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Commonwealth of Kentucky

Court of Appeals

NO. 2007-CA-001635-MR

KENTUCKY PUBLIC SERVICE COMMISSION AND
DUKE ENERGY KENTUCKY, INC., F/K/A THE
UNION LIGHT, HEAT AND POWER COMPANY APPELLANTS

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE PHILLIP J. SHEPHERD, JUDGE
ACTION NOS. 02-CI-00499, 02-CI-01628, 03-CI-01189,
04-CI-01308, AND 06-CI-00269

COMMONWEALTH OF KENTUCKY, EX REL.,
GREG STUMBO APPELLEE

OPINION
AFFIRMING IN PART
AND REVERSING IN PART

** ** ** ** **

BEFORE: NICKELL AND THOMPSON, JUDGES, ROSENBLUM,[1] SPECIAL JUDGE.

THOMPSON, JUDGE: This case involves five consolidated appeals by the Attorney General from the Public Service Commission's (PSC) orders over a five-

[1] Retired Judge Paul W. Rosenblum sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution.

year period approving and implementing a portion of Duke Energy Kentucky, Inc.'s, (f/k/a the Union Light, Heat, and Power Company (Duke)) rate schedule known as the Accelerated Main Replacement Program (AMRP) Rider. The AMRP Rider permits Duke to recover costs associated with the acceleration of the replacement of aging cast iron and bare steel mains. The issues presented are: (1) whether the PSC had authority to approve the AMRP Rider pursuant to its plenary rate-making powers and Kentucky Revised Statutes (KRS) 278.509, and (2) whether KRS 278.509 violates Kentucky Constitution Section 51. We agree with the circuit court that prior to the enactment of KRS 278.509 in 2005, the PSC lacked authority to approve the AMRP Rider. However, we disagree with the trial court's conclusion that KRS 278.509 does not confer such authority and that it is unconstitutional.

FACTS

In 2001, Duke developed a program to improve its gas distribution mains. The company owned approximately 1000 miles of mains, including over 150 miles of cast iron and bare steel mains dating back to 1887 and 1907. Because cast iron and bare steel mains leak more frequently than those constructed from coated steel or polyethylene, Duke at first intended to replace the aging mains over a fifty-year period. However, because of the age of the mains to be replaced, Duke implemented the AMRP to replace all mains within ten years.

In May 2001, confronted with increases in its capital expenditures, Duke filed an application with the Commission pursuant to KRS 278.180 for an

adjustment of its general rates and, in the same filing, sought approval to employ the AMRP Rider to streamline recovery of the costs associated with the main replacement program. The Attorney General intervened in the 2001 rate case and opposed the AMRP Rider contending that the PSC had no authority to permit a surcharge to recover costs incurred after a general rate case without conducting a new general rate case. It asserted that single-issue rate-making is not permitted under the statutory scheme unless the General Assembly specifically permits the procedure.

The PSC concluded that its authority was derived from its general powers conferred by KRS 278.030 and 278.040 to establish "fair, just and reasonable" rates and KRS 278.290, to revaluate new construction, extensions, and additions to utility property. On January 31, 2002, the PSC authorized Duke to implement the AMRP Rider for a three-year period subject to annual review of new AMRP costs during that period. Under the surcharge formula, Duke was permitted to automatically recover its return on investment of the preceding year's increase in plant investment incurred under the replacement program for three years following the completion of the 2001 general rate case. After the expiration of three years, if Duke intended to continue the program, it was required to file a new general rate application. The Attorney General appealed.

In the years that followed, the PSC approved each of Duke's annual applications for adjustments to the AMRP Rider and the Attorney General appealed each ruling to the Franklin Circuit Court. The final PSC order appealed

was entered on December 22, 2005. As directed by the PSC's 2001 order, on February 25, 2005, Duke filed its next general rate case and sought approval of the continuation of the AMRP Rider. Again, the Attorney General intervened.

While the Attorney General's appeals from the prior orders and Duke's 2005 rate case were pending, the Kentucky General Assembly passed KRS 278.509. As it did before, the PSC relied on its plenary rate-making powers but also relied on what it perceived as its specific authority conferred by the newly enacted KRS 278.509 and approved the rider. The Attorney General appealed.

The Franklin Circuit Court consolidated the Attorney General's appeals and, after the parties filed cross-motions for summary judgment, vacated and remanded the orders of the PSC pertaining to the AMRP Rider. It held that KRS 278.509 was unconstitutional in violation of the title and single-subject provisions of Section 51 of the Kentucky Constitution, and that the PSC's authority under KRS 278.030 and 278.040 did not permit the PSC to perform an interim review on a single cost absent specific statutory authority. The court concluded that the PSC's authority to consider any expense was limited to a general rate filing. Duke appealed.

While this appeal was pending, the PSC requested that the Attorney General express an opinion as to the authority of the PSC to approve fuel adjustment clause surcharges. The Attorney General responded that because there was no explicit, direct or statutory power to authorize such clauses, the PSC had no authority to approve the surcharge. Numerous utilities expressed concern that

without fuel adjustment clauses, they would default on credit agreements and that its low-income assistance programs would suffer. To avoid disruption, Duke and the PSC moved this Court for a stay of any effect the circuit court's order may have on surcharge proceedings, other than the AMRP Rider, pending the outcome of this appeal. By an order entered on September 14, 2007, this Court granted the requested intermediate relief.

As a consequence of the Attorney General's interpretation of the Franklin Circuit Court's order that its prohibition against single-rate adjustments includes those related to rate increases for fuel adjustment, water adjustment and gas adjustment clauses, a collection of public utilities filed a single *amici curiae* brief in this appeal.

STANDARD OF REVIEW

The PSC is granted exclusive jurisdiction that extends to all regulation of rates and services of utilities. KRS 278.040(2). Our scope of review of its administrative action is limited and dictated by KRS 278.430:

> In all trials, actions or proceedings arising under the preceding provisions of this chapter or growing out of the commission's exercise of the authority or powers granted to it, the party seeking to set aside any determination, requirement, direction or order of the commission shall have the burden of proof to show by clear and satisfactory evidence that the determination, requirement, direction or order is unreasonable or unlawful.

Although the PSC is granted broad authority to regulate public utilities, it remains a creature of statute and "has only such powers as granted by the General Assembly." *PSC v. Jackson County Rural Elec. Co-op, Inc*., 50 S.W.3d 764, 767 (Ky.App. 2000).

The Commission's powers are purely statutory; therefore, when a statute prescribes a precise procedure, an administrative agency may not add to such provision. *South Central Bell Telephone Co. v. Utility Regulatory Com'n*, 637 S.W.2d 649, 653 (Ky. 1982). In the context of the grant of power to the PSC, the authority granted is limited by the enabling statute:

> [T]he legislative grant of power to regulate rates will be strictly construed and will neither be interpreted by implication nor inference. It will be strictly construed. 73 C.J.S., Public Utilities, § 41, p. 1080. In fixing rates, the Commission *must* give effect to all factors which are prescribed by the legislative body, but may not act on a matter which the legislature has not established, *id.*, Sec. 41, (c)(aa) p. 1093. We have held that the Commission's powers are purely statutory.

Id. at 653 (Ky. 1982) (emphasis original). Thus, an order will be deemed unlawful if it violates a state or federal statute or a constitutional provision. The question of whether the PSC exceeded its statutory authority is a question of law that we review *de novo*. *Cincinnati Bell Telephone Co. v. Kentucky Public Service Com'n*, 223 S.W.3d 829, 836 (Ky.App. 2007).

The issues presented by this appeal involve statutory interpretation; thus, they are purely questions of law subject to *de novo* review.

THE APPLICATION OF KRS 278.290

Duke complains that the circuit court did not consider KRS 278.290(1). That statute provides:

> [T]he commission may ascertain and fix the value of the whole or any part of the property of any utility in so far as the value is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time and ascertain the value of all new construction, extensions and additions to the property of the utility. In fixing the value of any property under this subsection, the commission shall give due consideration to the history and development of the utility and its property, original cost, cost of reproduction as a going concern, capital structure, and other elements of value recognized by the law of the land for rate-making purposes.

The statute delineates the factors to be considered when fixing utility rates and has been interpreted to afford the PSC broad discretion. *National-Southwire Aluminum Co. v. Big Rivers Elec. Corp.* 785 S.W.2d 503 (Ky.App. 1990). However, the discretion given the PSC to consider a broad range of factors when rate-making does not resolve whether the PSC had authority to approve the AMRP Rider. The answer to that question is found in an analysis of KRS 278.030 and KRS 278.040.

WHETHER KRS 278.030 AND KRS 278.040 CONFERRED AUTHORITY UPON THE PSC TO APPROVE THE AMRP RIDER

KRS 278.030 and KRS 278.040 expressly grant the PSC plenary rate-making authority. KRS 278.030 provides that "[e]very utility may demand, collect and receive fair, just and reasonable rates for the services rendered or to be

rendered by it to any person." KRS 278.040 confers general authority upon the PSC to regulate utilities.

KRS 278.190 establishes the procedure to be followed when a rate change is sought, referred to as a general rate case. It is a complex and lengthy procedure in which the PSC is required to examine the utility's operations and costs. *National-Southwire Aluminum Co.*, 785 S.W.2d 503. Included in the factors to be considered are replacement cost, debt retirement, operating cost, capital structure and "other elements of value." KRS 278.290(1).

KRS 278.192 provides that to justify the reasonableness of a general rate increase, the utility may use either a historical test period of twelve months or a forward-looking test period corresponding to the first twelve consecutive calendar months the proposed increase would be in effect. Despite its complexity, the goal of the rate-making procedure is simplistic: the establishment of "fair, just, and reasonable rates." *National-Southwire Aluminum Co.*, 785 S.W.2d at 510.

The AMRP Rider at issue negated the lengthy procedure of obtaining a general rate increase, eliminating both the time and associated costs. Duke points out that expedited proceedings are not novel in the context of the operation of a

utility, a contention validated by even a cursory review of KRS Chapter 278.[2] Specifically, it relies on the historical approval of fuel adjustment clauses.

A fuel adjustment clause is an accepted method of recovering increased fuel costs and justified by the Commission's obligation to set "fair, just and reasonable" rates. In those jurisdictions accepting fuel adjustment clauses, the reason most often cited is a practical one and was explained in *People's Counsel of D.C. v. Public Service Commission*, 472 A.2d. 860, 863 (D.C. 1984):

> Few types of legal proceedings are more complex, intricate and expensive than the full-blown utility rate case, with its myriad problems in valuation, economics, accounting, law and engineering. A utility's fair rate of return for its services is determined on the basis of evidence presented during a public hearing, and changes in the rate schedule ordinarily cannot be made in the absence of such a hearing. Accordingly, the operating costs incurred by the public utility will be passed on to the consumer after a general rate hearing before a public service commission which establishes rates based on costs of production and return on investment. When inflation and cost fluctuations enter the economic picture, however, such formal rate hearings become inadequate as a means of ensuring a fair rate of return because of the delay inherent in them.

[2] *See* KRS 278.183 (authorizing recovery of environmental compliance costs through a surcharge); KRS 278.012, 278.015 and 278.023 (authorizing rate increases for water and sewer districts without prior PSC action under certain circumstances; KRS 278.130 (requiring approval with a limited hearing for the annual PSC assessment); KRS 278.285 (authorizing recovery for demand-side management and home energy hearing assistance programs through a general rate increase or separate proceeding); KRS 278.455 (authorizing a reduction in a G & T or a distribution cooperative's rates under certain conditions); and KRS 278.516 (permitting alterative rate recovery for telecommunications providers).

Id. at 863-864 (internal quotations and citations omitted). The position taken by the court is consistent with that taken by a majority of jurisdictions which have approved adjustment clauses for the cost of fuel and purchased power.[3]

In this Commonwealth, 807 KAR 5:056, promulgated in 1983, governs fuel adjustment clauses. Our highest Court has specifically recognized with approval the prevailing view that separate rate proceedings for fuel adjustment expenses are valid. *Kentucky Industrial Utility Customers, Inc. v. Kentucky Utilities Company*, 983 S.W.2d 493 (Ky. 1998).

Although not involving a fuel adjustment clause, similar reasoning was applied in *National-Southwire Aluminum Co*., 785 S.W.2d 503. The Court approved a PSC order authorizing a variable electric rate for electricity sold to smelters based on fluctuating aluminum prices.

Although the Court in *National-Southwire* used very broad language, it did so in the context of a unique situation. Big Rivers Electric Corporation served approximately 75,000 customers in Western Kentucky. Because of its debt, it faced insolvency and its future solvency was linked to the financial condition of two aluminum smelters that purchased 70 percent of Big River's electric output. At issue was a variable rate increase for the highly cyclical aluminum industry necessary to protect the financial health of a major electric supplier.

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[3] *See e.g., CenterPoint Energy Entex v. Railroad. Com'n of Texas*, 208 S.W.3d 608, 618 (Tex. App.-Austin, 2006); *Daily Advertiser v. Trans-La*, 612 So.2d 7, 23 (La. 1993); *Attorney General v. Michigan Pub. Serv. Comm'n,* 333 N.W.2d 131, 136 (Mich.App. 1983); *Alabama Metallurgical Corp. v. Alabama Pub. Serv. Com'n*, 441 So. 2d 565 (Ala. 1983).

Agreeing that the PSC reached a solution within its implied statutory powers, the Court rejected a rigid "used and useful" standard for a rate determination. Instead, it emphasized that the ultimate determination must be based on a "fair, just and reasonable" standard. *Id*. at 511. Permitting the rate charged the smelters to vary, depending on the price of aluminum, protected the solvency of the smelters which, in turn, protected that of Big Rivers. Pivotal to the court's reasoning was that the highly volatile aluminum market was beyond the control of Big Rivers. *Id.* at 508. Moreover, under the desperate situation presented and the "monstrous" consequences for Big Rivers' customers should it become insolvent, the court concluded that the PSC had implied authority to approve the proposed variable rate. *Id*. at 515. A contrary conclusion would have resulted in the inability of the PSC to ensure the continuation of electrical service.

What can be gleaned from those cases approving fuel adjustment clauses and *National-Southwire* is that each court's approval was based on the unique facts of the case. The subject of the rate increase was not amenable to review *via* a general rate increase; thus, to set a "fair, just, and reasonable" rate required by statute, the courts have held the authority to approve such rates outside the general rate procedure to be within the regulatory commission's implied authority.

The present controversy does not involve capital expenditures that are unanticipated, fluctuating, or beyond Duke's control, or threaten its solvency. To the contrary, aging mains are ordinary and within the realm of anticipated

expenditures. Additionally, unlike a fuel adjustment clause that permits the utility to pass the fluctuating fuel prices to its customers but from which it makes no additional profit, the replacement of the deteriorating mains is a pending long-term capital improvement that will increase the efficiency and value of Duke's assets. Duke was prepared to implement the program over a fifty-year period to be financed through general rate increases: The need for the AMRP Rider arose only after Duke, on its own initiative, decided to accelerate the program.

The proposed capital expenditure is amenable to the test-year review concept to be followed in a general rate case, and is a replacement cost to be considered in a general rate increase case. *Id*. at 512. We conclude that the PSC cannot authorize the imposition of a surcharge for the main replacement program proposed by Duke without specific statutory authorization.

Before examining the impact of KRS 278.509 on the recovery of costs associated with the AMRP, we must comment on the application of *Commonwealth ex. rel. Stumbo v. Kentucky Public Service Commission,* 243 S.W.3d 374 (Ky.App. 2007). In that case, the court held the PSC's interpretation of KRS 278.183 was entitled to deference under the principles set forth in *Chevron U.S.A., Inc v. Natural Resource Defense Council, Inc.,* 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). *Chevron* deference given to an administrative agency's interpretations of its governing statutes is not applicable where, as here, the statutes are clear and unambiguous. The statutes do not confer authority upon the PSC to approve the AMRP Rider.

THE ENACTMENT OF KRS 278.509

Duke contends that the General Assembly recognized the plight of it and other utilities facing infrastructure deterioration of their facilities and enacted KRS 278.509. It argues that the statute is a confirmation of the PSC's authority to approve the AMRP Rider. Because we reject Duke's contention that such authority existed prior to the enactment of KRS 278.509, logic dictates that the General Assembly did not validate a nonexistent right or power. Thus, we address whether the statute confers a new right on the utility to seek a surcharge to recover the costs of main replacements or if the statute merely confirms its right to seek a general rate increase to recover such expenditures.

Enacted while the present controversy was pending before the PSC and this Court, KRS 278.509 provides:

> Notwithstanding any other provision of law to the contrary, upon application by a regulated utility, the commission may allow recovery of costs for investment in natural gas pipeline replacement programs which are not recovered in the existing rates of a regulated utility. No recovery shall be allowed unless the costs shall have been deemed by the commission to be fair, just, and reasonable.

KRS 278.509, by its terms, permits "the recovery of costs for investment in natural gas pipeline replacement programs." As a precursor to a discussion of whether the statute permits recovery of cost through a surcharge such as the AMPR Rider, we state our agreement with Duke that "costs" as used in the statute includes the recovery of its return on investment. A return on investment is

a "cost" recognized in the common usage of the term and in the statutory scheme applicable to the regulation of public utilities. *See* KRS 278.183. We now turn to the question of the General Assembly's intent when it amended the statute.

The discernment of the General Assembly's intent is the goal of the courts when interpreting a statute:

> The essence of statutory construction is to ascertain and give effect to the intent of the legislature. To ascertain the intent of the legislature, courts should view the statute as a whole, considering not only its language but also its spirit. However, the language in the statute bears the greatest importance, and a statute may not be interpreted in a manner that conflicts with the stated language. Accordingly, a court may not insert language to arrive at a meaning different from that created by the stated language in a statute. Moreover, Kentucky statutes must be given a liberal construction, and the language used must be given its ordinary meaning except when the language used has a special meaning in the law; in such a case, the technical meaning is appropriate.

Peter Garrett Gunsmith, Inc. v. City of Dayton, 98 S.W.3d 517, 520 (Ky.App. 2002) (internal quotations and citations omitted).

Unlike KRS 278.183, which explicitly permits utilities to recover the costs of environmental compliance through a surcharge to existing rates, the term "surcharge" is not used in KRS 278.509. However, it states that the recovery is for costs "not recovered in the existing rates" which indicates that the General Assembly intended that the utility recover its costs by means other than a general rate increase. Although admittedly the statute could have included language similar to KRS 278.183 and left no doubt as to the appropriateness of a surcharge

to recover the replacement costs, the omission creates only an ambiguity in the General Assembly's intent, not absolute preclusion of such an intent. Where there is an ambiguity created by the statutory language used, the court may consider the available legislative history to determine its meaning. *Dalton v. Fortner*, 125 S.W.3d 316 (Ky.App. 2003).

Because of the pending judicial challenges to the AMRP Rider approved by the PSC, the General Assembly was aware of the financial barriers faced by utilities to finance the replacement of deteriorating infrastructures and the delay inherent in general rate cases. In response, Senator Ernie Harris proposed that KRS 278.509 be amended to include its current language, and when explaining its purpose stated:

> [F]loor amendment 1 is a simple but important clarification of the existing statute. The utilities in the Commonwealth who maintain and operate natural gas distribution systems all face the need to make significant long-term investments to provide for the continued integrity and safety of those systems. The Public Service Commission has reviewed these expenditures in a very deliberate manner, taking care to ensure that the investments are always fair, just and reasonable. And this language basically codifies the existing Public Service Commission policies and procedures . . . .

Based on the legislative history, the General Assembly's intent was to conform the statute to the most recent practice followed by the PSC in the Duke cases and its approval of the AMRP Rider. Otherwise the amendment would be a nullity and not rectify the inherent deficiencies in a general rate case to address the recognized significant costs and time associated with gas main replacements.

WHETHER KRS 278.509 IS CONSTITUTIONAL

The Kentucky Constitution Section 51 provides:

> No law enacted by the General Assembly shall relate to more than one subject, and that shall be expressed in the title, and no law shall be revised, amended, or the provisions thereof extended or conferred by reference to its title only, but so much thereof as is revised, amended, extended or conferred, shall be reenacted and published at length.

Although the risks of deceit and fraud by "hiding" legislation within an unrelated bill have been diminished by technology such as the internet, legislation remains subject to constitutional scrutiny under Section 51. *See McGuffey v. Hall*, 557 S.W.2d 401 (Ky. 1977). However, the act will he held constitutional unless it is "wholly inaccurate so as to actually deceive . . . ." The legislation must be titled so that it merely furnishes a "clue" as to the act's contents. *Yeoman v. Com., Health Policy Board*, 983 S.W.2d 459, 476 (Ky. 1998). If the title expresses a general subject, any provision in the Act that is germane or reasonably embraced within that subject is within the scope. *Bd. of Trustees v. City of Paducah*, 333 S.W.2d 515, 520 (Ky. 1960).

The bill containing the present version of KRS 278.509, HB 440, was entitled "An Act relating to gas delivery systems and appliances." We believe that KRS 278.509 relating to gas pipelines is sufficiently embraced within the term "gas delivery systems" to comply with Section 51. Although admittedly no other provision in the bill related to utility rates, we cannot conclude that a fraud was

committed or that the General Assembly titled the Act to deceive the public. *Yeoman*, 983 S.W.2d at 476.

The Franklin Circuit Court also invalidated the statute on the basis that HB 440 encompassed two vastly different subjects that are codified in unrelated statutes, KRS 278.509 and KRS 234.175, which pertain to "Liquefied Petroleum Gas and other Flammable Liquids." Although the statutes are unrelated, it remains that both relate to one general subject, "gas delivery systems and appliances." Accordingly, the portion of the Franklin Circuit's opinion and order holding KRS 278.509 unconstitutional is reversed.

RETROACTIVTY OF KRS 278.509

KRS 446.080(3) states "[n]o statute shall be construed to be retroactive, unless expressly so declared." Having concluded that the 2005 amendment to KRS.278.509 permits the approval of the AMRP Rider and is constitutional, we now address whether the statute can be applied retroactively.

The question is easily resolved by the Supreme Court's decision in *Kentucky Industrial Utility Customers, Inc*., 983 S.W.2d 493, where the Court declined to apply the surcharge provision of KRS 278.183 retroactively. In doing so, it held that the surcharge creates a new right for all electric utilities and is a substantive change to the Public Utility Code. *Id*. at 500. In its analysis, the Court recited a fundamental principle of statutory construction:

> [T]here is a strong presumption that statutes operate prospectively and that retroactive application of statutes will be approved only if it is absolutely certain the

> legislature intended such a result. This is particularly true when the legislation is substantive and not remedial, and new rights and new duties are created.

Id. at 500. Ultimately, the Court concluded that the utility could not utilize the specialized surcharge procedure to recover costs for environmental projects completed before the effective date of KRS 278.183.

We likewise conclude that the amendment to KRS 278.509 does not apply to AMRP Riders approved prior to its effective date. However, that does not preclude the recovery of those same costs through a general rate increase.

CONCLUSION

Utilities in this Commonwealth are facing infrastructure deterioration. Prior to 2005, the only procedure available to recover the costs of gas main replacement projects was a general rate increase. However, believing that the enormity of the projects and the associated costs rendered the traditional general rate adjustment procedure impractical, the General Assembly enacted KRS 278.509 to provide for a time- and cost-efficient procedure to recover the costs. It is our conclusion that prior to the enactment of KRS 278.509, the PSC had no authority to approve the AMRP Riders and, therefore, to that extent, we affirm the circuit court. However, the orders of the PSC approving the AMRP Riders after the statute's enactment are valid. To the extent that the circuit court held that the PSC had no authority to approve the AMRP Riders after the enactment of the statute, and that KRS 278.509 is unconstitutional, it is reversed.

` So that our opinion is not misunderstood and to address the issues raised in the *amici curiae* brief, we reiterate that our decision is premised on the nature of the long-term capital improvements proposed by Duke as distinguished from fuel increases that are fluctuating and unanticipated. The latter have been approved by our Supreme Court and remain the law.

Based on the foregoing, the judgment of the Franklin Circuit Court is affirmed in part and reversed in part.

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