COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

BIG RIVERS ELECTRIC CORPORATION'S PROPOSED MECHANISM TO CREDIT CUSTOMERS AMOUNTS RECOVERED IN JUDICIAL PROCEEDINGS INVOLVING FUEL PROCUREMENT CONTRACTS	)))))	CASE NO. 94-453

O R D E R

At the conclusion of Case No. 90-360-C,[1] the Commission directed Big Rivers Electric Corporation ("BREC") to develop a rate mechanism to refund any proceeds recovered in judicial proceedings involving its fuel procurement contracts. In response to the Commission's Order, BREC submitted a proposed refund mechanism. In addressing BREC's proposal, the Commission faces two issues: (1) May the Commission order BREC to refund monies which it recovers in judicial and administrative proceedings involving its fuel procurement contracts and which are not "fuel costs"? (2) Are any of the proceeds which BREC has recovered already through such actions a "negative cost of fuel" which must pass through BREC's fuel adjustment clause? Answering each question in the negative, the Commission closes this case.

BACKGROUND

On July 21, 1994, the Commission ordered BREC to develop a mechanism to distribute to its customers amounts which it received as damages or awards in the judicial proceedings involving its coal contracts and fuel procurement practices. On

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[1] Case No. 90-360-C, An Examination By the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation From November 1, 1991 To April 30, 1992 (July 21, 1994) at 37.

October 17, 1994, BREC submitted its proposal under protest.[2] It proposed that all damage awards, minus attorney fees and other reasonable costs and expenses, be credited to customers as a separate line item on monthly bills. BREC further proposed that a customer's refund be based on its share of BREC's total 1993 kilowatt hour sales. It also proposed to retain insurance policy proceeds, punitive damage awards and any compensatory damage awards attributed to off-system customers.

Following the submission of BREC's proposal, the Commission initiated this case and joined as parties to this proceeding all parties[3] of Case No. 90-360-C. The Commission also joined as parties BREC's distribution cooperatives.[4] All parties were given the opportunity to comment on BREC's proposal, to submit written briefs and to present oral arguments.

As of August 25, 1995, BREC has recovered $2,433,153.47 in various judicial and administrative actions involving its fuel procurement contracts. Shirley Pritchett, a business associate of former BREC General Manager William Thorpe, has paid

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2 BREC has brought an action for review of the Commission's Order of July 21, 1994. Big Rivers Electric Corp. v. Pub. Serv. Comm'n, No. 94-CI-001184 (Franklin Cir. Ct.) In its complaint, it alleges, inter alia, that the Commission's directive for a refunding mechanism is unlawful. Since the Commission has not yet established any refund mechanism nor addressed BREC's arguments in Case No. 94-453, the Franklin Circuit Court denied BREC's action on this point as premature. Big Rivers Electric Corp. v. Pub. Serv. Comm'n, No. 94-CI-001184 (Franklin Cir. Ct. Oct. 20, 1995).

3 Alcan Aluminum Company, Attorney General, Commonwealth Aluminum, Inc., Kentucky Industrial Utility Customers, NSA, Inc., Prestige Coal Company, and Willamette Industries, Inc.

4 Green River Electric Corporation, Henderson Union Electric Cooperative, Jackson Purchase Electric Cooperative, and Meade County Rural Electric Cooperative.

$1,007,548.21 as part of a sentencing agreement with federal prosecutors.[5] Eddie Brown, the owner of E&M Coal Company, has paid $935,605.26 to settle a lawsuit which BREC brought.[6] Reliance Insurance Company has paid BREC $490,000 under the terms of a fidelity bond issued for William Thorpe.[7] BREC currently has pending legal actions involving its fuel procurement contracts against William Thorpe, Denise Thorpe, Shirley Pritchett, Clyde Brown, the estate of Buddy Morris, Costain Coal Company, Jim Smith, and Jim Smith Coal Company in which it seeks damages in excess of $13.4 million.[8]

LEGAL AUTHORITY TO ORDER REFUNDS

Before considering BREC's proposal, the Commission first must determine the extent of its authority to order refunds of any litigation proceeds which are not fuel costs. The Commission's review of existing law indicates that any order to refund these litigation proceeds would constitute retroactive rate-making and would violate the rule against single-issue rate-making.

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5 U.S. v. Shirley Bethel Pritchett, Criminal Nos. 93-00022-01-O and 93-00023-01-O (W.D.Ky. Apr. 12, 1994). See also BREC's Response to KIUC's First Set of Data Requests, Item 2.

6 BREC's Response to KIUC's First Set of Data Requests, Item 3A.

7 BREC's Response to KIUC's First Set of Data Requests, Item 1D (document entitled "Amendment to Proof of Loss and Release and Waiver of Assignment").

8 Big Rivers Electric Corp. v. Thorpe, No. 93-0110-0(CS) (W.D. Ky. filed Aug. 30, 1993); Big Rivers Electric Corp. v. Green River Coal Co., Case No. 93-40568 (Bankr. W.D. Ky.); Big Rivers Electric Corp. v. Costain Coal, Inc., No. 94-CI-012 (Union Cir. Ct. Ky.). Since this case was submitted to the Commission for decision, Clyde Brown and Green River Coal Company were found guilty of fraud by a federal court and ordered to pay $200,000 in restitution to BREC. U.S. v. Clyde Brown, Jr. and Green River Coal Co., Criminal Action No. 94-00014-01-0 (W.D.Ky.).

As any refund of BREC's litigation proceeds reduces the rates which customers have previously paid for electric service, it is contrary to the prohibition against retroactive rate-making.[9] A pervasive and fundamental rule underlying the utility rate-making process is that "rates are exclusively prospective in application." Public Service Commission v. Diamond State Telephone Co., 468 A.2d 1285 (Del. 1983). Rate-making is a legislative function. Commonwealth ex rel. Stephens v. South Central Bell Telephone Co., Ky., 545 S.W.2d 927, 931 (1976). As rate-making orders have statutory effect, they are subject to the rules ordinarily applied in statutory construction. To accord a rate order retroactive effect requires "the clearest mandate." Claridge Apartments Co. v. Commissioner of Internal Revenue, 323 U.S. 141 (1944).

KRS Chapter 278 contains no such mandate. While KRS 278.260(1)[10] and

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9 The Commission notes that one exception to the filed rate doctrine and the prohibition against retroactive rate-making is where fraud has been committed upon the regulatory commission. See, e.g., MCI Telecommunications Corp. v. Public Service Commission, 840 P.2d 765 (Utah 1992); Matter of Minnesota Public Utilities Commission's Investigation, 417 N.W.2d 274 (Minn.App. 1987). The Commission has previously considered whether BREC committed fraud upon the Commission and found no evidence of such fraud. Case No. 90-360-C, supra Note 1, at 27-28.

10 "The commission shall have original jurisdiction over complaints as to rates or service of any utility, and upon a complaint in writing made against any utility by any person that any rate in which the complainant is directly interested is unreasonable or unjustly discriminatory, or that any regulation, measurement, practice or act affecting or relating to the service of the utility or any service in connection therewith is unreasonable, unsafe, insufficient or unjustly discriminatory, or that any service is inadequate or cannot be obtained, the commission shall proceed, with or without notice, to make such investigation as it deems necessary or convenient. The commission may also make such an investigation on its own motion. No order affecting the rates or service complained of shall be entered by the commission without a formal public hearing."

278.270[11] give the Commission authority to investigate existing rates and establish new rates, this power is limited to prospective rate changes. There is no express authority to support a rate mechanism which requires the refund of amounts lawfully collected.

In South Carolina Electric & Gas Co. v. Pub. Serv. Comm'n, 272 S.E.2d 793 (S.C. 1980), the South Carolina Public Service Commission ordered an electric utility to refund more than $7 million which resulted from a one-time fuel savings. Finding that the Commission was attempting to reduce past-ordered rates and that such action amounted to retroactive rate-making, the South Carolina Supreme Court set aside the order. The Court stated that, while the result of its decision might appear "unduly generous" to the utility, the Commission still had the authority to correct any unjust results by considering "these extraordinary monies in setting the test period operating experience when a future rate increase is requested." Id. at 795.

In Niagara Mohawk Power Corporation v. Pub. Serv. Comm'n, 388 N.Y.S.2d 157 (N.Y. App.Div. 1976), the New York Public Service Commission ordered an electric and gas utility to refund approximately $14 million which resulted from a one-time tax refund. Finding that the Order constituted retroactive rate-making, the New York Supreme Court (Appellate Division) vacated the Order. Rejecting the New York Commission's claims that the refund was not retroactive rate-making, the Court declared:

> The Commission refers to it as 'entitlement of present receipt of monies.' Despite this semantical distinction, what the Commission is attempting is a return of this subsequently

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11 "Whenever the commission, upon its own motion or upon complaint as provided in KRS 278.260, and after a hearing had upon reasonable notice, finds that any rate is unjust, unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any of the provisions of this chapter, ***the commission shall by order prescribe a just and reasonable rate to be followed in the future*** [emphasis added]."

> acquired money by Niagara Mohawk to its customers. This sum represents the overpayment of Federal taxes where the larger amount was utilized in determining the previous rates. The return of the money to the customers would in effect reduce the cost of utilities to them. In other words, it would lower the rates paid. Consequently, what is accomplished is a reduction of past rates. Admittedly, the rates for those years were in all respects proper at the time they were made.

Id. at 158. The Court noted that the proper remedy to any unjust enrichment on the utility's part was through general rate-making proceedings.[12]

Kentucky Industrial Utility Customers ("KIUC") argues that the Commission's holding in Case No. 93-113[13] supports the proposition that the Commission possesses the authority to require the refund of a utility's extraordinary revenue. The Commission's authority to direct such refund, however, was never at issue in that case. The only issue in contention was the manner of distribution. Case No. 93-113, therefore, is not controlling.

Requiring BREC to implement its proposed refund mechanism is also counter to the rule against single-issue rate-making. Courts have generally held that regulatory commissions may not establish rates based on a single expense or revenue source. In

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[12] > The present result might initially appear unfair and unjust to the ratepayer and unduly generous to Niagara Mohawk. On reflection and analysis, however, such is not the case. As we have stated, ratemaking is prospective in nature. Consequently, ***the proper approach for the Commission is to consider this acquired money when a future rate adjustment is requested. Such a procedure would fully protect the ratepayer from any unjust and unreasonable rates.***
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> Id. at 159 (emphasis added).

[13] Case No. 93-113, Application of Kentucky Utilities Company to Amortize, By Means of Temporary Decrease in Rates, Net Fuel Cost Savings Recovered in Coal Contract Litigation (Dec. 8, 1993).

Business & Professional People for the Public Interest v. Illinois Commerce Comm'n, 585 N.E.2d 1032 (Ill. 1991), the Illinois Supreme Court explained reasoning behind this concept:

> The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula.

Id. at 1061.[14] While exceptions to the rule against single-issue rate-making exist,[15] this case does not fall within those exceptions.

A separate rate which requires the refund of litigation proceeds without examining BREC's other expenses and revenues may also have unintended policy consequences. A utility which incurs a significant expense in one area, but which is otherwise earning large profits, may request a rate designed solely to recover the significant expense. If a utility can be ordered to refund particular revenues, it can also be authorized to collect a particular expense. While a refund of any litigation proceeds may be attractive in the

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[14] See also Public Service Co. of New Mexico v. FERC, 832 F.2d. 1201, 1205 (10th Cir. 1987) ("In determining a just and reasonable rate, the Commission must consider several factors, including operating expenses, depreciation expense, taxes, and a reasonable return to the utility's investors."); A. Finkel & Sons Co. v. Illinois Commerce Comm'n, 620 N.E.2d 1141 (Ill. App. Ct. 1993).

[15] See, e.g., City of Chicago v. Illinois Commerce Comm'n, 666 N.E.2d 1212 (Ill. App. Ct. 1996) (local franchise fees); Pennsylvania Industrial Energy Coalition v. Pennsylvania Pub. Util. Comm'n, 653 A.2d 1336 (Pa. Commw. Ct. 1995) (demand-side management costs where statute expressly provides for recovery); Re Missouri Gas Energy, 168 PUR 4th 61 (Mo. P.S.C. 1996) (purchased gas). See also KRS 278.183 (costs to comply with the Federal Clean Air Act).

short run, in the long run the precedent which it establishes may greatly disadvantage utility ratepayers.[16]

Based upon its review of the existing law, the Commission concludes that it lacks the legal authority to require BREC to establish a refund mechanism. As the Commission lacks such authority and BREC is opposed to the voluntary implementation of a refund mechanism, the issue of the design of such refund mechanism is moot.

LITIGATION PROCEEDS AS A "COST OF FUEL"

KIUC urges the Commission to consider the proceeds recovered in any administrative or judicial proceedings involving BREC's fuel procurement contracts as a cost of fuel. Commission Regulation 807 KAR 5:056 provides for the automatic

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[16] KIUC maintained the same position in earlier Commission proceedings. In Administrative Case No. 341, Investigation Into the Feasibility of Implementing Demand-Side Management Cost Recovery And Incentive Mechanisms, KIUC argued that the Commission could not implement a special mechanism to recover utility costs for demand-side management programs. Noting that such mechanisms would result in single-issue rate-making, KIUC stated:

> From one rate case to another, all elements of a utility's operations change. When rates are established in a rate case, the Commission uses a representative relationship among revenues, expenses and investments. After the rates are set, the utility may experience a declining rate base because of depreciation and deferred tax effects, may experience lower interest costs because of the redemption of high cost securities, may experience increased revenues due to customer growth, may experience increased O&M costs due to inflation, may experience reduced O&M costs due to the initiation of more efficient operations, etc. These types of changes occur daily in the operation of an electric utility, and except for the special case of fuel costs and Clean Air Act compliance costs not already included in base rates, ***there is no procedure to carve out specific items of cost for consideration.***

Administrative Case No. 341, Comments and Responses of Kentucky Industrial Utility Customers, Appendix A, at 4 (emphasis added).

adjustment of BREC's rates to reflect changes in fuel and purchased power costs. If litigation proceeds are a refund of fuel costs (a negative adjustment to the cost of fossil fuel), Commission Regulation 807 KAR 5:056 requires their refund.

Commission Regulation 807 KAR 5:056, Section 1(3), defines "fuel costs" as the most recent actual monthly cost of:

> (a) Fossil fuel consumed in the utility's own plants, and the utility's share of fossil and nuclear fuel consumed in jointly owned or leased plants, plus the cost of fuel which would have been used in plants suffering forced generation or transmission outages, but less the cost of fuel related to substitute generation; plus
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> (b) The actual identifiable fossil and nuclear fuel costs associated with energy purchased for reason other than identified in paragraph (c) of this subsection, but excluding the cost of fuel related to purchases to substitute for the forced outages; plus
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> (c) The net energy cost of energy purchases, exclusive of capacity or demand charges (irrespective of the designation assigned to such transaction) when such energy is purchased on an economic dispatch basis. Included therein may be such costs as the charges for economy energy purchases and the charges as a result of scheduled outage, all such kinds of energy being purchased by the buyer to substitute for its own higher cost energy; and less
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> (d) The cost of fossil fuel recovered through intersystem sales including the fuel costs related to economy energy sales and other energy sold on an economic dispatch basis.

Commission Regulation 807 KAR 5:056, Section 1(6), provides:

> ***The cost of fossil fuel shall include no items other than the invoice price of fuel less any cash or other discounts.*** The invoice price of fuel includes the cost of the fuel itself and necessary charges for transportation of the fuel from the point of acquisition to the unloading point, as listed in Account 151 of FERC Uniform System of Accounts for Public Utilities and Licensees [emphasis added].

Account 151 of the FERC Uniform System of Accounts defines fuel as:

> 151 Fuel Stock (Major Only)
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> This account shall include the book cost of fuel on hand.
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> Items
>
> 1. Invoice price of fuel less any cash or other discounts.
> 2. Freight, switching, demurrage and other transportation charges, not including, however, any charges for unloading from the shipping medium.
> 3. Excise taxes, purchasing agents' commissions, insurance and other expenses directly assignable to cost of fuel.
> 4. Operating, maintenance and depreciation expenses and ad valorem taxes on utility-owned transportation equipment used to transport fuel from the point of acquisition to the unloading point.
> 5. Lease or rental costs of transportation equipment used to transport fuel from the point of acquisition to the unloading point.

17 C.F.R. Part 101.

In Case No. 93-113, the Commission significantly limited the type of costs which qualify as fuel costs. In that case, Kentucky Utilities Company ("KU") sought Commission approval to return the proceeds which it recovered from litigation with its coal supplier to its customers through a temporary decrease in its fuel adjustment charge. Finding the refund of these monies through the fuel adjustment clause improper, the Commission declared:

> After lengthy proceedings involving all interests, in 1977 the Commission, by Order, adopted a uniform FAC [fuel adjustment clause] to be applicable to all electric utilities in Kentucky. The basic purpose and intent was to provide a vehicle whereby the fluctuations in the cost of fuel could be recognized in rates in a timely fashion, thus avoiding the extensive regulatory lag associated with the filing of periodic general rate cases. The interests of all parties were best served by establishing a mechanism to reflect both the incremental increases and decreases in fuel costs with only a one month lag and assurances that the automatic

> adjustments in rates would result in no gain or loss to the utility. The uniform FAC was derived from the clause in effect at the Federal Power Commission, now the Federal Energy Regulatory Commission ("FERC"), and was implemented to replace the existing company specific clauses.
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> The only connection that the escrow fund has with the FAC regulation is the fact that the funds deposited in the escrow were collected from KU's customers through the operation of the FAC. When it was designed, the FAC regulation simply did not envision the circumstances the Commission is faced with in this proceeding. The use of the FAC to accomplish the refund is not appropriate. ***807 KAR 5:056 narrowly defines what constitutes fuel costs which are recoverable through the mechanism. The refund of the escrow does not conform to this narrow definition.*** The regulation calls for reviews of the operation of the FAC at 6 month and 2 year intervals.

Order at 3 - 5 [bold italics added].

A comparison of BREC's three recoveries with KU's recovery leads the Commission to conclude that none may be considered a cost of fuel. Unlike the proceeds in Case No. 93-113, BREC's proceeds are not the result of litigation with its fuel suppliers over fuel contract issues. Two of the three recoveries involved persons who were not parties to any fuel procurement contract with BREC. In none of these recoveries is there clear evidence that the proceeds represent amounts previously collected through BREC's fuel adjustment clause. In the cases of Pritchett and Brown, BREC's proceeds represent the return of unjust enrichment obtained after inducing a BREC employee to breach his fiduciary duty to BREC.

BREC's recoveries, moreover, do not meet the definition of cost of fuel. Contrary to KIUC's arguments, these recoveries cannot be considered a "discount" pursuant to 807 KAR 5:056, Section 1(6), on the price of fuel. "Discount" is defined as "a deduction from an original price or debt, allowed for paying promptly or in cash." Black's Law

Dictionary 418 (5th ed. 1979). Neither court-ordered restitution from conspirators in a kickback scheme nor insurance proceeds on a fidelity bond fall within this definition.[17] Moreover, since the recovered amounts are not fuel cost refunds coming from fuel suppliers and are for actions other than fuel procurement (i.e. breach of fiduciary duty), considering the proceeds as a reduction or adjustment to fuel costs is contrary to the literal language of Commission Regulation 807 KAR 5:056.

In reviewing BREC's recoveries, the Commission distinguishes between recoveries of unreasonable fuel costs and of BREC's losses. In recent proceedings involving BREC's fuel adjustment clause,[18] the Commission has refused to permit BREC to pass through to its ratepayers unreasonable fuel costs in excess of $27 million. It has directed BREC to calculate its fuel cost to eliminate the consequences of unreasonable fuel procurement decisions. BREC's ratepayers, therefore, are protected. BREC, however, must absorb the difference between its actual cost of fuel and the cost recovered through its fuel adjustment clause. To the extent that the recoveries at issue merely compensate BREC for this difference or for non-fuel related losses,[19] these recoveries cannot be considered as a cost of fuel.

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17 The Commission's decision today does not preclude insurance proceeds from meeting the definition of a fuel cost or being subject to return through a utility's fuel adjustment clause. Each case must be decided on its own circumstances.

18 See, e.g., Case No. 90-360-C, An Examination By the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation From November 1, 1991 To April 30, 1992 (July 21, 1994).

19 Among such non-fuel related losses, are the losses associated with an employee's breach of a fiduciary duty. Unless the employee's action can be shown to cause the incurrence of unreasonable fuel costs, any recoveries associated with the breach of the employee's fiduciary duty, to include punitive damages and recovery of unjust enrichment, are not fuel costs.

The Commission's decision today should not be interpreted as precluding the flow through of subsequent BREC recoveries through BREC's fuel adjustment clause. Each recovery will be judged upon its individual circumstances. Those recoveries which are fuel-related and which compensate BREC for fuel costs which are still being flowed through its fuel adjustment clause will be closely reviewed as a potential cost of fuel subject to return to BREC ratepayers. The Commission will continue to monitor BREC's recovery efforts through its periodic reviews of BREC's fuel adjustment clause, and where appropriate, it will order the amounts recovered returned to BREC's ratepayers.

SUMMARY

Having carefully considered the parties' argument and being otherwise sufficiently advised, the Commission concludes that it lacks the legal authority to require BREC to establish a refund mechanism and that monies already received from its efforts do not constitute a cost of fuel subject to its fuel adjustment clause.

IT IS THEREFORE ORDERED that this matter is closed and removed from the Commission's docket.

Done at Frankfort, Kentucky, this 21st day of February, 1997.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Vice Chairman

ATTEST:

Don M Mills
Executive Director