain an employee or payroll factor, an asset or investment factor, and an operation and maintenance expense factor. Effective January 2003, PPL accepted the PUC's recommended three-factor method.

The three-factor allocation methodology results in a reasonable allocation of indirect costs to all subsidiaries of PPL. Because these subsidiaries are involved in several businesses, they may have disproportionate amounts of invested capital, operation and maintenance expenses and employees, when compared to other PPL subsidiaries. Through the three-factor allocation methodology, all subsidiaries that comprise a material proportion of PPL, as measured by either invested capital, operation and maintenance expenses, or employees, will receive an equitable proportion of the indirect cost allocation.

### **CALCULATION OF THE MULTI – FACTOR INDIRECT COST ALLOCATION**

1. The first factor calculates each subsidiary's proportion of invested capital relative to its affiliates. For this calculation, invested capital includes all of the following components of invested capital for subsidiaries (Short Term Debt, Long Term Debt Due in One Year, Long Term Debt, Minority Interest, Company Obligated Preferred Stock, Preferred Stock, and Common Equity) that are added together and allocated by each subsidiary's relative Invested Capital as compared to its affiliates.
2. The second and third factors calculate each subsidiary's proportion of operation and maintenance expenses and number of employees relative to its affiliates. For these factors, the methodology generally is the same as for Invested Capital. Each

subsidiary's data is summed and allocated by each subsidiary's relative operation and maintenance and employee data as compared to its affiliates.

3. PPL determined that each of the three factors was equal in importance and, therefore, the sum of the three was divided by three to obtain the average multi-factor allocation % for each subsidiary. For simplicity, and to reduce immaterial allocations, subsidiaries with a multi-factor average allocation rate of less than 1% are identified and do not receive an allocation. Excess %'s due to not allocating to subsidiaries with an average multi-factor rate of less than 1% will be charged to the unregulated affiliates.

### **EXCLUDING THE ALLOCATION OF CERTAIN INDIRECT COSTS TO AFFILIATES THAT DO NOT BENEFIT FROM THOSE COSTS**

1. Each year, Support Groups analyze their indirect costs to determine what PPL subsidiaries do not receive a significant portion of their services. If these services and related costs are significant, the Support Groups isolate them from other indirect costs to ensure that the PPL subsidiaries that do not receive a benefit from the costs are not allocated costs applicable to those services. Support Groups identify either specific costs to be excluded or an appropriate % of services that should be excluded based on the operation and the expenses incurred.
2. After the Support Groups determine which PPL subsidiaries benefit from their services (or a % of them if applicable), Financial Planning calculates the allocation rate for each Support Group. If all of a particular Support Group's costs benefit the same set of PPL subsidiaries equally, the appropriate allocation method for that Support Group is obtained using the average multi-factor allocation % for each subsidiary as discussed on Page 1 of Attachment II-D-8b. If, however, a portion of the costs only benefit certain subsidiaries, while the balance of the costs benefit another set of subsidiaries, then, for accounting simplicity, a Support Group blended multi-factor allocation factor is calculated for that Support Group and used for allocating all the costs of that Support Group.