COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE APPLICATION OF THE FUEL ADJUSTMENT CLAUSE OF KENTUCKY UTILITIES COMPANY FROM MAY 1, 2001 TO OCTOBER 31, 2001	)))))	CASE NO. 2000-00497-B

O R D E R

This proceeding involves a review of the operation of the fuel adjustment clause (FAC) of Kentucky Utilities Company (KU) for the 6 months ended October 31, 2001. At issue is whether KU incurred unreasonable fuel costs as a result of fuel procurement practices that led it to acquire imported coal from a non-regulated affiliate. Finding that it incurred unreasonable fuel costs, we direct KU to reduce by $673,000 its fuel cost for purposes of calculating its FAC charge.

PROCEDURE

On December 20, 2001, the Commission, pursuant to 807 KAR 5:056, Section 1(11), initiated a review of the operation of KU s FAC for the 6-month period ending October 31, 2001. As part of its review, the Commission ordered KU to submit certain information concerning its fuel procurement, its fuel usage, and the operation of its FAC. Kentucky Industrial Utility Customers, Inc. (KIUC) and AEI Coal Sales, Inc. (AEI) were permitted to intervene in this proceeding.

The Commission conducted a public hearing on February 19, 2002. Testifying for KU were: Fred Howard Bush, Jr., KU s Manager of Regulatory Compliance; Lonnie

Bellar, KU s Director of Generation Services; and Mike Dotson, KU s Manager of Fuels. On April 9, 2002, following our review of the transcript of this hearing and of testimony that KU officials presented before a committee of the Kentucky House of Representatives, we found that additional inquiry into KU s coal procurement practices during the review period was necessary and directed that a second hearing be held.

Following discovery, the Commission held a second hearing on August 21, 2002. Testifying for KU were: Gregory P. Cantrell, Director of Corporate Fuels and Byproducts for LG&E Energy Inc.; Mike Dotson; and Mark McAdams, Manager of Fuel Strategy and Procurement for West Kentucky Energy Corporation (WKE). After the filing of KU s written brief, the case was submitted for decision on September 23, 2002.

STATEMENT OF THE CASE

KU, a Kentucky corporation, is a privately owned electric utility that generates, transmits, and sells electricity to approximately 446,000 customers in all or parts of 77 counties in Kentucky.[1] It is a wholly owned subsidiary of LG&E Energy Corporation (LG&E Energy), a non-utility holding company. LG&E Energy is also the parent company of Louisville Gas and Electric Company (LG&E), an electric and gas utility subject to this Commission s jurisdiction and Western Kentucky Energy Corporation (WKE), the non-regulated affiliate from which KU purchased imported compliance coal.

Authority for KU s fuel procurement practices is consolidated within the hands of a few persons. Mike Dotson, KU s Manager of Fuels, is responsible for KU s day-to-day

[1] Operating under the name of Old Dominion Power Company, KU generates, transmits, distributes, and sells electricity to approximately 30,000 customers in 5 counties in southwestern Virginia. It also provides service on a wholesale basis to 12 municipalities and one private retail electric provider.

procurement operations. He also holds the same position and responsibilities for LG&E, another LG&E Energy affiliate that is subject to this Commission s jurisdiction. Mr. Dotson reports to Gregory Cantrell, Director of Corporate Fuels and Byproducts for LG&E Energy, who is ultimately responsible for fuel procurement, logistics, and inventory of LG&E Energy s three electric generation subsidiaries.[2] Mr. Cantrell reports to Paul W. Thompson, Senior Vice-President, Energy Services, LG&E Energy.

Prior to mid-2000, KU enjoyed an extended period of declining fuel prices. Several factors had created this decline in coal prices. Improvements in long-wall and continuous mining technology led to greater productivity within the coal industry. Lower oil and natural gas prices, the deregulation of natural gas pricing, and competition within the coal industry exerted economic pressures to lower coal prices. Further contributing to lower fuel costs were relatively mild winters that reduced electric utilities demand for coal, resulting in coal supplies significantly exceeding demand for coal.[3]

The trend toward lower coal prices reversed in 2000. Coal production declined approximately 2.3 percent as several mines lacked excess production capacity while others elected not to expand production.[4] While production fell, coal consumption increased 2.4 percent. The resulting imbalance led to increasing coal prices. This

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[2] Transcript of 8/21/2002 Hearing at 11. In addition to KU and LG&E, LG&E Energy owns WKE which leases and operates electric generation facilities in western Kentucky.

[3] See, e.g., Richard Bonskowski, The U.S. Coal Industry in the 1990 s: Low Prices and Record Production (U.S. Energy Information Administration), *available at* ftp://ftp.eia.doe.gov/pub/coal/coalfeat.pdf (January 22, 2003).

[4] Fred Freme, U.S. Coal Supply and Demand: 2000 Review (U.S. Energy Information Administration), *available at* http://www.eia.doe.gov/cneaf/coal/page/special/feature.pdf (January 22, 2003).

situation was further exacerbated by colder than normal temperatures in the winter of 2000-2001.

Between July 2000 and May 2001, KU experienced several fuel delivery problems as a result of the changing coal market conditions. To comply with federal air quality laws, KU burns compliance coal[5] at Ghent Units 2, 3, and 4, none of which are equipped with flue-gas desulfurization equipment (scrubbers). For the period July 2000 through May 2001, KU had contracted for delivery of approximately 2.6 million tons of compliance coal to its Ghent Station through contracts whose terms ranged from a period of several weeks to a year or longer. Between July 2000 and December 2000, actual deliveries of compliance coal were 427,000 tons less than contracted amounts. During the next 2 months, compliance coal vendors delivered only 43 percent of their contractual commitments, causing the difference between actual deliveries and contracted deliveries to grow an additional 367,000 tons to 794,000 tons.

Following the dramatic drop in deliveries in the first 2 months of 2001, KU took several steps to increase deliveries. It contacted vendors by telephone and in writing to direct the delivery of coal. To assess claims of operational problems, it requested vendor production information and inspected vendors mining sites. It also met with vendors who failed to make contract deliveries to discuss the reasons for non-delivery and to negotiate potential solutions.[6]

These efforts to stem the flow of non-deliveries had limited effect. As shown in the chart below, coal deliveries increased during the next 3 months, but never met or

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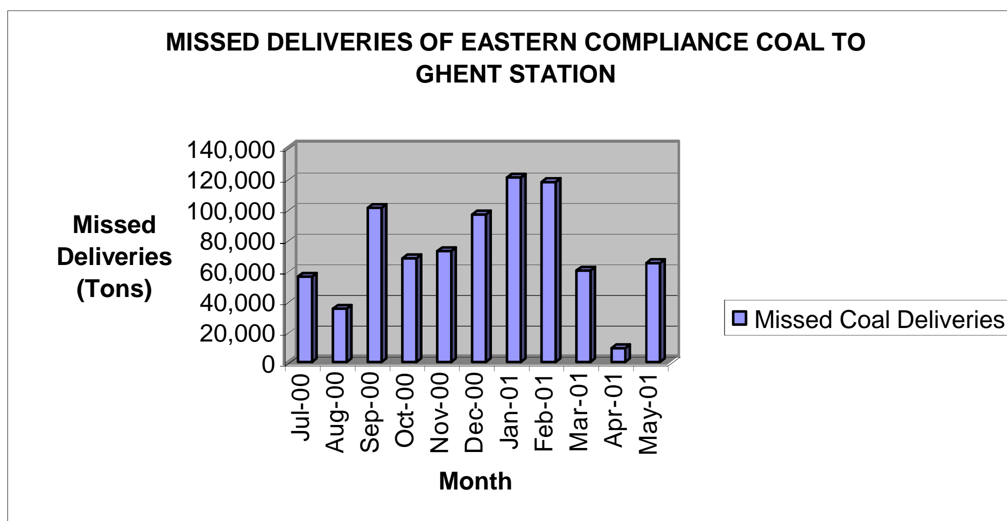
[5] Compliance coal is coal that produces less than 1.2 pounds of sulfur dioxide per 1,000 BTUs of energy released when the coal is burned.

[6] Direct Testimony of Gregory P. Cantrell at 8; KU s Brief at 6.

exceeded contract delivery requirements. For the first 5 months of 2001, KU suffered a net shortfall of 484,339 tons of coal. By May 2001, the delivery shortfall at Ghent Station had reached 911,893 tons of eastern compliance coal and the shortfall in such deliveries to Ghent Station had occurred for 11 consecutive months.



Almost one-third of the missed deliveries, approximately 300,000 tons, was attributable to one coal supplier AEI.[7] Based upon its executed contracts with coal suppliers, KU had expected AEI to be the largest volume supplier of compliance coal to Ghent Station between mid-2000 to mid-2001. In May 2001, KU entered discussions with AEI regarding the missed deliveries. During these discussions, which continued into June 2001, AEI reportedly demanded a $5-per-ton increase for all coal deliveries made to KU and LG&E, and implied that failure to accede to these demands would

[7] The remaining 600,000-ton shortfall was the result of under-deliveries from re: Logan & Kanawha Coal Company; Asset Management Group, Inc.; Pen Coal Corporation; Massey Coal, Black Hawk Synfuel, LLC; Arch Coal Sales Company, Inc., and Ceredo Synfuel LLC. These suppliers resolved these under-deliveries by increasing delivered tonnage in later months or agreeing to contract amendments to compensate KU. See KU s Response to Commission Staff s Interrogatories and Requests for Production of Documents, Item 22.

result in AEI s non-performance on its other coal supply agreements with KU and LG&E.[8]

After a coal inventory assessment performed on June 15, 2001, KU determined that it lacked an adequate inventory of compliance coal for Ghent Units 2, 3 and 4. It issued a solicitation for proposals for compliance steam coal on June 20, 2001.[9] This solicitation closed on June 27, 2001. KU received responses to this solicitation from 13 coal suppliers.[10] It accepted a proposal from Arch Coal to provide 400,000 tons of western U.S. compliance coal, also known as Powder River Basin (PRB) coal,[11] but deemed all bids for eastern U.S. compliance coal as unacceptable. KU found these offers unacceptable either because the coal offered did not meet the quality specifications in the solicitation or because the proposal was from a broker with no production or a producer with no specification as to a source for the coal.[12] KU rejected the bids for eastern U.S. compliance coal without contacting any of the bidders to ascertain additional information about their bids or to explore possible improvement of these bids.

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[8] Transcript of 8/21/2001 Hearing at 49, 71-72. The record indicates that LG&E Energy officials from May until December 2001 engaged in discussions with AEI regarding existing coal supply agreements for coal deliveries to Ghent Station and other generation stations. In January 2002 AEI sought relief from its creditors under the United States Bankruptcy Code.

[9] Direct Testimony of Gregory P. Cantrell at Exhibit GPC-3. The solicitation defined compliance coal as including coal synfuels.

[10] Id. at 12.

[11] PRB coal can be blended with eastern compliance coal in a mix of 30 percent PRB coal and 70 percent eastern U.S. compliance coal to be effectively burned at KU s generation plants.

[12] The prices in the 14 bids that KU received for eastern compliance coal ranged from $43.42 to $67.75 per ton.

While KU was addressing its inventory problems, WKE, an LG&E Energy affiliate that leases and operates electric generation facilities in western Kentucky, acquired approximately 150,000 tons of foreign coal comparable in quality to eastern U.S. compliance coal. On May 17, 2002, WKE entered into an agreement with Energy Coal Spa for the purchase of 150,000 tons of compliance quality imported Polish coal at prices ranging from $54 to $56 per ton depending on heat content.[13]

WKE s reasons for procuring this coal are unclear. None of the generation units that it operates is required to burn compliance quality coal. To realize economic efficiencies while complying with environmental requirements, it burns a blend of high quality and poor quality coals at these units.[14] In internal WKE and LG&E Energy documents reviewing the purchase in June 2001, Mark William McAdams, WKE s Manager of Fuel Strategy and Procurement, and Mr. Cantrell state that the coal could be assignment to the regulated utility as a hedge against failing suppliers, potential resale to the open market, or blending to provide emergency fuel for WKE in the event of a strong summer. [15]

Aware of the existence of this supply of compliance coal when assessing KU s inventory, Mr. Cantrell, on July 2, 2001, directed that 102,000 tons of this supply be

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[13] Energy Coal Spa is an energy broker and acts as agent for the Polish coal consortium in the United States.

[14] The only units in the LG&E-KU-WKE fleet that must burn compliance quality coal are KU s Ghent Units 2, 3, and 4.

[15] WKE s Award Recommendation Memorandum of June 11, 2001, *found in* KU s Response to Commission Staff s Interrogatories and Request for Production of Documents, Item 3.

transferred to KU and delivered to Ghent Station.[16] Mr. Cantrell testified that this action was taken after he determined that the additional purchases of PRB coal from Arch Coal would be insufficient to achieve targeted inventory levels and that the transfer of coal was required to avoid unnecessary risks. [17] Delivery of this imported coal to KU s Ghent Station began in July 2001 and continued through October 2001.[18]

The average price of the imported coal, which is comparable in quality to eastern U.S. compliance coal, was $58.37 per ton. The total value to KU of this tonnage at this price was approximately $5.9 million. During this period (July 2001 - October 2001), KU paid an average price of $29 per ton for all other spot market deliveries of eastern compliance coal and $27 per ton for eastern compliance coal purchased under contract. Arrangements and terms for these other deliveries at these prices had been made in 2000 or early 2001, prior to the summer of 2001 when the price of eastern compliance coal peaked.

Unlike previous fuel transactions between WKE and the LG&E Energy affiliates that this Commission regulates, KU did not prepare a purchase order or contract agreement to evidence transfer of the coal. It did not follow the internal award recommendation procedures that generally govern KU and LG&E s fuel purchases.[19]

[16] Transcript of 8/21/2001 Hearing at 44 - 46. KU s procurement personnel were not aware of the existence of this supply of coal until Mr. Cantrell brought it to their attention on July 2, 2001.

[17] Direct Testimony of Gregory P. Cantrell at 14.

[18] WKE burned the remaining 48,000 tons of foreign coal at its Henderson Facility. Transcript of 8/21/2002 Hearing at 126; KU s Response to Commission Staff s Supplemental Interrogatories and Request for Production of Documents, Item 12b.

[19] Transcript of 8/21/2001 Hearing at 46 - 48.

ANALYSIS

Fuel Adjustment Clause: An Overview

An FAC is a means for [an electric] utility to recover from its customers its current fuel expense through an automatic rate adjustment without the necessity for a full regulatory rate proceeding. This rate may increase or decrease from one billing cycle to the next depending on whether the utility s cost of fuel increased or decreased in the same period. The rate provides for a straight pass-through of fuel costs, with no allowance for a profit to the utility. Kentucky Power Company, Case No. 6877 (Ky. P.S.C. Dec. 15, 1977) at 2.

807 KAR 5:056 permits electric utilities to establish FACs to adjust their rates to reflect changing fuel prices. It requires that an FAC provide for periodic adjustment per KWH [kilowatt hour] of sales equal to the difference between the fuel costs per KWH sale in the base period and in the current period. 807 KAR 5:056, Section 1(1). It establishes an adjustment factor based on a mathematical formula. This factor, which is also expressed in terms of cents per KWH, is multiplied by monthly KWH usage to determine a customer s monthly FAC charge. The charge, which may be positive or negative, appears as a separate line item on the customer s bill.

Because the adjustments are automatic, the Commission periodically reviews utilities FACs. 807 KAR 5:056, Section 1(11), requires the Commission to conduct public hearings on a utility s past fuel adjustments and to order a utility to charge off and amortize, by means of a temporary decrease of rates, any adjustments it finds unjustified due to improper calculation or application of the charge or improper fuel

procurement practices. 807 KAR 5:056, Section 1(7), requires the Commission to disallow [f]uel charges which are unreasonable.[20]

When reviewing the reasonableness of fuel charges that are flowed through a utility s FAC, the Commission applies the same standard of review as is applied in any rate adjustment proceeding. The burden of proof falls upon the electric utility to demonstrate the reasonableness of its fuel charges. See KRS 278.190(3). Generally, a utility management decision to incur a fuel charge will be presumed reasonable absent evidence that the charge is unreasonable, inefficient, or an abuse of management discretion. See, e.g., West Ohio Gas Co. v. Ohio Pub. Util. Comm n, 294 U.S. 63 (1935); Pennsylvania Pub. Util. Comm n v. Philadelphia Electric Co., 561 A.2d 1224 (Pa. 1989); City of Newport v. Campbell County Kentucky Water District, Case No. 89-014 (Ky. PSC Jan. 31, 1990).

This presumption, however, does not apply to transactions involving affiliates. Courts have long recognized that expenses incurred in transactions between utilities and their affiliates deserve special scrutiny, given the potential lack of arms-length bargaining and improper subsidization of the affiliate s unregulated operations through the utility s rates and that regulatory commissions need not assume that the fees charged to a utility by its affiliate are fair. Midland Cogeneration Venture Ltd Partnership v. Public Service Comm n, 501 N.W.2d 573, 586 (Mich. 1993). See also Attorney General v. New Mexico Public Service Comm n, 685 P.2d 957 (N.M. 1984);

[20] See, e.g., Case No. 1990-00360-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) (in which the Commission disallowed $12.4 million of unreasonable fuel costs which an electric utility had incurred).

Washington Water Power Co. v. Idaho Public Utilities Comm n, 668 P.2d 1007 (Id. 1983). Accordingly, in those instances where an electric utility has purchased fuel from an affiliate, it must demonstrate that its purchase was reasonable.

Purchase of Foreign Coal

The principal issue in this proceeding is the reasonableness of KU s decision to purchase approximately 102,000 tons of foreign coal for its Ghent Station. The question of reasonableness involves not only the specific terms of the transaction between KU and WKE, but KU s fuel procurement activities in the months prior to the purchase in response to missed coal deliveries. Based upon our review of the record, we find that KU has failed to demonstrate that it acted in a reasonable manner in addressing its delivery shortfall and securing additional supplies of compliance coal and, under the then-existing conditions, that the price of the coal secured from WKE was reasonable.

KU maintains that its efforts to address its delivery shortfalls were reasonable. It argues that its need for and timing of any spot purchases depended entirely on the continuing performance of its vendors under contract. [21] While acknowledging that a problem with coal deliveries existed as of late 2000, KU asserts that the problem did not require any action until February 2001 when suppliers delivered only 43 percent of their contract commitments. Its response to these reduced delivery levels, KU argues, led to improved delivery performance by suppliers in the months of March and April 2001. Only after delivery performance again worsened in May and June 2001, KU argues, did a sufficient need exist to make additional solicitations to supplement its coal supplies.

[21] KU Brief at 6.

Using the bids submitted in response to its June 20, 2001 solicitation as representative of existing market conditions, KU further argues that the price expended for the foreign coal from WKE was reasonable. It notes that Aquila Energy s (Aquila) offer to provide 60,000 tons at a delivered price of $55.92 was the best bid for eastern U.S. compliance coal received in response to the solicitation. This price is only slightly less than WKE s price for its purchase of imported coal. Although KU rejected Aquila s bid because of previous delivery problems and the lack of a source for the coal, KU argues that the Aquila bid price is an appropriate price against which to compare the price of the WKE imported coal. Purchasing the 60,000 tons of coal that Aquila offered at its bid price in lieu of the price for WKE coal, KU argues, would produce a savings of less than $200,000. This relatively small savings, KU argues, would have been outweighed by the certainty of delivery of the WKE coal and the uncertainty of Aquilia s ability to deliver.

We find KU s arguments concerning the timing of its search for additional coal suppliers to be unconvincing. Under-deliveries of coal to KU s Ghent Station between June and December 2000 totaled 427,000 tons. These under-deliveries increased by 85 percent to 794,000 tons in the following 2 months. Through February 2001, KU had experienced 9 consecutive months of delivery shortfalls of eastern U.S. compliance coal to its Ghent Station. Moreover, industry publications had been warning of tight market conditions. These conditions strongly suggested the need to secure additional supplies earlier, especially in the face of the risks that Mr. Cantrell described in his testimony.[22]

[22] Direct Testimony of Gregory P. Cantrell at 14.

KU has failed to demonstrate that its decision to delay seeking additional coal supplies until June 2001 was reasonable.

Furthermore, we are skeptical of KU s contention that modest increases in deliveries in the months of March and April justify its delay in seeking additional coal supplies. While deliveries improved, they did not reach contract levels. During March and April, the shortfall of deliveries of compliance coal at the Ghent Station actually continued to increase. Such performance does not suggest a trend toward excess monthly deliveries that would reduce the total shortfall. KU has not pointed to any forecast of coal market improvements or strong evidence of improved supplier delivery performance in the spring or summer of 2001 to support its decision to not act.

The record clearly shows that KU s delay in seeking additional supplies significantly limited its ability to obtain an advantageous price. When KU went to the market for supplemental supplies of compliance coal in June 2001, market conditions had worsened and prices had increased. KU concedes that it simply had no leverage under these extreme market conditions. [23]

As to KU s arguments regarding the reasonableness of the price of the WKE coal, we find them to be without merit. The record shows that in March 2001, East Kentucky Power Cooperative, Inc. (EKPC) arranged for spot deliveries of compliance coal from Kiva Synfuel Products at a price of $43.54 per ton to its Spurlock Generating Station from July 2001 through October 2001.[24] It further shows that EKPC, on June 29, 2001, was able to extend the delivery period for an additional 60 days and

[23] KU Brief at 8.

[24] Transcript of 8/21/2002 Hearing at Staff Exhibit 7.

increase the contract quantity by 130,000 tons for the same price.[25] We recognize that this delivery involved a synfuel product, which is typically discounted compared to conventional coal purchases. If the contract price is adjusted upwards by $3 to reflect its nature as a synfuel product[26] and the additional transportation costs related to Ghent Station s location,[27] we believe this transaction serves as a representative indicator of spot market conditions for eastern U.S. compliance coal in March 2001 and June 2001.[28] Therefore, it appears that the price paid for WKE Coal was not reasonable.

KU s rejection of all bids for eastern U.S. compliance coal without contacting any of the bidders to ascertain additional information about their bids or to explore possible improvement of these bids undercuts its assertions that the WKE price is representative of market conditions. Mr. Cantrell testified that generally KU does not accept a bid at face value but will continue to negotiate with bidders to extract additional concessions.[29] In the case at bar, fuel procurement management recognized low coal inventories as posing significant risks to the continuity of service; however, it took no action to improve bids or obtain additional information to resolve perceived problems with bids.

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[25] KU Brief at Attachment A.

[26] KU suggests that the cost of a synfuel product is generally discounted at least 8 to 12.5 cents/Mmbtu ($2.00 to $3.00). KU Brief at 13.

[27] KU s Ghent Station is a greater distance by river barge from the source of supply than is EKPC s Spurlock Station.

[28] We concede that determining market conditions with absolute certainty or precision is not possible. Our methodology, which considers the nature of the product and additional transportation costs, should produce a reasonable indication of market conditions in June 2001. We acknowledge that other methods may be used to ascertain a measure of market conditions.

[29] Transcript of 8/21/2002 Hearing at 30 31.

The record suggests that considerations other than price and quality played a role in KU s actions. Fuel procurement officials depict a very combative fuel market during the period in question. Mr. Cantrell testified:

> In this market, we had a lot of people - the market was truly short of supply, but we had people that were also trying to take advantage of that supply situation. . . . So, you know, we clearly understood that we had a gun against our head. We had, on one hand, the duty and the obligation to make sure these power plants run and we have enough coal. We also had the duty to make sure that we get that coal both in the short and the long term at the best possible price we can get. We were not interested, we did not want to, you know, capitulate [to] those kind of demands.[30]

KU and other LG&E Energy entities clearly viewed the procurement of foreign coal as a means to send a message to aggressive coal producers. Mr. Cantrell termed the procurement of such coal as a means to push back producer demands.[31] Mr. Dotson referred to the purchase of such coal as providing an opportunity to let the marketplace know that we would, if we have to, import an imported coal into our power plant. [32]

The circumstances surrounding the purchase raise additional questions about the reasonableness of the transaction. WKE initially purchased the foreign coal, but had no operational reason for its purchase. Its generation units did not require

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[30] Id. at 49 - 50.

[31] Id. at 50. He noted in his written testimony that [p]urchasing the coal gave KU experience with this type of coal and its transportation and, **importantly**, sent a signal to potential vendors of coal that KU would purchase imported coal if necessary to maintain adequate inventories. Direct Testimony of Gregory P. Cantrell at 16 (emphasis added).

[32] Transcript of 2/19/2002 Hearing at 17. See also Electronic Message from Mark McAdams, Manager of Fuel Strategy and Procurement for WKE, to Steve Dufour, KU Senior Contract Administrator, July 17, 2001 (Unloading the Polish coal will . . . be good to send a message to regional coal suppliers that there are other choices of high quality compliance coal).

compliance quality coal, nor did WKE as a general practice purchase coal for resale. Moreover, WKE s Fuel Manager justified the proposed purchase on the basis that the coal could be assigned to the regulated utility as a hedge against failing suppliers. [33] While personnel within KU s Fuel Procurement Department were unaware of WKE s purchase, Mr. Cantrell, who had ultimate authority for KU s procurement actions and who made the decision to transfer the coal to KU, played a major role in WKE s purchase.[34]

When making the purchase from WKE, KU failed to comply with regulatory requirements regarding affiliated fuel transactions. 807 KAR 5:056, Section 1(7),[35] required KU to provide a written notice and explanation of the transaction and all related transaction documents. While such information had previously been provided to the

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[33] Memorandum of Mark McAdams, Manager of Fuel Strategy and Procurement for WKE, to Contract File (June 11, 2001).

[34] WKE at least indirectly benefited from its role in these transactions. While KU s ratepayers ultimately bore the risk of the transaction when the coal was transferred to KU, WKE, as an affiliate of KU, would benefit as the message sent to coal suppliers regarding foreign coal would be sent not only to KU s potential suppliers but also to WKE s suppliers.

[35] 807 KAR 5:056, Section 1(7), provides in part:

> At the time the fuel clause is initially filed, the utility shall submit copies of each fossil fuel purchase contract not otherwise on file with the commission and all other agreements, options or similar such documents, and all amendments and modifications thereof related to the procurement of fuel supply and purchased power. Incorporation by reference is permissible. Any changes in the documents, including price escalations, or any new agreements entered into after the initial submission, shall be submitted at the time they are entered into. Where fuel is purchased from utility-owned or controlled sources, or the contract contains a price escalation clause, those facts shall be noted and the utility shall explain and justify them in writing.

Commission when LG&E purchased coal from WKE, KU did not comply with this requirement.[36] While KU s failure to comply with this requirement is not alone sufficient to render the transaction unreasonable, this failure, when considered with KU s other actions, raises substantial questions about the reasonableness of the transaction that KU has failed to adequately address.

Lacking insufficient evidence to find that KU s purchase of the WKE coal was reasonable, the Commission must determine the appropriate level of fuel costs that KU should be permitted to recover through its FAC. We find that, for purposes of determining the amount of reasonable fuel costs, our focus should be on market prices when KU should have sought supplemental supplies of compliance coal and actual market prices when KU purchased compliance quality coal from WKE. Given the circumstances existing in the coal industry during the period from early to mid-2001, we find that a range of prices should be considered as representative of the market and that a price range from $46.54, the adjusted EKPC price, to $55.92, the price in the Aquila bid, should be used to determine the appropriate disallowance of unreasonable fuel costs.

Given the circumstances at the time, the tonnage purchased by KU from WKE, the tonnage offered by Aquila, and the fact that the Aquila price reflects one of the bids received by KU, the Commission will give primary consideration to the Aquila price and the tonnage offered in its bid. Therefore, a portion of the disallowance will be based on the purchase of 60,000 tons, the level offered by Aquila, at Aquila s price versus the price KU paid to WKE. The remainder of the disallowance, derived from the remaining

[36] KU s backup filing in support of its monthly FAC report noted the purchases, but provided no explanation of it.

tonnage purchased from WKE (41,920 tons), is based on the adjusted EKPC price of $46.54 per ton versus the WKE price of $58.37per ton. The resulting total disallowance of unreasonable fuel costs incurred by KU equals $673,000.[37]

KU s Current Fuel Procurement Structure

This proceeding has highlighted significant problems in KU s fuel procurement structure. As currently designed, significant fuel procurement authority for LG&E Energy s regulated and non-regulated operations is vested in the same person. As clearly demonstrated by the case at bar, this combination represents a threat to the integrity of KU s fuel procurement process. Clearly, LG&E Energy officials had serious concerns about the under-deliveries of compliance coal to KU s Ghent Station. LG&E Energy s non-regulated operations viewed KU s potential coal delivery problems as a possible means of limiting its own exposure when experimenting with the purchases of foreign coal. Transfers or sales of this coal from WKE to the regulated utilities were considered as a possible alternative. The presence of these supplies along with LG&E Energy s desire to send a signal to suppliers may have led these officials to be less than fully diligent in their efforts to secure a supply of eastern U.S. compliance coal. Moreover, KU s failure to fully document the transaction and to provide notice and explanation of the transaction, as 807 KAR 5:056 requires, further undermines the integrity of KU s fuel procurement practices. While we are encouraged that KU has implemented revised fuel procurement policies and procedures that address affiliate purchases and has agreed to provide more prominent notice of affiliate purchases in the

[37] $177,000 + (41,920 X ($58.37 - $46.54)) = $672,914.

future, the Commission finds that the issues raised in this proceeding call for a broader review of KU s fuel procurement activities.

With conditions changing in both the electric utility and coal industries, and recognizing the organizational changes that have occurred within LG&E Energy and its utility subsidiaries in recent years, and particularly with the current organizational structure giving one individual the authority to effect decisions resulting in the transfer of coal between non-regulated and regulated operations, we find that a focused management audit of KU s electric fuel procurement function and structure is necessary. Given the joint nature of KU s and LG&E s fuel procurement functions and their tight integration within LG&E Energy s fuel procurement activities, we find that this audit should also focus on the fuel procurement function and structure of LG&E and LG&E Energy. We further find that KU should bear the cost of such audit and that KU s recovery of such costs through its rates should be made pursuant to KRS 278.255.

SUMMARY

Having considered the evidence of record and being otherwise sufficiently advised, the Commission finds that:

1. In light of the under-deliveries of eastern U.S. compliance coal that KU experienced beginning in mid-2000 and continuing until June 2001, KU failed to act in a reasonable manner by not seeking additional supplies of such coal prior to June 2001.

2. KU has failed to demonstrate that its purchase of approximately 102,000 tons of compliance quality coal at a price of $58.37 per ton from July through October 2001 was reasonable.

3. After purchasing the 102,000 tons of compliance quality coal from WKE, KU failed to comply with 807 KAR 5:056, Section 1(7), by failing to provide to the Commission adequate written notice and explanation of the purchase.

4. As a result of its failure to exercise reasonable fuel procurement practices, KU incurred $673,000 of unreasonable fuel costs during the period under review.[38] Upon filing its monthly fuel adjustment to be applied to bills rendered in the month of March 2003 and for each of the 3 months thereafter, KU should, in calculating its monthly fuel cost, reduce actual monthly fuel cost by $168,250 to reflect unreasonable fuel costs incurred as a result of its purchase of imported compliance coal from WKE.

5. A competent, qualified and independent firm should be retained to perform a focused audit of the operational and managerial aspects of KU s fuel procurement functions, including the organizational structure of KU s fuel procurement management with the cost of such audit borne by KU.

IT IS THEREFORE ORDERED that:

1. Upon filing its monthly fuel adjustment to be applied to bills rendered in the month of March 2003 and for each of the 3 months thereafter, KU shall, in calculating its monthly fuel cost, reduce actual monthly fuel cost by $168,250 to reflect unreasonable fuel costs incurred as a result of its purchase of imported compliance coal from WKE.

2. A competent, qualified and independent firm shall be retained to perform a focused audit of the operational and managerial aspects of KU s fuel procurement functions, including the organizational structure of KU s fuel procurement management.

[38] This finding refers only to the reasonableness of fuel charges recovered through KU s FAC and is based upon generally accepted rate-making principles. Our finding should not be interpreted or construed as a measure of KU s ability to mitigate its damages from any breach of contractual obligations by any KU fuel supplier.

Done at Frankfort, Kentucky, this 28th day of January, 2003.

By the Commission

OPINION OF MARTIN J. HUELSMANN
DISSENTING IN PART AND CONCURRING IN PART

The question directly before us is whether KU acted reasonably when it purchased imported coal from an unregulated affiliate. In order to answer that question, it is necessary to review the coal and electricity industries. These two industries are extremely important to Kentucky s economic development.

KU currently has the lowest price of electricity in the United States and one of the lowest prices worldwide. KU s average per kWh rates of $.043 for residential, $.041 for commercial, and $.032 for industrial provide the most important factor for economic development for Kentucky. These low rates make it extremely attractive for industry to locate and stay in Kentucky.

The coal industry is also very important in Kentucky. The industry employs over 14,000 workers and paid over $678 million in direct wages in 2001. In 2000, 131.8 tons of coal were produced in Kentucky. Kentucky has two distinct coalfields Western and Eastern.

The coal industry sells coal to 27 states and 11 foreign countries, which brought to Kentucky coal companies $2.5 billion. These Kentucky coal companies paid $141.2 million in severance taxes.[1] (See Attachments A, B, and C.)

The value of the electricity industry to Kentucky is comparable to that of with the coal industry. In 2001, the electric utilities had a combined income of $170 million and employed 3,500 people.

Without the good independent work of these two valuable industries, Kentucky could not boast about the lowest electricity rates in the U.S. There can be no doubt that the coal and electricity industries have from time to time had conflicts. The coal industry naturally wants the highest price it can get for coal. The electricity industry wants the cheapest coal it can get to sell electricity to its customers at a fair and low rate.

The coal industry wants long-term contracts when the price of coal is high. The utilities want long-term contracts when the price of coal is low. There has been in the past, and will be in the future, friction between the industries. We at the Commission determine what is a fair, just and reasonable rate for electricity. It is with these underlying interests that we must make our decision.

Here, we review whether a coal purchase was reasonable; but the standard should not be predicated upon an abstraction i.e., whether a reasonable hypothetical utility would have made the purchase under the same or like circumstances. In my opinion, the application of the fuel adjustment clause should be based upon a subjective standard. In other words, the finder of fact should determine whether the

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[1] The Kentucky Coal Council and the Kentucky Coal Association each year publishes an extremely informative publication entitled Kentucky Coal Facts.

purchase in question was reasonable by placing himself in the shoes of the coal purchaser at the time the purchase was made.

The record reflects that KU had long-term contracts with five coal producers: Asset Management Group, Arch Coal Sales Co., Inc., Ceredo Synfuel, LLC, AEI Coal Sales Company, Inc., and Black Hawk Synfuel, LLC.

The record clearly shows non-deliveries of 427,554 tons of coal contracted for from July through December 2000. During the five-month period January through May 2001, there were 484,339 non-deliveries that were contracted to be delivered, or a total of 911,893 tons. (See Attachments D and E.)

During this period of time KU met with each vendor, visited the mine sites and listened to the reasons why the coal could not be delivered on time. Sometimes the coal companies sought exceptions; sometimes they asked for a price increase over the price at which they had agreed to sell the coal. With the federal bankruptcy court providing a ready escape hatch for the vendor, KU had no choice but to try to work with the vendor for timely delivery. [2]

The period from January to May 2001 was the coldest winter in Kentucky history. Surely, this factor concerned Mr. Cantrell as the next winter was quickly approaching. Would this winter be the same? If so, was there enough coal for the winter? Was there enough coal for air conditioners if July and August (high burn period) were hot? Those operating the Ghent facility needed to be sure there was an adequate supply of coal (i.e., 60 days worth).

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[2] In fact, one vender AEI subsequently filed bankruptcy after KU sued them in the Jefferson Circuit Court for the non-deliveries.

On June 15, 2001, KU performed an inventory assessment and determined that 330,000 tons of compliance coal would be needed to get to the end of the fiscal year. On June 20, 2001, KU issued an RFP for coal to be purchased on the spot market. The solicitation was sent to 29 coal suppliers and published in two coal industry publications. The response was due June 27, 2001.

Only thirteen responses were received. The nine current suppliers of coal to KU did not respond. KU must have been extremely concerned. With no current suppliers listed it had to wonder if it would receive any coal in the future from its existing coal suppliers. Would the companies simply renege? Was this a coal industry stance? Would all the present companies do what AEI did? Would they, too, say they would deliver at $5.00 more a ton? Or $10.00? or $15.00?

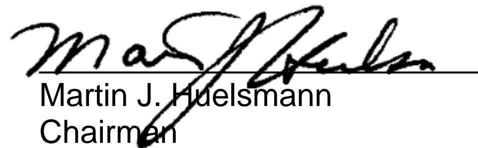
When KU evaluated the bids it found that the bids received had problems. The problems included, but were not limited to, subject and prior sale, quality and delivery issues, lack of any source of coal (Enron Global Market). Thus, there were no reasonable bids for KU to accept.

KU and AEI were parties to this case. No evidence was presented by either of them as to the unreasonableness of KU looking elsewhere and purchasing the coal at issue in this proceeding.

In my opinion, we cannot look back to March of 2001 and say KU was unreasonable in not trying to negotiate further with coal suppliers. The fact that EKPC purchased coal in March of 2001 is irrelevant. We must look back at all the factors that KU faced at that time to see if it acted reasonably.

It is for these reasons that I would not disallow any of the costs of KU s purchase of the coal at issue in this case.

I am, however, extremely concerned that KU purchased coal from a non-regulated affiliate. There must be a separation of some functions between regulated and unregulated companies. In my opinion, the purchase of coal for regulated and nonregulated affiliated entities <u>must</u> be made by two different people with complete separation. In short, Mr. Cantrell should never have been in the position of purchasing coal for both regulated and unregulated producers of electricity in Kentucky; therefore, I concur with the majority s decision to order a focused management audit.



Martin J. Huelsmann
Chairman

ATTEST:

Executive Director

Attachment A

Top 10 Coal Producers in Kentucky Tons Produced in 2001 by State (000's)																
Mine Controlling Co.	**KY**	**TN**	**VA**	**WV**	**CO**	**IL**	**WY**	**IN**	**MD**	**UT**	**OH**	**PA**	**AZ**	**NM**	**MT**	**Total**
A.T. Massey Coal	11,001		552	33,263												44,816
Horizon Natural Resources	19,300			13,820	5,389	4,709		4,241								47,459
AEP KY Coal	6,399															6,399
Alliance Coal	11,505					1,889		1,666	2,684							17,744
Consol Energy	5,675		7,051	23,660		1,951					5,414	27,129				70,880
Cumberland Resources	3,491		1,814													5,305
James River Coal	10,360															10,360
Lodestar Energy	5,226			335	323					537						6,421
Peabody Group	7,746			14,666	1,706	1,033	101,873	18,970					13,418	6,041	2,592	168,045
TECO Energy	5,109	261	411													5,781
Totals	85,812	261	9,828	85,744	7,418	9,582	101,873	24,877	2,684	537	5,414	27,129	13,418	6,041	2,592	383,210
Source: RDI COALdat																

Attachment B

Markets for Coal Produced in Kentucky – 2001				
Plant Operator	Western KY	Eastern KY	Total Tons (000)	Cumulative Percent of Total
Tennessee Valley Authority	14,073	6,163	20,236	18%
Georgia Power Co.	---	15,115	15,115	31%
LG&E Energy	9,628	2,884	12,512	43%
Duke Energy Corp.	---	7,551	7,551	49%
South Carolina Public Service Authority	---	7,548	7,548	56%
Carolina Power & Light Co.	---	5,212	5,212	61%
Cincinnati Gas & Electric Co.	8	3,464	3,472	64%
Dominion Virginia Power	---	3,182	3,182	67%
Kentucky Power Co.	---	3,048	3,048	69%
South Carolina Electric & Gas Co.	---	3,015	3,015	72%
Florida Power Corp.	---	2,944	2,944	75%
East KY Power Coop, Inc.	---	2,849	2,849	77%
Detroit Edison Co.	---	2,771	2,771	80%
Orlando Utilities Comm.	---	2,544	2,544	82%
Seminole Electric Coop, Inc.	2,049	245	2,294	84%
Dayton Power & Light Co.	---	2,258	2,258	86%
South Carolina Generating Co., Inc.	---	1,579	1,579	87%
Tampa Electric Co.	998	379	1,377	89%
Sub Total	**26,756**	**72,751**	**99,507**	
Total KY Market	**28,205**	**84,228**	**112,433**	
Source: RDI COALdat				

Attachment C

15 Largest U.S. Coal Producers Tons (000) Produced in 2001							
Company	Western Low Sulfur	Eastern & Mid-Cont (excludes Ill-Basin and KY)	Illinois Basin	Western KY	Eastern KY	Total Tons (000)	Cumulative Percent of Total
Peabody Group	125,630	14,666	20,003	7,746	---	168,045	15%
Arch Coal	86,154	27,493	---	---	2,814	116,461	25%
Kennecott Energy & Coal	110,548	---	---	---	---	110,548	35%
Consol Energy	---	63,254	1,951	---	5,675	70,880	41%
RAG	44,290	19,378	1,463	---	---	65,131	47%
Horizon Natural Resources	5,389	13,820	8,950	---	19,300	47,459	51%
Vulcan Partners	43,049	---	---	---	---	43,049	55%
A.T. Massey Coal	---	33,815	---	---	11,001	44,816	59%
North American Coal	23,480	3,248	---	---	---	26,728	62%
TXU Corporation	---	22,814	---	---	---	22,814	64%
Westmoreland Mining	14,666	7,386	---	---	---	22,052	66%
Robert Murray	---	8,697	7,009	2,278	---	17,984	67%
Alliance Coal	---	2,684	3,555	8,569	2,936	17,744	69%
Pittsburg & Midway Coal	11,302	3,230	---	---	---	14,532	70%
BHP Minerals	15,643	---	---	---	---	15,643	71%
Top 15 Total	**480,251**	**220,485**	**42,931**	**18,493**	**41,726**	**803,886**	
U.S. Total	**546,366**	**349,725**	**96,558**	**25,477**	**108,304**	**1,126,430**	
SOURCE: RDI COALdat November 2002 (Data revised periodically)							

Attachment D

Kentucky Utilities Company
Tonnage Shortfall / July - December 2000

Vendor Month	Tonnage Commitment	Tons Received	Over (Under)
AEI (KUF00755)			
July 2000	40,000	12,672	(27,328)
August	40,000	24,926	(15,074)
September	40,000	9,367	(30,633)
October	50,000	29,234	(20,766)
November	50,000	18,691	(31,309)
December	50,000	15,241	(34,759)
Cumulative Net			(159,869)
L & K (KUF98653)			
July 2000	18,750	15,483	(3,267)
August	18,750	12,395	(6,355)
September	18,750	6,362	(12,388)
October	25,000	7,736	(17,264)
November	25,000	9,131	(15,869)
December	25,000	7,607	(17,393)
Cumulative Net			(72,536)
Pen Coal (KUF99679)			
July 2000	37,500	12,409	(25,091)
August	37,500	34,391	(3,109)
September	37,500	15,766	(21,734)
October	37,500	25,023	(12,477)
November	37,500	27,854	(9,646)
December	37,500	23,536	(13,964)
Cumulative Net			(86,021)
Massey Coal (KUF99710)			
Ceredo (KUF00773)			
July 2000	60,000	60,077	77
August	60,000	49,679	(10,321)
September	60,000	24,159	(35,841)
October	60,000	42,831	(17,169)
November	60,000	44,348	(15,652)
December	60,000	29,778	(30,222)
Cumulative Net			(109,128)
Total Cumulative Net Tonnage Shortfall July - December 2000			(427,554)

Attachment E

Kentucky Utilities Company
Tonnage Shortfall / January - May 2001

Vendor Month	Tonnage Commitment	Tons Received	Over (Under)
AEI (KUF00755)			
January 2001	50,000	9,251	(40,749)
February	50,000	16,904	(33,096)
March	50,000	34,836	(15,164)
April	50,000	42,395	(7,605)
May	50,000	6,227	(43,773)
Cumulative Net			(140,387)
L & K (KUF98653)			
January 2001	25,000	24,463	(537)
February	25,000	10,632	(14,368)
March	25,000	16,867	(8,133)
April	-	6,051	6,051
May	-	4,597	4,597
Cumulative Net			(12,390)
Pen Coal (KUF99679)			
January 2001	64,137	49,653	(14,484)
February	64,137	32,752	(31,385)
March	64,137	63,913	(224)
April	64,137	46,502	(17,635)
May	-	-	0
Cumulative Net			(63,728)
Massey Coal (KUF99710) **Ceredo (KUF00773)**			
January 2001	41,000	29,134	(11,866)
February	41,000	14,836	(26,164)
March	41,000	29,748	(11,252)
April	-	15,872	15,872
May	-	14,492	14,492
Cumulative Net			(18,918)
Black Hawk (KUF99728) **Direct Coal**			
January 2001	31,250	14,659	(16,591)
February	31,250	13,171	(18,079)
March	31,250	22,022	(9,228)
April	25,000	23,555	(1,445)
May	25,000	20,809	(4,191)
Cumulative Net			(49,534)
AMG (KUF00775) **Ceredo (KUF01864)**			
January 2001	35,000	15,925	(19,075)
February	35,000	9,502	(25,498)
March	35,000	41,447	6,447
April	35,000	24,229	(10,771)
May	35,000	21,237	(13,763)
Cumulative Net			(62,660)
Arch (KUF01777) **Black Hawk (KUF01832)** **Ceredo (KUF01833)**			
January 2001	75,000	15,163	(59,837)
February	75,000	18,467	(56,533)
March	75,000	70,318	(4,682)
April	75,000	116,635	41,635
May	75,000	89,478	14,478
Cumulative Net			(64,939)
Massey Coal (KUF01776) **Ceredo (KUF01840)** **Sandy River (KUF01863)**			
May	33,333	-	(33,333)
Cumulative Net			(33,333)
AMG (KUF01830)			
April	38,333	3,271	(35,062)
May	38,333	34,945	(3,388)
Cumulative Net			(38,450)
[illegible]			[illegible]