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**VIA OVERNIGHT MAIL**

CINERGY.

November 18, 2003

Mr. Thomas Dorman
Executive Director,
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615



Re: Case No. 2003-00252

Dear Mr. Dorman:

Please find enclosed an original and twelve (12) copies of the Brief of The Union Light, Heat and Power Company for filing in the above-captioned case. Please return two (2) file-stamped copies of the brief to me in the enclosed overnight mail envelope.

Should you have any questions, please feel free to contact me at (513) 287-3075.

Sincerely,

Michael J. Pahutski/mak

Michael J. Pahutski

MJP/mak

Enclosures

**COMMONWEALTH OF KENTUCKY**

**BEFORE THE PUBLIC SERVICE COMMISSION**

| | | |
|---|---|---|
| In the Matter of the Application of The Union Light, Heat and Power Company for a Certificate of Public Convenience and Necessity to Acquire Certain Generation Resources and Related Property; for Approval of Certain Purchase Power Agreements; for Approval of Certain Accounting Treatment; and for Approval of Deviation from Requirements of KRS 278.2207 and 278.2213(6) | ) | Case No. 2003-00252 |



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**BRIEF OF**

**THE UNION LIGHT, HEAT AND POWER COMPANY**

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The Union Light, Heat and Power Company (ULH&P) respectfully submits its Brief in the above-captioned proceeding.

Respectfully submitted,

THE UNION LIGHT, HEAT AND POWER COMPANY

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**COMMONWEALTH OF KENTUCKY**

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**BRIEF OF**

**THE UNION LIGHT, HEAT AND POWER COMPANY**

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## I. OVERVIEW OF CASE

### *A. Summary of requested relief*

On July 21, 2003, The Union Light, Heat and Power Company (ULH&P) filed an application for an Order pursuant to KY. REV. STAT. ANN. § 278.020 and 807 KY. ADMIN. REGS. 5:001 Sections 8 and 9 granting ULH&P a Certificate of Public Convenience and Necessity (CPCN) to acquire, at net book value plus transaction costs, ownership of three electric generating station facilities, the East Bend Generating Station (East Bend), Miami Fort Unit 6 (Miami Fort 6), and the Woodsdale Generating Station (Woodsdale) (collectively, the Plants), and related property from The Cincinnati Gas & Electric Company (CG&E), ULH&P's parent company (Application). Additionally, ULH&P requested approval of certain purchase power agreements with CG&E, authority to establish accounting deferrals for the recovery of transaction costs related to the

acquisition by ULH&P of the Plants, and retention of profits related to off-system sales from the Plants. In accordance with KY. REV. STAT. ANN. § 278.2219, ULH&P also requested a deviation from the requirements of KY. REV. STAT. ANN. § 278.2207 and KY. REV. STAT. ANN. §278.2213(6) to allow ULH&P to become the assignee of certain affiliate contracts related to the operation of the Plants. Finally, ULH&P requested approval to terminate the current Power Sale Agreement with CG&E concurrent with its acquisition of the Plants and to continue to freeze its generation, fuel and wholesale transmission rates through 2006. On October 29, ULH&P amended this Application, modifying the relief that it sought from the Commission (Amendment; together with its Amendment, ULH&P shall refer to its Application hereinafter as its Amended Application).

### *B. Impetus for ULH&P's Application*

ULH&P filed its Amended Application in direct response to the Commission's directive in Case No. 2001-00058.[1] In Case 2001-00058, the Commission required that ULH&P perform a "detailed analysis of constructing generation to lock in prices for the long term ... (and to) ensure that the northern Kentucky areas served by ULH&P have an assured long-term power supply at the lowest reasonable cost."[2] The Commission reinforced this directive in its Order in Administrative Case No. 387, where it stated, "While (ULH&P) has committed to filing a stand-alone IRP in 2004, the Commission

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[1] *See* Direct Testimony of Greg C. Ficke (hereinafter Ficke) at 10.

[2] *See In the Matter of The Application of The Union Light, Heat and Power Company for Certain Findings Under 15 U.S.C.§79Z*, Case No. 2001-00058 at 14 (Order dated May 11, 2001).

anticipates initiating a review of ULH&P's long-term power supply requirements at some earlier date" and "(t)he resource plans of ... ULH&P do not adequately address the need to provide reliable service at reasonable costs beyond the terms of their respective wholesale power contracts that expire over the next 3 to 5 years."[3]

In these Orders, the Commission recognized the risks imposed on retail customers from the volatility of the wholesale marketplace. As supported by the testimony of ULH&P's witness Mr. Turner, ownership of generating assets by regulated electric utilities is more important now than at any other time in history, providing a measure of certainty and stability for regulated utilities that simply cannot be achieved through substantial or total reliance on purchases of power in the wholesale market.[4] Both in the near term and over the long run, reduced dependence on the wholesale market is the best way to ensure a reliable and adequate supply of electricity at stable prices for ULH&P's end use customers.[5]

### *C. ULH&P's due diligence*

ULH&P's development of the proposed transaction was in direct response to the Commission's directive in Case No. 2001-00058 and Administrative Case No. 387, as described above. With that directive in mind, ULH&P considered viable options for

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[3] *See In the Matter of a Review of the Adequacy of Kentucky's Generation Capacity and Transmission System,* Administrative Case No. 387 (Order dated December 20, 2001).

[4] *See* Direct Testimony of James L. Turner (hereinafter Turner) at 4.

[5] *Id.*

securing electric generation for its customers at stable prices over the long term.[6] ULH&P analyzed the predicted market prices of wholesale power and the costs of constructing new generation to meet its needs, and also explored many alternative arrangements, including transferring various combinations of generating plants from CG&E to ULH&P.[7]

ULH&P's original Application in this proceeding requested approval to acquire "iron in the ground" in the form of low-cost, proven, reliable generating plants, directly interconnected to the Cinergy joint transmission system, and well-suited to neatly fill ULH&P's full load requirements, as well as provide optionality for future growth.[8] Subject to receiving certain regulatory commitments from the Commission, ULH&P proposes acquiring base load, intermediate and peaking capacity at original cost less accumulated depreciation (*i.e.* net book value), which is more than $600 million less, in terms of present value revenue requirement, than a full-requirements purchase power arrangement, and more than $700 million less than the cost of new construction.[9] ULH&P proposes to continue to jointly dispatch the Plants with the remainder of the Cinergy system, and proposes obtaining firm back-up power from its parent, CG&E, at

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[6] *See* Ficke at 10.

[7] *Id.*

[8] *See generally* Application and supporting testimony.

[9] *Id.*

today's market prices.[10] Further, ULH&P has re-committed to its current generation, fuel and wholesale transmission related rate freeze through 2006.[11]

CG&E and Cinergy conditioned the availability of the Plants under the above terms on receiving certain regulatory commitments, primary of which were ULH&P's retention of all profits from off-system sales from the Plants, and present Commission approval for ULH&P to transfer the Plants back to CG&E should ULH&P not receive the ratemaking treatment ULH&P requested.[12]

### *D. ULH&P sweetens the deal*

Prior to hearing and subsequent to discovery by the Attorney General's Office of Rate Intervention (AG) and the Commission Staff, ULH&P amended its request. ULH&P's Amendment to the Application: (1) removed the requirement for present Commission approval to transfer the Plants back to CG&E if ULH&P was not afforded the requested ratemaking treatment; (2) committed up to the first $1 million in annual off-system sales profit to its customers, with additional profit, if any, shared equally between its customers and the Company; and (3) capped transaction costs at 50% of the estimated amount.[13]

### *E. Intervenor's position*

The AG, the only other party to the proceeding, took the following positions regarding ULH&P's Amended Application: (1) an RFP should be issued to further test

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[10] *Id.*

[11] *See* Ficke at 6.

[12] *See generally* Application and supporting testimony.

[13] *See generally* Amendment to the Application.

the cost effectiveness of the offer; and (2) deferred tax-related balances accrued by CG&E when the Plants were operated as regulated facilities should inure to the benefit of ULH&P's customers. However, as detailed herein, these propositions are supported by neither the record in this proceeding nor the law. Adoption of either of the AG's positions would render the transaction infeasible, and cause CG&E to withdraw its offer to transfer these Plants to ULH&P.

## II. RELIEF REQUESTED

In its Amended Application, ULH&P has requested the Commission to:

a. Grant ULH&P a CPCN, pursuant to KY. REV. STAT. ANN. § 278.020, and otherwise grant all necessary approvals for the acquisition of the Plants at original cost less accumulated depreciation;

b. Fix the value of the Plants for ratemaking purposes at the original cost less accumulated depreciation, in accordance with the Commission's authority granted by KY. REV. STAT. ANN. § 278.290;

c. Approve ULH&P's request for authorization to defer no more than $2.45 million of transaction costs incurred, without carrying charges, with such recovery to be amortized over five years beginning on the effective date of the Commission's Order in ULH&P's next general rate proceeding;

d. Approve certain wholesale power agreements with CG&E to provide firm back-up service to East Bend and Miami Fort 6 during periods of maintenance or forced outages (Back-up Power Sale Agreement (Back-up PSA)) and to provide for joint economic dispatch of the Plants (Purchase Sale and Operations Agreement (PSOA));

e. Grant ULH&P a waiver, in accordance with KY. REV. STAT. ANN. § 278.2219, from the requirements of KY. REV. STAT. ANN. § 278.2213(6) that its acquisition of the Plants from its affiliate, CG&E, be an arm's length arrangement;

f. Grant ULH&P a deviation, pursuant to KY. REV. STAT. ANN. § 278.2207, for certain affiliate agreements;

g. Grant ULH&P authorization to terminate its current Power Sale Agreement with CG&E effective on the closing date of the transfer of the Plants to ULH&P;

h. Find that the inclusion in base rates of the monthly capacity charges specified in the Back-up PSA, and reasonable capacity charges specified in successor back-up power supply agreements as approved by the Federal Energy Regulatory Commission (FERC) is just and reasonable; and approve such treatment of said capacity charges;

i. Find that the recovery and inclusion in ULH&P's fuel adjustment clause (FAC) of the energy charges assessed under the Back-up PSA, on a going forward basis from the date that ULH&P's next FAC on or after January 1, 2007 goes into effect, in accordance with 807 KY. ADMIN. REGS. 5:056 and applicable Commission precedent is just and reasonable; and approve such treatment of said energy charges;

j. Find that the recovery and inclusion in ULH&P's FAC of all costs of energy transfers from CG&E assessed under the PSOA, on a going forward basis from the date that ULH&P's next FAC on or after January 1,

2007 goes into effect, in accordance with 807 KY. ADMIN. REGS. 5:056 and applicable Commission precedent, is just and reasonable; and approve such treatment of said costs of energy transfers;

k. Find that the inclusion of the costs of all fuel consumed in the Plants in ULH&P's FAC from the date that ULH&P's next FAC on or after January 1, 2007 goes into effect, in accordance with 807 KY. ADMIN. REGS. 5:056 and applicable Commission precedent, is just and reasonable; and approve such treatment of said fuel costs;

l. Find in the present proceeding that ULH&P's request to retain 50% of the profits from off-system sales of energy from the Plants above $1 million annually is just and reasonable; and render a finding that the Commission sees no reason why such treatment should not be approved in ULH&P's next general rate proceeding;

m. Find that ULH&P's request for a waiver of the Commission's requirement, as set forth in Case No. 2001-00058, for ULH&P to analyze bids for purchased power in its stand-alone integrated resource plan (IRP) filed by June 30, 2004, is just and reasonable, and approve such request.

As consideration for the relief it has requested, ULH&P has made several commitments. First, ULH&P stands by its commitment to continue to freeze generation, fuel and wholesale transmission-related retail rates through December 31, 2006.[14] Second, ULH&P commits that it will not seek implementation of an environmental

[14] *See* Ficke at 6.

surcharge through the pendency of this rate freeze.[15] Third, ULH&P commits to submit to the Commission for approval all transaction documents related to ULH&P's acquisition of the Plants prior to closing the transaction.[16] It is ULH&P's intention that this transaction be fully transparent and open for complete review by the Commission in a timely manner.

## III. PROCEDURAL POSTURE

ULH&P filed its Application, supported by the pre-filed Direct Testimony of eleven witnesses, with the Commission on July 21, 2003, opening this docket. On July 25, 2003, the AG filed a motion for full intervention in this proceeding. On July 29, 2003, the Commission granted the AG's motion for full intervention. On August 8, 2003, the Commission issued a procedural schedule in this proceeding, calling for two rounds of discovery to be served on ULH&P, the filing of testimony by opposing parties, and a round of discovery to be served by ULH&P. On August 20, 2003, the Commission revised its procedural schedule, setting this matter for hearing on October 29, 2003.

On August 21, 2003, ULH&P was served the Commission Staff's (Staff) first set of discovery, consisting of 181 distinct requests/subparts, as well as the AG's first set of discovery, consisting of 201 distinct requests/subparts. On September 2, 2003, ULH&P provided responses to these discovery requests.

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[15] *See* Response of The Union Light, Heat and Power Company to First Set of Staff Interrogatories, No. 54(f).

[16] *See* Amendment to Application at 5.

On September 10, 2003, ULH&P was served the Staff's second set of discovery, consisting of 118 distinct requests/subparts, as well as the AG's second set of discovery, consisting of 97 distinct requests/subparts. On September 17, 2003, ULH&P provided responses to these discovery requests.

On September 26, 2003, the AG filed testimony of three witnesses. On October 6, 2003 ULH&P served the AG with a set of data requests focused on these witnesses' testimony. On October 6, 2003, the Staff also served the AG with discovery regarding these witnesses' testimony. On October 17, 2003, the AG provided responses to ULH&P's and the Staff's data requests.

On October 29, 2003, ULH&P filed an Amendment to its Application.[17] In summary, this Amendment reduced the extent of the relief sought by ULH&P to that described above. As described by ULH&P witness Mr. Turner at hearing, the purpose of the Amendment was to refine the proposed transaction to further clarify and enhance the benefits for ULH&P's customers.[18]

A hearing on ULH&P's Amended Application was held on October 29 and 30, 2003 at the offices of the Commission in Frankfort, Kentucky. At the hearing, nine of ULH&P's witnesses were cross-examined by the AG and the Staff, while the three AG witnesses were cross-examined by ULH&P and the Staff.

Several data requests were raised at hearing. ULH&P filed responses to these data requests on November 7, 2003.

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[17] *See Amendment to Application* filed by ULH&P, October 29, 2003.

[18] *See* Trans. Vol. I at 16.

## IV. SUMMARY OF TESTIMONY

ULH&P supported its Application with the pre-filed testimony of eleven witnesses:

Greg C. Ficke, President of ULH&P and CG&E, provided context for ULH&P's Application, and well as summarized the filing and the testimony of the remaining witnesses.[19]

Mr. James L. Turner, Executive Vice President of Cinergy Corp. (Cinergy) and Chief Executive Officer of Cinergy's Regulated Business Unit, provided a view of the current energy industry outlook, and described certain conditions that Cinergy requires must be met before it can allow the Plants to be transferred to ULH&P.[20]

Dr. Richard G. Stevie, General Manager of Cinergy's Market Analysis group, sponsored ULH&P's load forecast, and discussed ULH&P's demand side management efforts as well as other efforts of the Company to encourage customers to reduce energy demands during peak load periods.[21]

Mr. M. Stephen Harkness, Vice President of Cinergy Corp. and Chief Operations and Financial Officer of Cinergy's Energy Merchant Business Unit,[22] adopted the pre-

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[19] *See generally* Ficke.

[20] *See generally* Turner.

[21] *See generally* Direct Testimony of Dr. Richard G. Stevie (hereinafter Stevie).

[22] Note that on October 31, 2003, Cinergy Corp. announced a reorganization of its management personnel, effective November 1, 2003. Some of the ULH&P witnesses referenced herein now have new job titles and responsibilities. Additionally, the *Energy Merchant Business Unit* has been renamed the *Commercial Business Unit*. This Brief will continue to reference ULH&P's witnesses in accordance with their job responsibilities at the time their testimony was submitted into the record, and will continue to reference the Energy Merchant Business Unit.

filed Direct Testimony of Mr. Robert C. McCarthy, describing in detail the Back-up PSA, and also explaining the PSOA and the joint economic dispatch of Cinergy's generation fleet.[23] Mr. Harkness also discussed off-system sales, and the need, or lack thereof, for issuing a request for proposal.

Mr. John J. Roebel, Vice President of Cinergy's Generation Resource Group, testified regarding the history, condition, operation and maintenance of the Plants and discussed the two affiliate agreements to be assigned to ULH&P.[24] Mr. Roebel also provided testimony regarding the costs of new generation construction, as well as projected operation and maintenance costs.[25]

Mr. H. Davis Ege, a Principal Mechanical Technical Specialist/Consultant with Burns & McDonnell Engineering Co., Inc. (Burns and McDonnell), opined on the condition of the Plants and how they have been operated and maintained by CG&E over the years, based on his personal examination of the Plants.[26]

Mr. J. Thomas Mason, Vice President of Cinergy's Fuels Origination group, provided testimony on the East Bend and Miami Fort 6 coal supply and origination of coal contracts.[27]

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[23] *See generally* Direct Testimony of Robert C. McCarthy, as adopted by M. Stephen Harkness (hereinafter Harkness).

[24] *See generally* Direct Testimony of John J. Roebel (hereinafter Roebel).

[25] *Id.*

[26] *See generally* Direct Testimony of H. Davis Ege (hereinafter Ege).

[27] *See generally* Direct Testimony of J. Thomas Mason (hereinafter Mason).

Mr. Ronald C. Snead, Manager of Cinergy's Bulk Transmission Planning group, discussed the transmission of power from the Plants to ULH&P's distribution system, and also discussed transmission as it relates to the wholesale power agreements as well as the issue of transmission constraints.[28]

Mr. Judah L. Rose, Managing Director of ICF Consulting, testified regarding projected market prices for wholesale power, the effects of potential environmental legislation and regulation on market prices, the projected price for natural gas, and the potential market value of the Plants.[29]

Ms. Diane L. Jenner, Manager of Cinergy's Asset Planning and Analysis group, provided testimony regarding the least cost alternative means for providing ULH&P's customers a long-term, stable supply of electric generation.[30]

Finally, Mr. John P. Steffen, Vice President of Cinergy's Rate Department, testified to the estimated effect that this proposal would have on retail rates paid by ULH&P's customers, and supported the net book value of the Plants and estimated transaction costs.[31] Mr. Steffen also supported ULH&P's position on the recording of transferred accumulated deferred income tax (ADIT) and accumulated deferred investment tax credit (ADITC).[32]

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[28] *See generally* Direct Testimony of Ronald C. Snead (hereinafter Snead).

[29] *See generally* Direct Testimony of Judah L. Rose (hereinafter Rose).

[30] *See generally* Direct Testimony of Diane L. Jenner (hereinafter Jenner).

[31] *See generally* Direct Testimony of John P. Steffen (hereinafter Steffen).

[32] *Id.*

The AG submitted the pre-filed testimony of three witnesses. Mr. David H. Brown Kinloch supported the AG's position on the need for a request for proposal (RFP).[33] Mr. Charles W. King offered testimony primarily on the conditions that CG&E placed on its willingness to transfer the Plants to ULH&P.[34] Mr. Michael J. Majoros supported the AG's position on the recording of ADIT and ADITC balances following ULH&P's acquisition of the Plants.[35]

## V. ULH&P'S PROPOSED ACQUISITION OF THE PLANTS AND ITS REQUEST TO ENTER INTO THE WHOLESALE POWER AGREEMENTS ARE FULLY SUPPORTED BY THE RECORD AND SHOULD BE GRANTED AS REQUESTED.

### *A. The Commission should grant ULH&P a CPCN and all other authority ULH&P requires to acquire the Plants at original cost less accumulated depreciation.*

#### *1. Legal Standard*

The legal standard for granting CPCNs to regulated utilities in Kentucky is embodied in KY. REV. STAT. ANN. § 278.020.[36] Although this statute does not squarely address the acquisition of existing electric generating facilities, the Commission has relied upon the authority granted to it by this statute in granting CPCNs to electric utilities for acquisition of existing electric generating facilities.[37] In granting a CPCN, the

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[33] *See generally* Testimony of David H. Brown Kinloch (hereinafter Kinloch).

[34] *See generally* Direct Testimony of Charles W. King (hereinafter King).

[35] *See generally* Direct Testimony of Michael J. Majoros, Jr. (hereinafter Majoros).

[36] KY. REV. STAT. ANN. § 278.020 (Baldwin 2003)

[37] *See e.g. In the Matter of Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity for the Acquisition of Two Combustion*

Commission must consider whether the public convenience and necessity require the proposed expenditure.[38] Further, the Commission has generally applied the *least cost alternative* standard in assessing a request for a CPCN.[39]

*2. Cinergy considered many factors in offering the Plants to ULH&P.*

ULH&P's development of the proposed transaction was in direct response to the Commission's directive in Case No. 2001-00058 and Administrative Case No. 387, as described above. With that directive in mind, ULH&P considered viable options for securing electric generation for its customers at stable prices over the long term.[40] ULH&P analyzed the predicted market prices of wholesale power and the costs of constructing new generation to meet its needs, and also explored many alternative arrangements, including transferring various combinations of generating plants from CG&E to ULH&P.[41]

As ULH&P's witness, Mr. Harkness, testified upon cross-examination, CG&E and ULH&P considered a variety of factors in determining which of CG&E's plants

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*Turbines*, Case No. 2002-00029 (hereinafter *LG&E/KU*) (LG&E and KU applied for a CPCN to acquire ownership of two combustion turbines from a non-regulated affiliate); *In the Matter of The Application of the Kentucky Power Company for a Certificate of Public Convenience and Necessity*, Case No. 8271 (Kentucky Power applied for a CPCN to purchase a 15% undivided interest in two 1,300 MW generating units constructed in Indiana.)

[38] KY. REV. STAT. ANN. § 278.020 (Baldwin 2003) ("No person ... shall commence ... the construction of any plant, equipment, property or facility ... until that person has obtained a certificate that public convenience and necessity require the service or construction.")

[39] *See LG&E/KU* ("LG&E's and KU's analysis supports the construction of the two CTs as the least cost option for meeting loads in 2002 and 2003 compared to relying on purchase power peaking alternatives... Based on the evidence of record, the Commission finds that the acquisition of the two CTs is the least cost option to reliably serve LG&E's and KU's customer loads, is reasonable, and should be approved.")

[40] *See* Ficke at 10.

[41] *Id.*

might suit ULH&P's needs.[42] First, CG&E only considered making available to ULH&P high-quality, proven and reliable plants with a good track record, such as CG&E's "number-two prize" generating facility, East Bend.[43] CG&E also assumed that the Commission and ULH&P customers would appreciate the benefits of being served from a plant physically located in Kentucky, and that has installed a scrubber for $SO_2$ removal and a selective catalytic reduction (SCR) control system for $NO_X$ removal – these factors also pointed CG&E toward East Bend.[44] Third, CG&E steered away from plants that were encumbered in some way, for instance by being co-owned by a third party which had not approved the transfer of the plants, or by being named in an EPA lawsuit.[45] Fourth, CG&E looked to plants that had good long-term operating characteristics.[46] Fifth, CG&E sought to transfer plants that would result in a balanced and stable revenue requirement for ULH&P so that the transfer of the plants would not have a significant effect on rates.[47] Finally, CG&E sought to identify plants the transfer of which would not have an unreasonable impact on Cinergy's other stakeholders and would not impair CG&E operationally and financially, particularly with respect to CG&E's credit rating.[48]

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[42] *See* Trans. Vol. I at 115 – 118.

[43] *Id.* at 115 – 116.

[44] *Id.* at 116.

[45] *Id.*

[46] *Id.* at 117.

[47] *Id.*

[48] *Id.*

*3. The record evidence supports ULH&P's proposed acquisition of the Plants as the least cost alternative.*

The evidence of record conclusively establishes that ULH&P's proposed acquisition of the Plants is the least cost alternative to meet the need expressed by the Commission's mandate that ULH&P "ensure that the northern Kentucky areas served by ULH&P have an assured long-term power supply at the lowest reasonable cost."[49]

ULH&P presented the Direct Testimony of Diane L. Jenner, Manager of Asset Planning and Analysis, describing the integrated resource planning (IRP) process she employed to analyze options in determining an optimal combination of resources that can be used to reliably and cost-effectively meet ULH&P's customers' future electricity requirements.[50] Ms. Jenner considered ULH&P's load requirements, as forecasted by Dr. Stevie, as well as an adequate reserve requirement considering Operating Reserves, Load and Frequency Regulation Reserves, Spinning Reserves, unscheduled outages, and fluctuations in load caused by, among other things, unexpected weather conditions.[51]

Ms. Jenner provided uncontested testimony regarding the IRP process she employed in assessing ULH&P's proposal.[52] This IRP process involved a number of steps: (1) development of planning objectives and assumptions; (2) preparation of an electric load forecast; (3) identification and screening of potential electric demand-side resource options; (4) identification and screening of, and performing sensitivity analyses

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[49] *See* Case No. 2001-00058 at 14.

[50] *See* Jenner at 4.

[51] *See* Jenner at 6 – 7.

[52] *See* Jenner at 9 – 10.

of, the cost-effectiveness of potential electric supply-side resources; (5) identification and screening of, and performing analysis around, the cost-effectiveness of potential environmental compliance options; (6) integration of the demand-side and supply-side and environmental compliance options; (7) performing final sensitivity analyses on the integrated resource alternatives; and (8) selecting an optimal plan based on quantitative and qualitative factors (such as risk, reliability, technical feasibility, and other qualitative factors); and use of a sophisticated, independently developed computer model, STRATEGIST®, to assist with this highly data-intensive analytical process.[53]

Ms. Jenner testified that she considered a multitude of options and combinations of options, including demand-side management (DSM) programs, peaking units, combined cycle units, coal-fired units, fuel cells, renewable resources (such as wind and solar), and power purchases in ULH&P's IRP process.[54] Ms. Jenner testified that she relied upon a variety of sources, including the Electric Power Research Institute (EPRI) Technical Assessment Guide® (TAG), Cinergy-specific cost estimates, and information from a study prepared for Cinergy by Sargent & Lundy, a well-known utility engineering and construction firm, in estimating the cost of new supply-side resource options.[55] Ms. Jenner also described the screening process and sensitivity analyses she conducted, as well as her consideration of potential environmental compliance options.[56] Finally, Ms.

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[53] *Id.*

[54] *Id.* at 10.

[55] *Id.* at 12.

[56] *Id.* at 12 – 16.

Jenner described the specific modeling performed on the options, including the proposed acquisition of the Plants, taking into consideration the load forecast and demand-side management impacts provided to her by ULH&P witness Dr. Richard G. Stevie, fuel prices provided to her by ULH&P witnesses J. Thomas Mason and Judah L. Rose, forecasted market prices under a variety of sensitivity assumptions provided by Mr. Rose, and projected operations, maintenance, administrative and general costs provided by ULH&P witnesses John J. Roebel and John P. Steffen.[57] Ms. Jenner also considered the proposed PSOA and the Back-up PSA in her analysis.[58] Ultimately, Ms. Jenner's analysis demonstrated that ULH&P's proposed acquisition of the Plants resulted in a present value revenue requirement of $643 million less than the next best alternative, a full requirements purchase power agreement, over the study period (*i.e.* 20-year planning period plus infinite end effects).[59] This analysis assumed that ULH&P could acquire the Plants at original cost less accumulated depreciation, took into consideration the budgeted capital expenditures of the Plants, and assumed that the effect on customers would not be felt until January 1, 2007 at the earliest (in light of ULH&P's commitment to the current rate freeze).[60] Further, Ms. Jenner testified at hearing that given the Amendment to the Application, the savings to customers would be even greater.[61]

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[57] *Id.* at 17 – 18; 23 – 24.

[58] *Id.* at 19, 23.

[59] *Id.* at 26.

[60] *Id. at* 23, 24, 25.

[61] See Trans. Vol. I at 87.

Additionally, Ms. Jenner considered several risk-related qualitative factors in assessing alternatives.[62] These included: (1) risk associated with siting and constructing new generation; (2) pricing risk; (3) non-performance risk; and (4) deliverability risk considerations associated with purchasing large amounts of power from the wholesale market from distant generating units.[63] These risks are mitigated with a plan that calls for the acquisition of on-system generating capacity by ULH&P, as opposed to a plan that relies heavily on purchased power or ownership of generating units distant from the Cinergy transmission system.[64]

Ms. Jenner's analysis was uncontested by the AG and the Staff.

*4. The Plants are in good condition and can be relied upon to provide reliable electric generation service to ULH&P's customers for many years to come.*

ULH&P presented the testimony of John J. Roebel and H. Davis Ege in support of the features and the quality of the Plants. As described by Mr. Roebel, East Bend is a 648 MW (nameplate rating) coal-fired base load unit, jointly owned by CG&E and The Dayton Power and Light Company, located along the Ohio River in Boone County, Kentucky, that was commissioned in 1981, of which CG&E owns 69%, or 447 MW.[65] East Bend has river facilities to allow barge deliveries of coal and lime, and is designed

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[62] See Jenner at 29.

[63] *Id.* at 29 – 30.

[64] *Id.* at 30.

[65] *See* Roebel at 2 – 3.

to burn low- to high-sulfur eastern bituminous coal.[66] East Bend achieved a net plant heat rate for 2002 of 10,911 Btu/kWh and for 2003 through April achieved a net plant heat rate of 10,423 Btu/kWh.[67] East Bend has considerable pollution control features, including a mechanical draft cooling tower, a high-efficiency hot side electrostatic precipitator, a lime-based flue gas desulfurization (FGD) system and a selective catalytic reduction control (SCR) system designed to reduce nitrogen oxide ($NO_X$) emissions by 85%.[68] Significantly, the station's electrical output is directly connected to the Cinergy 345 kV transmission system.[69]

Miami Fort 6 is a 168 MW (nameplate rating, 163 MW net rating) coal-fired base/intermediate load unit located at Miami Fort Station along the Ohio River in Hamilton County, Ohio, that was commissioned in 1960.[70] Unit 6 is one of four coal-fired units at the Miami Fort Generating Station, which has river facilities to allow for barge delivery of coal.[71] Unit 6 is designed to burn low- to high-sulfur eastern bituminous coal and achieved a net unit heat rate for 2002 of 10,012 Btu/kWh and for 2003 through April achieved a net unit heat rate of 9,930 Btu/kWh.[72] Like East Bend, this unit is directly connected to the Cinergy high voltage joint transmission system.[73]

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[66] *Id.*

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *Id.* at 3 – 4.

[71] *Id.*

[72] *Id.*

Woodsdale is a six-unit combustion turbine (CT) station located in Butler County, Ohio, just north of Cincinnati, with a collective nameplate rating of 490 MW.[74] Woodsdale's net summer capacity is 500 MW due to the efficiencies associated with Woodsdale's inlet cooling capabilities.[75] Woodsdale is designed for peaking service, and it has dual fuel capability (natural gas and propane) and black start capability, *i.e.* Woodsdale has the ability to initiate a recovery of a substantial portion of load without relying on energy from outside sources if the regional grid experiences a blackout.[76] Further, Woodsdale is connected to two separate gas transmission companies, Texas Eastern Transmission Company (TETCO) and Texas Gas Transmission Company, that transport the natural gas to supply the Plant.[77] As with East Bend and Miami Fort 6, Woodsdale's electrical output is directly connected to the Cinergy 345 kV transmission system.[78]

As indicated above, ULH&P retained the services of Burns and McDonnell to perform an engineering due diligence of the Plants. Mr. Ege, of Burns and McDonnell, led a team of engineers in on-site tours and analyses of the Plants.[79] Mr. Ege testified that the Plants are designed and constructed in accordance with industry standards, the Plants

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[73] *Id.*

[74] *Id.* at 4.

[75] *Id.*

[76] *Id.*

[77] *Id.* at 5.

[78] *Id.*

[79] *See* Ege at 4.

are well-maintained, and the Plants' operating staffs appear qualified and cross-trained to perform routine maintenance on the Plants.[80] Mr. Ege concluded that the Plants are capable of providing long-term reliable service.[81] Neither Mr. Roebel's nor Mr. Ege's testimony was contested by the Staff or the AG.

### *B. The proposed wholesale power agreements are necessary to supplement ULH&P's acquisition of the Plants and are otherwise just and reasonable.*

ULH&P seeks approval of two wholesale power agreements in this proceeding, the Back-up PSA and the PSOA. Both wholesale power agreements are subject to FERC jurisdiction.[82] The Back-up PSA is designed to provide a firm supply of power for ULH&P's native load customers to replace capacity from East Bend and Miami Fort 6.[83] Some outages and de-ratings of East Bend and Miami Fort 6 are inevitable, and ULH&P will need a firm supply of back-up power when this happens.[84] The Back-up PSA provides for CG&E to sell firm power to ULH&P when such outages or de-rates of East Bend and/or Miami Fort 6 occur.[85]

The Back-Up PSA provides for a capacity charge and an energy charge, which when taken together, replicate a market price for back-up power.[86] The energy charge is

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[80] *Id.* at 4 – 8.

[81] *Id.*

[82] *See* Ficke at 9.

[83] *See* Harkness at 3.

[84] *Id.*

[85] *Id.*

[86] *Id.* at 4.

priced at the average variable cost per MWh of energy produced during the prior calendar month at the Plant for which back-up power is required.[87] The capacity charge was determined based on valuation of power, using the forward market prices quoted from *Megawatt Daily* and off-peak prices quoted from the *North American Power 10x Report*, and on an estimate of how often ULH&P would require back-up power for East Bend and Miami Fort 6.[88] The estimate of how often ULH&P would require the back-up power was calculated by applying planned outage schedules and an equivalent forced outage rate based on historical performance for East Bend and Miami Fort 6.[89] Thus, through the Back-up PSA, ULH&P is assured a firm supply of power during outages of East Bend and Miami Fort 6 at rates calculated to replicate market pricing, a proposition unlikely to be offered by any unaffiliated entity.

The PSOA provides the terms and conditions under which ULH&P will allow the Plants to be jointly dispatched along with CG&E's and PSI Energy, Inc.'s (PSI) generating units.[90] The system dispatch provisions of the PSOA call for CG&E and ULH&P to economically dispatch their respective generating units.[91] In addition, the PSOA is designed to permit ULH&P's units to be dispatched, in effect, as CG&E

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[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* at 7.

[91] *See* Harkness at 8.

generation for purposes of the existing Joint Generation Dispatch Agreement (JGDA), thus allowing continued joint dispatch of the generation of PSI, CG&E and ULH&P.[92]

Under the PSOA, the Plants will be dispatched no differently than they currently are under the JGDA.[93] The only real change will come in how energy transferred from CG&E to ULH&P will take place.[94] Under joint economic dispatch, ULH&P's generation may be used to serve CG&E load and vice versa, as one company's lower-cost units are used to serve some portion of the load of the other company when excess generation is available.[95] The PSOA's energy transfer provisions specify a methodology for ensuring that such energy transfers shall be at the market price for the hour in which the energy transfer takes place, but in no event shall the price of such energy transfers exceed the incremental cost of the next available generating unit of the receiving company.[96]

Even though these two wholesale power agreements are FERC jurisdictional, ULH&P requests that the Commission formally recognize the benefits they provide, and issue an Order approving these agreements. These agreements will be wholesale power agreements between two affiliated entities. FERC generally requires that agreements between affiliates be based upon a benchmark of market price, such as a market index.[97]

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[92] *See* Harkness at 7.

[93] *See* Harkness at 8.

[94] *Id.*

[95] *Id.*

[96] *See* Harkness at 8.

[97] *See* Ficke at 9.

While transfers of energy between ULH&P and CG&E under the PSOA will occur at market prices, and the Back-up PSA, as described by Mr. Harkness, has been priced based on market indices, FERC will nevertheless scrutinize these agreements to ensure that ULH&P's customers are not harmed by these affiliate agreements.[98] This Commission's approval of these agreements will assist in demonstrating to FERC that ULH&P's customers' interests are adequately protected under these agreements.[99]

### C. *A Request for Proposal (RFP) would not have yielded lower-cost alternatives, and would have simply been a futile effort.*

The AG presented the testimony of David H. Brown Kinloch, who advocated the AG's position that ULH&P should be required to issue an RFP for generation supply to meet its full requirements needs.[100] However, as ULH&P established in its pre-filed testimony, and again at the hearing, such an RFP process would not have yielded any credible offers of lower-cost generation supplies over the long term.[101]

As Mr. Harkness testified, ULH&P could not have obtained benefits from the marketplace similar to those it can obtain through its proposed transaction.[102] CG&E is offering ULH&P a combined package consisting of an asset transfer of existing Plants interconnected to Cinergy's joint transmission system, joint economic dispatch, and a

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[98] *Id.*

[99] *Id.*

[100] *See generally* Kinloch.

[101] Note that ULH&P, given its proposal in this proceeding, has requested a waiver of the Commission's requirement in Case No. 2001-00058 that it analyze bids for purchased power in its June 2004 IRP (*see* Amendment to Application at 5). If its proposal in this proceeding is not approved, ULH&P will undertake a June 2004 filing of an IRP consistent with the Commission's Order in Case No. 2001-00058.

[102] *See* Harkness at 15.

back-up power supply arrangement, plus continuation of existing rates through 2006.[103] Other market participants might be able to offer one or another of these benefits, but the overall package is clearly unique. CG&E is offering ULH&P *existing and proven* physical assets, both coal-fired and gas-fired, that will provide ULH&P with the benefits of owning its own resources – benefits that it does not now enjoy – and will enable ULH&P to avoid the risks inherent in constructing new assets or purchasing power, and transmitting power across multiple control areas.[104] Another entity could potentially offer a generating unit for sale, but most units available for purchase in today's market are merely peaking units rather than units designed to operate as base load and/or intermediate load facilities,[105] a fact with which the AG's witness, Mr. Kinloch, would seem to concur.[106]

Even if another entity were to offer physical generation, the price at which such generation was offered would almost certainly be far greater than the price offered to ULH&P by CG&E. As supported by the testimony of Judah L. Rose, the Plants' potential market value exceeds the net book value of the Plants, even after subtracting off-system sales revenues.[107] For example, East Kentucky Power Cooperative's 268-MW Gilbert coal-fired project currently under construction is projected to cost $1,369 per kW, or

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[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *See* Responses of the Attorney General to Interrogatories of ULH&P, Nos. 3, 5, 7.

[107] *See* Rose at 8.

$1,731 per kW in 2007 dollars.[108] Wisconsin regulators recently approved Wisconsin Energy's request to construct two new coal-fired generating units at an estimated cost of $1,884/kW (in 2007 dollars).[109] Further, the price of several coal-fired plant sales concluded since 1998 averaged $901 per kW in 2007 dollars.[110] On the other hand, CG&E is offering ULH&P an effective price of $332/kW.[111] In fact, under all of the scenarios examined by ICF Consulting, the potential market value of the Plants exceed their net book value, by as much as three times.[112] Ultimately, the Commission must recognize that there is no evidence in the record that even *suggests* that comparable generation is available at a price comparable to, much less *lower than*, that offered to ULH&P in the instant case.

Even assuming *arguendo* that a comparable mix of generating assets was available for purchase at a better price, it is highly unlikely that those would be within the Cinergy control area. Accordingly, it would be difficult if not impossible, under such a scenario, to realize the considerable benefits of minimizing the potential for transmission

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[108] *See In the Matter of: Application Of East Kentucky Power Cooperative, Inc. For A Certificate Of Public Convenience And Necessity, And A Certificate Of Environmental Compatibility, For The Construction Of A 250 Mw Coal-Fired Generating Unit (With A Circulating Fluid Bed Boiler) At The Hugh L. Spurlock Power Station And Related Transmission Facilities, Located In Mason County, Kentucky, To Be Constructed Only In The Event That The Kentucky Pioneer Energy Power Purchase Agreement Is Terminated*, Case No. 2001-00053, 2001 Ky. PUC LEXIS 1382 (Order issued September 26, 2001). (Inflation is assumed to be 2.5% per year after 2002.)

[109] *See* Response of the Union Light, Heat and Power Company to the data requests raised at hearing, No. 1

[110] *Id.*

[111] *See* Roebel at 2 – 4 for net capacity ratings; *see* Steffen, Attachment JPS-1 for net book value of Plants as of December 31, 2006.

[112] *See* Rose at 9.

disruptions such as the August 14th blackout, and of joint economic dispatch. Moreover, purchasing assets located outside of the Cinergy control area would likely result in increased transmission costs and reliability issues as compared to acquiring the Plants.[113]

As supported by the testimony of ULH&P witness Mr. Snead, a major benefit of having the Plants directly interconnected to the Cinergy joint transmission system is that it will reduce the exposure of the ULH&P system to electric supply disruptions.[114] Transactions that cross electric utility systems are generally at greater risk of curtailment simply due to exposure to more potential problems.[115] Therefore, generation imports from a greater distance can be subject to more interruptions due to transmission loading relief (TLR) procedures than power from local generation.[116] With the Plants interconnected to the Cinergy joint transmission system, reliance on power imports to the joint transmission system from other electric systems is significantly reduced.[117] Recent TLR events in the Midwest suggest that there is increasing potential for transmission constraints, with the corresponding increasing potential for disruptions of purchased power imports, including at peak times when this may be critical.[118] Utilizing generation from the Plants will help reduce ULH&P's exposure to electric supply interruptions

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[113] *See* Harkness at 16.

[114] *See* Snead at 10. *See also* Rose at 11.

[115] *See* Snead at 10.

[116] *Id.*

[117] *Id.*

[118] *Id.*

caused by the implementation of TLR procedures due to transmission problems on other electric systems.[119] Further, ULH&P's ability to reliably purchase power from generating plants located in other areas of the electric transmission grid is uncertain.[120] For example, the Midwest ISO reports that there is zero transmission capability into Cinergy from The Louisville Gas & Electric Company (LG&E) through 2006.[121]

Without even addressing any of these transmission issues, which the AG's witnesses agree must be considered,[122] the AG advocates that ULH&P should issue an RFP that considers purchased power as an alternative to buying generating assets.[123] Setting aside for the moment the transmission issues described above, in order to approach the reliability and economic benefits of plant ownership, a purchased power arrangement would have to be long-term, *i.e.* covering a period of at least 15 years.[124] Yet in recent years, various factors have caused the market for long-term power purchases to greatly diminish.[125] These factors include the California energy crisis, the Enron debacle, bankruptcy filings by certain energy companies and the credit downgrades of other energy companies by credit ratings agencies, attempts to cancel long-term purchase power deals as a result of bankruptcy filings and litigation, the economic downturn, and

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[119] *Id.*

[120] *Id.*

[121] Trans. Vol. I at 158.

[122] *See* Responses of the Attorney General to Interrogatories of ULH&P, Nos. 37, 83.

[123] *See* Kinloch at 14.

[124] *See* Harkness at 16.

[125] *Id.*

the continued uncertainty in the transmission market. These factors have made the long-term power market risky for buyers and as a result, new long-term purchase power agreements currently tend to run no longer than five years from the date of execution.[126] If ULH&P were to issue an RFP for its full wholesale power requirements for the long-term, the inception date for the new wholesale contract would be January 1, 2007.[127] And if the contract would run for the remaining useful life of the Plants, potential bidders would have to agree to provide a fixed price for power through an equivalent date.[128] Of course, the market for such contracts is illiquid.[129] Even if some owner of a sizeable merchant fleet would offer such an agreement against current market trends, such a solution would present risks of credit problems, bankruptcy, and efforts at contract renegotiation and, possibly, cancellation, that are now prevalent among merchants.[130] Most telling, the AG's primary witness with respect to the RFP issue is not aware of an RFP ever being issued by a utility seeking to obtain a complete set of base load, intermediate load and peaking generating assets.[131]

Thus, it is the combination of owning high quality, proven assets within and proximate to ULH&P's service area directly connected to the Cinergy transmission system, the benefits of joint economic dispatch, and the certainty of a Back-up PSA (plus

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[126] *See* Harkness at 16.

[127] *Id.*

[128] *Id.*

[129] *Id.*

[130] *Id.*

[131] *See* Responses of the Attorney General to Interrogatories of ULH&P, Nos. 3.

the continuation of current rates through 2006 notwithstanding the asset purchase) that distinguish this package from anything else that could possibly be available in the market place, and make this package uniquely valuable to ULH&P.[132]

## VI. THE RATE MAKING TREATMENT THAT ULH&P SEEKS IN THIS PROCEEDING IS JUST AND REASONABLE, AND SHOULD BE GRANTED BY THE COMMISSION AS REQUESTED.

Cinergy has conditioned its willingness to allow CG&E to transfer the Plants to ULH&P on several terms, among them receiving certain rate treatment as described in ULH&P's Amended Application and as further discussed below:

### *A. ULH&P's request for the Commission to fix the valuation of the Plants for ratemaking purposes is just and reasonable.*

In its Amended Application, ULH&P has requested that the Commission fix the value of the Plants at their original cost less accumulated depreciation under the authority granted to the Commission by KY. REV. STAT. ANN. § 278.290.[133] ULH&P recognizes that this Commission cannot conclusively bind a future Commission; however, the authority granted to the Commission by KY. REV. STAT. ANN. § 278.290 permits the Commission to fix the value of utility assets such that these valuations can only be changed after the utility, or other party, is afforded due process:

> (1) Subject to the provisions of subsection (2) of this section, the commission may ascertain and fix the value of the whole or any part of the property of any utility in so far as the value is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time and ascertain the value of all

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[132] *Id.*

[133] *See* Amendment to Application at 5.

> new construction, extensions and additions to the property of the utility. In fixing the value of any property under this subsection, the commission shall give due consideration to the **history and development of the utility and its property, original cost**, cost of reproduction as a going concern, capital structure, and other elements of value recognized by the law of the land for rate-making purposes.
>
> (2) The commission shall not value or revalue the property of any utility unless the valuation or revaluation is necessary or advisable in order to determine the legality or reasonableness of any rate or service or of the issuance of securities, **and then only after an investigation affecting the rate, service or securities has been instituted by the commission upon complaint or application or upon its own motion, and a hearing has been held on reasonable notice.**[134]

Significantly, KY. REV. STAT. ANN. § 278.290 contemplates a review of the history and development of the utility and the property, and specifically permits valuing property at original cost. Section (2) of this statute provides parties with due process certainty that the valuation of utility property will not be changed through any arbitrary or capricious process. By replacing its condition that ULH&P be permitted to transfer the Plants back to CG&E with this condition, that the Commission fix the value of the Plants in this proceeding, Cinergy is relying on the Commission exercising its statutory authority and the due process afforded by KY. REV. STAT. ANN. § 278.290 to provide some measure of certainty to Cinergy that ULH&P will be permitted to recover an adequate return on and of these Plants in its next base rate case.

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[134] KY. REV. STAT. ANN. § 278.290 (Baldwin 2003, emphasis added)

### B. *The rate treatment requested for the Back-up PSA and PSOA in ULH&P's Amended Application is just and reasonable. Further, the Commission should approve these agreements.*

ULH&P has requested that the Commission allow ULH&P to recover the costs associated with the Back-up PSA and PSOA. Specifically, ULH&P requested that the Commission allow the demand charges associated with the Back-up PSA, and successor back-up agreements, to be recovered in base rates.[135] ULH&P also requested that the energy charges assessed under the Back-up PSA be recoverable in its FAC in conformance with Kentucky's FAC regulation, 807 KY. ADMIN. REGS. 5:056 and applicable Commission precedent.[136] Finally, ULH&P requested that the costs associated with energy transfers under the PSOA be recoverable in its FAC in conformance with 807 KY. ADMIN. REGS. 5:056 and applicable Commission precedent.[137]

As described above, the Back-up PSA is designed to provide a firm supply of power for ULH&P's native load customers to replace the capacity of East Bend and Miami Fort 6.[138] Some outages and de-ratings of East Bend and Miami Fort 6 are inevitable, and ULH&P will need a firm supply of back-up power when this happens.[139] Where such outages are *forced outages* as defined by 807 KY. ADMIN. REGS. 5:056, ULH&P would expect to recover the energy charges as provided for in 807 KY. ADMIN.

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[135] *See* Amendment to Application at 3.

[136] *Id.*

[137] *Id.* at 4.

[138] *See* Harkness at 3.

[139] *Id.*

REGS. 5:056. Where such outages are planned, any power taken under the Back-up PSA would be economy power (since the Back-up PSA would be jointly dispatched as a proxy for East Bend/and or Miami Fort 6[140]), and ULH&P would expect to recover these costs as economy purchases under 807 KY. ADMIN. REGS. 5:056.

The Back-up PSA allows ULH&P to obtain a firm supply of power from an affiliate that has a diverse supply of generating stations and that operates with adequate reserve margins, such that it will be able to supply the power when called upon to do so.[141] The price for the back-up power is below the price embedded in ULH&P's existing Power Sale Agreement with CG&E.[142] As demonstrated, there is considerable value in the Back-up PSA and allowing ULH&P to recover the associated costs is clearly just and reasonable.

The PSOA provides the terms and conditions under which ULH&P will allow the Plants to be jointly dispatched along with CG&E's and PSI's generating units.[143] The PSOA's energy transfer provisions specify a methodology for ensuring that transfers of energy shall be at the market price for the hour in which the energy transfer takes place, but in no event shall the price of such energy transfers exceed the incremental cost of the next available generating unit of the receiving company. As such, energy transfers under

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[140] *See* Harkness at 11 – 12.

[141] *See* Harkness at 3.

[142] *Id. at 5.*

[143] *Id.* at 7.

the PSOA fit squarely into the definition of economy purchases recoverable under 807 KY. ADMIN. REGS. 5:056.

Significantly, the AG, through the testimony of its witness, Mr. King, endorsed ULH&P's request to recover the costs associated with these wholesale power agreements as described herein.[144]

### C. *ULH&P's request to defer for future recovery the transaction costs incurred by ULH&P and by CG&E on ULH&P's behalf is just and reasonable and should be approved by the Commission.*

In its Amended Application and supporting testimony, ULH&P requested that a portion of the transaction costs incurred by itself and CG&E on ULH&P's behalf associated with ULH&P's acquisition of the Plants be deferred for future recovery, amortized over a five-year period.[145] ULH&P described the transaction costs it anticipated as including consulting fees, engineering assessment fees, costs associated with financing, and increases in tax liabilities, and estimated these total costs to be approximately $4.9 million.[146] ULH&P requested authority to defer no more than $2.45 million of these costs for future recovery.[147] As supported by the testimony of ULH&P witness Mr. Steffen, these costs represent one-time costs incurred in order to complete the proposed transaction.[148] Considering the significant value accruing to ULH&P's

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[144] *See* King at 4 (ULH&P recognizes that Mr. King has actually endorsed ULH&P's original request for blanket approval to recover these costs.)

[145] *See* Amendment to Application at 2.

[146] *See* Steffen at Attachment JPS-7.

[147] *See* Amendment to Application at 3.

[148] *See* Steffen at 11.

customers from this transaction, as described herein and in ULH&P's Amended Application and supporting testimony, it is manifestly just and reasonable to afford ULH&P the ability to recover some portion of costs incurred to provide ULH&P's customers the benefits of this transaction.

### *D. ULH&P's request to retain some portion of off-system sales is just and reasonable, and should be approved by the Commission.*

In its Amended Application, ULH&P requested Commission approval to share the profits from off-system sales as follows:

> ii. Customers shall receive up to one million dollars in profits from off-system sales annually, and 50% of such profits above one million dollars annually, if any;
>
> iii. ULH&P shall retain 50% of the profits from off-system sales above one million dollars annually, if any;
>
> iv. The costs attributable to such off-system sales shall include only the Incremental Costs listed in the PSOA, paragraph 1.10, Attachment RCM-2 to the Direct Testimony of Robert C. McCarthy previously filed in this proceeding;
>
> v. ULH&P commits to implement the processes necessary to appropriately allocate such Incremental Costs to off-system sales.[149]

Off-system sales occur when the owner of a generating facility sells power to the marketplace, after fulfilling the owner's native load and wholesale contract obligations, because the market price for power exceeds the owner's cost of generating the power.[150]

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[149] *See* Amendment to Application at 4, 5.

[150] *See* Harkness at 11.

ULH&P currently has no off-system sales because it does not own generating facilities.[151] CG&E currently makes off-system sales under the JGDA, consisting of energy transfers to PSI, and sales to third parties.[152] Because CG&E's generation is non-regulated, CG&E retains 100% of the revenue from off-system sales from its generating stations.[153] ULH&P's off-system sales would occur under the PSOA, and would only go to CG&E.[154] CG&E would make off-system sales under both the PSOA and the JGDA.[155] Thus, any sales of ULH&P-generated energy to third parties would be made by CG&E, essentially on ULH&P's behalf.[156] If ULH&P has excess energy on an hourly basis that could be economically dispatched and sold into the market, it would be sold to CG&E as an energy transfer under the PSOA, and CG&E would either use this energy itself, or sell it into the market.[157] ULH&P would be compensated for this energy at the market price.[158]

ULH&P's original Application sought to retain all profits from off-system sales.[159] ULH&P believes that this request is appropriate because of the significant value that ULH&P's customers are realizing in acquiring "iron in the ground" at a net book value

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[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] *Id.*

[156] *Id.*

[157] *Id.*

[158] *Id.*

[159] *See* Turner at 18.

that is less than potential market value.[160] Nevertheless, ULH&P amended its request so as to share a significant portion of the profits from off-system sales with its customers.

There is precedent in Kentucky for the sharing of off-system sales profits. The Commission has recognized the value in providing Kentucky electric utilities an incentive to engage in profitable off-system sales.[161] The AG concurs with this principle, but argues that ULH&P should only retain 10% of the profits from off-system sales.[162] The AG's witness, however, has neither performed nor reviewed any studies that would support a conclusion that this 10% retention would provide an electric utility *sufficient* incentive to maximize the value of its plants.[163] However, on cross-examination, Mr. King admitted that under ULH&P's amended proposal for sharing off-system sales, ULH&P's share of

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[160] *Id.*

[161] *See In the Matter of: Joint Application Of Kentucky Power Company D/B/A American Electric Power, American Electric Power Company, Inc. And Central And South West Corporation For (1) Approval Of The Changes To The System Sales Clause Tariff; (2) Entry Of Certain Findings Pursuant To 15 U.S.C. 97z; (3) Entry Of Certain Findings Pursuant To 17 C.F.R. 200.53; (4) The Entry Of An Order Declaring That The Transfer Of The Stock Of Kentucky Power Company From American Electric Power Company, Inc. To Its Wholly Owned Subsidiary, Central And South West Corporation May Be Consummated Without Approval By The Commission; Or, Alternatively, Approving The Transfer Pursuant To KRS 278.020(4) And KRS 278.020(5); And (5) For Related Relief,* Case No. 2002-00039, 2002 Ky. PUC LEXIS 958, (Order issued December 17, 2002 ("Historically, Kentucky Power has had a relatively high level of revenue from off-system sales, although that revenue level has been variable. To ensure that ratepayers receive benefits from those sales, while also providing incentive for Kentucky Power to maximize those sales, a System Sales Clause has been in effect for over a decade. Under the System Sales Clause, for each month that the off-system sales net revenue exceeds a base amount, 50 percent of the excess is credited to ratepayers. Similarly, if the monthly off-system sales net revenue falls below the base amount, 50 percent of the shortfall is charged to ratepayers.")

[162] *See* King at 14.

[163] *See* Trans. Vol. II at 31.

the profits from off-system sales would approach his recommended 10% level over time given Mr. Rose's projected level of off-system sales.[164]

Given the uncontroverted agreement that electric utilities should be provided a share of the profits from off-system sales as an incentive to maximize the value of their generating resources, and the significant value being provided to ULH&P's customers in the proposed transaction, there is an abundance of evidence in the record to support ULH&P's proposal to share off-system sales as just and reasonable, and it represents a fair compromise between the original proposal offered by ULH&P and the proposal from the AG. The Commission should approve this request, and further find that it sees no reason that such treatment should not be granted in ULH&P's subsequent base rate cases.

### *E. ULH&P's requested treatment of ADIT and ADITC balances is in accordance with IRS rulings, is just and reasonable, and should be approved as requested.*

As described by ULH&P witness Mr. Steffen, there are accumulated deferred investment tax credit (ADITC) balances and accumulated deferred income tax (ADIT) balances associated with the Plants on CG&E's books.[165] ULH&P has proposed to amortize any transferred ADIT balances on ULH&P's books *below-the-line* over the remaining lives of the Plants, and to amortize any transferred ADITC balance *below-the-line* in accordance with its current amortization schedule.[166] Amortization of these

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[164] *See* Trans. Vol. II at 33.

[165] *See* Steffen at 12 – 13.

[166] *Id.* (ULH&P shall use the term *below-the-line* to indicate that the item is not to be considered for rate-making purposes, and the term *above-the-line* to indicate that the item is to be considered for rate-making purposes.)

balances *below-the-line* will exclude these pre-transfer amounts from retail ratemaking in Kentucky.[167]

The AG advocates recording these balances *above-the-line* for ratemaking purposes, thus providing ULH&P's Kentucky customers the benefit of these deferrals.[168]

ULH&P asserts that its proposed treatment is correct for several reasons. First, a thorough review of IRS precedent shows that ULH&P's position with respect to ADIT and ADITC represents the proper treatment for these items in a transaction involving a step-up in the tax basis.[169]

Second, the ADIT and ADITC balances within these accounts accrued prior to ULH&P acquiring the Plants – indeed under two regulatory schemes that are no longer in effect. That is, a portion of these balances were paid for by CG&E retail customers prior to the Plants being deregulated by Ohio's electric restructuring legislation.[170] In CG&E's stipulated settlement of its electric transition plan case, which was approved by the Public Utilities Commission of Ohio in an Order dated August 31, 2000 in Case No. 99-1658-EL-ETP, these balances were among the issues settled by the signatory parties in determining CG&E's regulatory transition charge.[171]

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[167] *Id.*

[168] *See generally* Majoros

[169] *See* Responses of The Union Light, Heat and Power Company to data requests raised at hearing, No. 4.

[170] *See* Trans. Vol. I at 207, 216.

[171] *Id.*

Similarly, a small portion of these balances was paid for by wholesale customers, including ULH&P, prior to termination of their cost-of-service based contracts.[172] In accordance with FERC's Order 888, at the time of such termination, these wholesale customers had the ability to raise the issue of stranded benefits at FERC.[173] Since neither the Commission nor the AG raised this issue in Case No. 2001-00058, in which the current market-based PPA replacing the cost-of-service agreement was approved, nor at FERC in the subsequent federal docket, it is clear that, as in Ohio, the issue of stranded benefits was settled in these cases.

Significantly, the AG's witness, Mr. Majoros, failed to consider CG&E's electric restructuring case, Case No. 2001-00058, and FERC Order 888 in concluding that these balances should inure to the benefit of Kentucky ratepayers.[174] Nor did Mr. Majoros consider the tax normalization rules of the Internal Revenue Service.[175] Mr. Majoros did not consider that CG&E had already returned the value of these balances to ratepayers in the context of these other two cases, but in essence simply asserted that since *some*

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[172] *See* Trans. Vol. I at 200.

[173] *See Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Docket* Nos. RM95-8-000 and RM94-7-001; Order No. 888, 61 Fed. Reg. ¶ 21,540 at ¶ 21,542. ("With regard to stranded costs, the Final Rule adopts the Commission's supplemental proposal. It will permit utilities to seek extra-contractual recovery of stranded costs associated with a limited set of existing (executed on or before July 11, 1994) wholesale requirements contracts...") See *also Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Docket* Nos. RM95-8-000 and RM94-7-001; Order No. 888B, 81 F.E.R.C. ¶ 61,248 at ¶ 62,110 ("Notwithstanding TDU Systems' arguments, we continue to believe that the extent to which a customer could demonstrate a reasonable expectation of continued service at the existing contract rate (or at a cost-based rate, if that was the customer's expectation) is best addressed on a case-by-case basis.")

[174] *See* Trans. Vol. II at 40 – 43.

[175] *See* Trans. Vol. II at 43, 46.

ratepayer *somewhere* had paid into these balances, ULH&P customers should now be entitled to receive the benefit.[176] While ULH&P is attempting in this proceeding to provide significant benefits to its customers,[177] it simply cannot risk the consequences of improper tax normalization treatment in doing so.[178] Thus, CG&E's willingness to transfer the Plants to ULH&P is conditioned on ULH&P recording the ADIT and ADITC amortization *below-the-line*.

Mr. Majoros also responded to a data request posed at the hearing in which he attempted to calculate an estimate of the revenue requirement impact of ULH&P's proposal to treat ADITC and ADIT *below-the-line*.[179] However, Mr. Majoros made several critical errors in this calculation, resulting in a significant overstatement of the revenue requirement impact of ULH&P's proposal. First, he used balances from March 31, 2003 rather than the estimated balances at the time of ULH&P's next projected rate case. Second, he used an incorrect "expansion factor"[180] for converting the ADITC to a revenue requirement level. Third, he used the ADITC balance as a rate base reduction, which is prohibited due to the Company's election of Section 46(f)(2) treatment of its ADITC under the Internal Revenue Code. Finally, Mr. Majoros did not take into account the fact that ADIT will only exist on ULH&P's books to the extent that the tax basis of

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[176] *See* Trans. Vol. II at 51 – 52.

[177] *See* Trans. Vol. I at 16.

[178] *See* Trans. Vol. I at 222 – 223.

[179] *See* Attorney General's Response to Hearing Data Request.

[180] Mr. Majoros uses the term 'expansion factor' to describe what is commonly referred to as the 'revenue conversion factor'.

the assets is not stepped-up in this transaction. ULH&P believes the actual revenue requirement impact of *below-the-line* treatment of the ADIT and ADITC is significantly overstated by Mr. Majoros in his response to the Hearing Data Request.

## VII. THE EVIDENCE SUPPORTS ULH&P'S REQUESTED WAIVER OF REQUIREMENTS FOR ARM'S LENGTH DEALINGS WITH ITS AFFILIATES

In its Amended Application, ULH&P requested a waiver of Kentucky's affiliate transaction pricing requirements in two areas. First, ULH&P requested a waiver of the requirements for arm's length dealing for the acquisition of the Plants from CG&E. Second, ULH&P requested a deviation from these requirements for certain fuel supply and management agreements. Each such request should be granted for the reasons set forth below.

### *A. ULH&P's acquisition of the Plants at net book value rather than at an arm's length market price is reasonable.*

In its Amended Application, ULH&P requested a waiver of the requirement embodied in KY. REV. STAT. ANN. § 278.2213(6) that all dealings with affiliates be at arm's length.[181] As a preliminary matter, ULH&P notes the apparent incongruity of this requirement with that imposed by KY. REV. STAT. ANN. § 278.2207, which requires sales to a utility by its affiliates to be priced at the lesser of cost or market.[182] In any event,

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[181] KY. REV. STAT. ANN. § 278.2213(6).

[182] KY. REV. STAT. ANN. § 278.2207. (It would seem obvious that in an arm's length transaction between two unaffiliated entities, agreeing on the price to be paid for a particular good or service, would result in a market price, and that the seller would usually not engage in such a transaction if the market price were to be less than its cost. Therefore, a sale at the lower of cost or market is inconsistent with an arm's length transaction. Thus, a utility complying with KY. REV. STAT. ANN. § 278.2207 arguably could be found to be in violation of KY. REV. STAT. ANN. § 278.2213(6)).

ULH&P has proposed acquiring the Plants at the lesser of cost or market, in accordance with KY. REV. STAT. ANN. § 278.2207, as supported by the testimony of Mr. Rose,[183] and there would plainly be no benefit to ULH&P's customers in requiring that they pay a higher, market-based price. It is uncontested that ULH&P is being offered the Plants at a value far less than the potential market value of the Plants. Given this great value offered to ULH&P, and by extension to its customers, as supported throughout ULH&P's filing and this Brief, it would be unreasonable to expect ULH&P to pay CG&E the higher market value of the Plants, which would have to occur for the transaction to be at arm's length in accordance with KY. REV. STAT. ANN. § 278.2213.

### *B. ULH&P's request for a deviation from the affiliate transaction pricing requirements related to the fuel supply, management and storage agreements is reasonable and should be approved.*

ULH&P has requested a deviation from the affiliate transaction pricing requirements embodied in KY. REV. STAT. ANN. § 278.2207 and KY. REV. STAT. ANN. § 278.2213(6) for two fuel supply and management agreements and a propane storage agreement.[184] CG&E has a contract with Cinergy Marketing & Trading, LP (CM&T), its affiliate, that provides for CG&E to obtain natural gas for Woodsdale (Gas Supply and Management Agreement).[185] Additionally, CG&E has a contract with Ohio River Valley Propane LLC (ORVP), its affiliate, to store propane in the Todhunter propane cavern,

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[183] *See* Rose at 8.

[184] *See* Amendment to Application at 7.

[185] *See* Roebel at 5.

which is partially owned by ORVP (Commodity Storage Agreement).[186] Finally, CG&E has a contract with ORVP that provides for CG&E to obtain propane for Woodsdale (Propane Supply and Management Agreement).[187]

Under the Gas Supply and Management Agreement, CM&T supplies the full requirements of natural gas needed by Woodsdale either by selling the gas to CG&E from supplies owned or controlled by CM&T or by purchasing gas from third parties as agent for CG&E.[188] CG&E pays CM&T market prices for any gas it purchases from CM&T, and reimburses CM&T for CM&T's cost to transport the gas from the point where CM&T acquires the gas to Woodsdale.[189] The Gas Supply and Management Agreement provides for CG&E to pay CM&T an administrative fee of $.03/MMBTU for gas consumed at the Plant.[190] The Gas Supply Management Agreement allows CG&E to obtain the natural gas for Woodsdale more economically by using CM&T as the supplier, versus obtaining its own supply and paying for transportation service at CG&E's tariffed rate.[191] To the extent that CG&E did not seek bids for this service, ULH&P assumes that could be characterized as not an arm's length agreement.

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[186] *Id.*

[187] *Id.* at 6.

[188] *Id.*

[189] *Id.*

[190] *Id.*

[191] *Id.*

Under the Commodity Storage Agreement: (1) ORVP provides CG&E with 50,000 barrels of storage space within ORVP's share of the Todhunter propane cavern located in Butler County, Ohio, during the months of November through March; and (2) CG&E pays ORVP to store the propane: (a) $15,000 per month from November through March; and (b) $0.12 per barrel per month from April through October.[192] The Commodity Storage Agreement expires on November 1, 2007.[193] To the extent that CG&E did not seek bids for this service, ULH&P assumes it could be characterized as not an arm's length agreement.

The Propane Supply Management Agreement is similar to the Gas Supply Management Agreement.[194] The Propane Supply Management Agreement provides for CM&T to supply the full requirements of propane needed by Woodsdale, either from CM&T's own supplies or from supplies purchased by CM&T from third parties.[195] CG&E pays CM&T market prices for any propane it purchases from CM&T, and reimburses CM&T for CM&T's cost to transport the propane from the point where CM&T acquires the propane to Woodsdale.[196] The Propane Supply and Management

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[192] *Id* at 7.

[193] *Id.*

[194] *Id.*

[195] *Id.*

[196] *Id.*

Agreement provides for CG&E to pay CM&T an administrative fee of $.03/MMBTU for propane consumed at the Plant.[197] The initial term of the agreement is three years.[198]

The purpose of the Propane Supply Management Agreement and the Commodity Storage Agreement is to provide propane fuel for Woodsdale as a hedge against high natural gas prices when gas is needed by Woodsdale.[199] A peaking station such as Woodsdale is designed to operate when a utility's load requirements exceed the output of its base load and intermediate load units.[200] This generally occurs during hot weather, which leads to higher demand and higher power market prices throughout the region.[201] If natural gas prices spike when Woodsdale is required to run and propane were unavailable as a substitute fuel, CG&E would lose a substantial benefit of owning peaking capacity because fuel is the largest component of Woodsdale's variable operating costs.[202] To the extent that CG&E did not seek bids for this service, ULH&P assumes that it could be characterized as not an arm's length agreement.

However, notwithstanding that these three agreements were not the result of a competitive bidding process, and thus may not be at arm's length, ULH&P requests that the Commission grant a deviation request such that ULH&P can be assigned these

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[197] *Id* at 7 – 8.

[198] *Id* at 8

[199] *Id.*

[200] *Id.*

[201] *Id.*

[202] *Id.*

agreements. Attempting to undertake a competitive bidding process for these services, while at the same time attempting to close this transaction, would place an undue burden on ULH&P with no guarantee of any benefit arising from such a process, and would thus be unreasonable under KY. REV. STAT. ANN. § 278.2213(6). Given the benefits arising under these agreements, as described *supra,* ULH&P has demonstrated that it is in the public interest for its requested deviation to be granted.

## VIII. CONCLUSION

CG&E has presented its affiliate, ULH&P, a unique opportunity to assemble a complete portfolio of high-quality, reliable electric generating plants at a price that is substantially below market and more than $600 million below the next least cost supply alternative. With the acquisition of the Plants in accordance with ULH&P's Amended Application, ULH&P's customers will see little resulting impact to their rates while enjoying the insulation from the volatility of the wholesale power marketplace that comes with generation asset ownership.[203] In return for making the Plants available to ULH&P at a price far below the potential market value of these Plants, CG&E has asked that the Commission commit to certain rate-making treatment. The treatment requested would be reasonable in any utility rate case, but is even more so here, where such significant value is being provided to ULH&P and its customers. ULH&P strongly encourages the Commission to approve each and every request made in its Amended Application so that ULH&P's customers can realize the great benefits awaiting them with the closing of this

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[203] *See* Steffen at 4; Trans. Vol. I at 186.

proposed transaction, and enjoy a stable, reliable, low-cost supply of power for many years to come.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby give notice that on this 18th day of November, 2003, I have mailed for filing an original and 10 true copies of the foregoing Brief with the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601, and I further certify that this same day I have served the parties by mailing a true copy of the same via overnight mail, postage prepaid, to those listed below.

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