COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY TO ADJUST ELECTRIC RATES) CASE NO. 91-370

O R D E R

On May 8, 1992, the Attorney General's office, by and through his Utility and Rate Intervention Division ("AG"), filed a Petition for Rehearing of the Commission's May 5, 1992 Order granting The Union Light, Heat and Power Company ("ULH&P") an increase in electric revenues of $22.3 million annually. The AG raised four issues on rehearing: 1) purchased power expense; 2) Deferred taxes; 3) Interruptible Credit - Newport Steel; and 4) Residential Rate Design. On May 19, 1992, ULH&P filed a response in opposition to the AG's request for rehearing. Each of the issues raised by the AG will be discussed in detail.

PURCHASED POWER EXPENSE

The crux of the AG's argument is that since the Commission has found that Cincinnati Gas and Electric Company's ("CG&E") wholesale rate increase was filed solely to recover increased generating costs attributable to Zimmer, and since the Commission stated that the cost of Zimmer is excessive by at least 50 percent, the Commission should have disallowed the purchased power expense as being excessive. The AG also argues that the increase in purchased power expense should have been excluded due to

ULH&P's failure to meet its burden of proof under KRS 278.190(3) to show that the expense was reasonable. The AG further argues that he introduced evidence as to the existence of lower cost power supplies, there is insufficient record evidence to disprove the existence of lower cost supplies, and the Commission improperly shifted the burden of proof on this issue to the AG.

The AG has seriously misconstrued both the Commission's May 5, 1992 Order as well as ULH&P's rate application in this case. Merely because the Commission expressed the opinion that the power cost from Zimmer was excessive, this does not mean that ULH&P's purchased power rate is excessive. ULH&P's application requests authority to recover an increase in its wholesale power rate which has been accepted by the FERC. Although the wholesale power increase was triggered by the commercialization of Zimmer, the issue before this Commission is not the reasonableness of the cost of Zimmer but the reasonableness of the cost of purchased power. As we stated in our May 5, 1992 Order, "Even though we believe the cost of Zimmer to be excessive, the FERC filed rate is a composite rate which reflects the cost of all of CG&E's generating units, not just Zimmer." That Order also stated that we have no jurisdiction over either CG&E's cost of Zimmer or the determination of a reasonable rate to be charged by CG&E to ULH&P.

The Commission's statement in the May 5, 1992 Order that the cost of Zimmer is excessive by at least 50 percent is preceded by the phrase, "Based upon our knowledge. . . ." This knowledge was gained from information we have obtained as an intervenor at the FERC in the pending CG&E rate case. On reflection this

"collateral dictum" perhaps would have been better stated by saying "Based upon our knowledge of the cost of Zimmer and the costs of comparable coal-powered generating plants, it may well be that the cost of Zimmer is excessive by at least 50 percent." However, due to our lack of jurisdiction over either CG&E or Zimmer, the cost of Zimmer is irrelevant to ULH&P's rate application and played no part in our decision. What is relevant is ULH&P's cost of purchased power which, in this case, was proposed to increase from $8.195 to $10.02. The increase to $10.02 was accepted by the FERC and allowed to go into effect subject to refund on February 13, 1992.

In Nantahala Power and Light v. Thornburg, 476 U.S. 953 (1986), the U.S. Supreme Court declared that,

> FERC clearly has exclusive jurisdiction over the rates to be charged. . . interstate wholesale customers. Once FERC set such a rate, a State may not conclude in setting retail rates that the FERC-approved wholesale rates are unreasonable. A State must rather give effect to Congress' desire to give FERC plenary authority over interstate wholesale rates, and to ensure that the States do not interfere with this authority.

Nantahala at 966. The Court continued by stating that, "[S]tate courts which have considered the question have uniformly agreed that a utility's cost based upon a FERC-filed rate must be treated as a reasonably incurred operating expense for the purposes of setting an appropriate retail rate." Nantahala at 967.

Just two years later, the U.S. Supreme Court revisited these issues in Mississippi Power and Light Company v. Mississippi, ex rel. Moore, 487 U.S. 354 (1988). In that case the Court stated,

> Our decision in Nantahala relied on fundamental principles concerning the pre-emptive impact of federal jurisdiction over wholesale rates on state regulation.

> First, FERC has exclusive authority to determine the reasonableness of wholesale rates. It is now settled that "the right to a reasonable rate is the right to the rate which the Commission files or fixes, and, . . . except for review of the Commission's orders, [a] court can assume no right to a different one on the ground that, in its opinion, it is the only or the more reasonable one." Nantahala, 476 U.S., at 963-964. This principle binds both state and federal courts and is in the former respect mandated by the supremacy clause. (Emphasis added.)

Mississippi Power at 371.

Contrary to the AG's argument, there has been no shift in the burden of proof. That burden has at all times rested with ULH&P as mandated by KRS 278.190(3). However, since ULH&P purchases its power pursuant to an agreement and rate on file with the FERC, the FERC-filed rate must be accepted by a state commission as reasonable. This identical issue was decided in Narragansett Electric Company v. Burke, 119 R.I. 559, 381 A.2d 1358 (1977) cert denied, 435 U.S. 972 (1978). In that case, the retail electric supplier, Narragansett, purchased all its power from an affiliate, NEPCO. The Rhode Island PUC, like the Kentucky PSC, operates under a statute that requires a utility to bear the burden of proof to establish the reasonableness of an expense. Although the Rhode Island PUC determined that Narragansett had failed to meet this burden, the Rhode Island Supreme Court reversed, holding that,

> [F]or the purpose of fixing intrastate rates, the PUC must treat NEPCO's R-10 interstate rate filed with the FPC [predecessor of FERC] as a reasonable operating expense. Narragansett has met the burden of proof prescribed by §39-3-30 by establishing that the price of the contract with its affiliate is the FPC filed and effective rate.

Narragansett at 1363. The decision in Narragansett was cited with approval by the U.S. Supreme Court in its 1986 decision in Nantahala. Quoting from Narragansett, the Supreme Court stated,

> Thus the rate increase in the cost of electricity to Narragansett, filed and bonded by [the supplier] constitutes an actual operating expense and must be so viewed by the [state utility commission].

Nantahala 965.

The Commission is acutely aware that this issue of federal versus state rate-making jurisdiction is not one of first impression in Kentucky. To the contrary, the AG, along with the Commission, vigorously fought but ultimately lost this issue in Kentucky Power Company v. Kentucky Public Service Commission, et al., Ky.App., No. 86-CA-1031-MR (June 3, 1988). The Kentucky Court of Appeals has mandated that the Commission apply and follow the principles enunciated in both Nantahala and Narragansett. The Commission has no authority to do otherwise.

As stated in our May 5, 1992 Order, at page 23, the limited exception to a state commission's recognition of the reasonableness of a wholesale power rate arises when there is evidence to support a decision that a lower cost alternative supply of power is available elsewhere. This is commonly referred to as the "Pike County exception," based on the decision in Pike County Light and Power Company v. Pennsylvania Public Utility Commission, 465 A.2d 735 (Pa. Cmwlth. 1983).

In the Pike County case, the Court upheld the PUC's decision to disallow a portion of power purchased by Pike County from its parent, Orange and Rockland Utilities, Inc., even though the

purchase was pursuant to a FERC-filed rate. The disallowance was based on a finding that a lower cost alternative power supplier did exist. In affirming the partial cost disallowance, the Court emphasized that,

> The record contains testimony from expert witnesses regarding the viability of power purchases from Pennsylvania Power & Light Company (PP&L) on the basis of existing PP&L rates approved by the FERC. The record contains expert testimony that a purchase from PP&L was feasible technically, that economic advantages would accrue to Pike by transmission of power from PP&L over Orange and Rockland transmission lines, and that because PP&L's generation mix was predominately coal, its production costs were less than the predominately oil and natural gas fire generation of Orange and Rockland. Also admitted into the record was a letter from PP&L indicating the Company's willingness to discuss power sales to Pike on the basis of contemporary FERC rate schedules.

Pike County at 738. In stark contrast to the evidence in the Pike County case, the evidence before us consists of power from CG&E at $10.02 per KW per month on a firm basis, which has the highest degree of reliability, versus alternative power supplies at similar or greater prices on a non-firm basis. These alternative supplies are not viable for ULH&P when viewed in terms of quality or economics. While the AG's petition for rehearing references our prior finding that the Louisville Gas and Electric Company ("LG&E") had substantial excess capacity from its Trimble County Plant ("Trimble"), the record shows that LG&E has already sold the 25 percent of Trimble that we deemed to be excess.

In summary, the AG is simply wrong when he argues in his petition for rehearing, at page 3, that the Commission "can refuse to allow an excessive level of purchased power expense." We are bound to accept as reasonable the FERC-filed rate for power

purchased by ULH&P from CG&E. Despite our observation that the cost of Zimmer is excessive, that cost is but one component of CG&E's FERC-filed rate. Due to our lack of jurisdiction to review the reasonableness of either the Zimmer component or the composite FERC-filed power rate, the Commission has intervened at the FERC to protect the interests of Kentucky ratepayers. Accepting as we must FERC's judgment on CG&E's wholesale filed rate, there is no credible evidence to persuade us that there is a lower cost alternative power supply available to ULH&P.

DEFERRED TAXES

The AG claims that the Commission's decision on Deferred Taxes is in error and based on an inaccurate finding from ULH&P's last rate case, Case No. 90-041.[1] In Case No. 90-041 the Commission found that ratepayers benefitted from deferred income tax debits since at the time the debits were recorded, book income tax expense was lower than the actual income tax liability. The AG states that book income tax expense is not reduced as a result of recording deferred income tax debits and that ratepayers have not benefitted because tax expense was not reduced, only shifted.

Because of the existence of both temporary and permanent tax timing differences in the recognition of expenses for book and tax purposes, income tax expense for book and tax purposes will be different at any point in time such as a test year end. If book

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1 Case No. 90-041, An Adjustment of Gas and Electric Rates of The Union Light, Heat and Power Company.

income tax expense exceeds the actual tax liability, a deferred income tax credit is created. Since ratepayers are required to pay the book tax expense, in this situation the ratepayers have overpaid the expense, creating a deferred tax credit. This credit is then, over time, flowed through to reduce book tax expense, thus returning to the ratepayer the amounts that were paid in advance of the actual income tax liability for tax purposes. Since such income tax credits represent an advance from the ratepayer to the utility, such credits are appropriately deducted from rate base.

Deferred income tax debits are just the opposite. The debits are created when book income tax expense is less than the actual tax liability. Ratepayers have thus underpaid the expense, creating an immediate benefit which will reverse over time as the tax debits are flowed through to increase book tax expense. Since these tax debits represent a delay in payment by the ratepayer to the utility, it is appropriate for the utility to include in rate base the underpayments.

In the AG's original testimony he had argued that rate base needed to be adjusted for an amount the AG calculated as representing the "unfunded, accrued liabilities" for uncollectible accounts, post-retirement benefits, and vacation pay. The deferred tax balances were used to impute the amount of unfunded, accrued liabilities in the amount of $2.5 million, which the AG proposed to deduct from rate base. The AG argued that these liabilities represent amounts paid by ratepayers and not included as expensed for income tax purposes. The AG's petition for

rehearing does not address the merits of his original position. The AG has not proposed the determination of rate base using a balance sheet approach to determine total working capital. The Commission has ruled in previous cases that without a determination of total working capital using the balance sheet approach, it would not allow selective adjustment of the rate base, as has been proposed by the AG in this case.

INTERRUPTIBLE CREDIT-NEWPORT STEEL

The AG argues that the Commission has identified two concerns with ULH&P's interruptible service contract with Newport Steel, but has failed to establish a remedy for the concern that CG&E's wholesale power contract with ULH&P fails to accurately reflect the interruptible nature of ULH&P's retail customer, Newport Steel Corporation ("Newport Steel"). As stated in our May 5, 1992 Order, this concern involves an issue that is subject to the exclusive jurisdiction of the FERC. As an intervenor at the FERC, the Commission has raised this issue and will continue to pursue an appropriate remedy in that forum.

Furthermore, the premise of the AG's argument is erroneous. The Commission did not fashion a remedy for only one of its expressed concerns. The remedy adopted was in response to both of the concerns. After discussing both concerns, the adoption of a remedy was preceded by the phrase, "For these reasons. . . ."

RESIDENTIAL RATE DESIGN

The Commission adopted the AG's proposal to modify ULH&P's residential rate design by adopting an inverted block summer rate. However, the Commission rejected such a rate design for winter

rates, finding that "increased off-peak demands can produce many of the same benefits as reduced on-peak demands." The AG seeks rehearing on this issue, arguing that there is no evidence of record to support the Commission's findings. Contrary to the AG's position, our findings are based on substantial record evidence.[2]

IT IS THEREFORE ORDERED that the AG's motion for rehearing be and it hereby is denied.

Done at Frankfort, Kentucky, this 27th day of May, 1992.

PUBLIC SERVICE COMMISSION

Chairman

Commissioner

DISSENTING OPINION OF VICE CHAIRMAN THOMAS M. DORMAN

I respectfully dissent. The Attorney General's request for rehearing on The Union Light, Heat and Power Company's purchased power expense should be granted. This Commission has taken the position that the cost of Zimmer is excessive and has intervened in this matter at the FERC. Though the reasonableness of Zimmer costs to Kentucky ratepayers will be ultimately decided by the

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2 *Transcript of Evidence*, Vol. II, page 108; Vol. V, pages 195-196; and Vol. V, page 201.

FERC, the Attorney General has correctly observed that this Commission can address the issue by examining whether a lower cost alternative power is available elsewhere. I believe this Commission should fully explore the availability of lower cost alternative power. Rehearing should be granted for the purposes of bringing in all relative utility companies to receive testimony regarding what, if any, alternative power exists for The Union Light, Heat and Power Company.

Thomas M. Dorman
Vice Chairman
Kentucky Public Service Commission

ATTEST:

Executive Director, Acting