COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF DUKE ENERGY KENTUCKY, INC. FOR AN ORDER APPROVING THE ESTABLISHMENT OF A REGULATORY ASSET FOR THE DEPRECIATION EXPENSE OF ITS EAST BEND UNIT 2 GENERATING STATION	)))))	CASE NO. 2015-00120

ORDER

On April 10, 2015, Duke Energy Kentucky, Inc. ("Duke Kentucky" or "the Company") filed an application ("Application") seeking approval to establish a regulatory asset for depreciation expense associated with the Company's acquisition of a 31 percent interest in East Bend Unit 2 Generating Station ("East Bend") from Dayton Power & Light Company ("DP&L"). Duke Kentucky sought this approval due to the excessive depreciation expense that would result from a strict application of a recent ruling issued by the Federal Energy Regulatory Commission ("FERC") relating to depreciation on acquisition adjustments.[1]

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), is the only intervenor in this proceeding. On May 14, 2015, the AG filed a motion requesting the Commission to establish a limited procedural schedule authorizing the AG to issue a request for information to Duke Kentucky to ensure that the record in this case is complete and thorough. By Order entered May 29, 2015, the Commission granted the AG's motion and established a date for Duke

[1] Application at 1.

Kentucky to respond to the AG's request for information. Duke Kentucky responded to requests for information from both Commission Staff and the AG. The matter now stands submitted to the Commission for a decision.

BACKGROUND

Pursuant to the Commission's December 4, 2014 Order in Case No. 2014-00201[2] approving a stipulation between the Company and the AG, Duke Kentucky was granted a Certificate of Public Convenience and Necessity to acquire the remaining 31 percent interest in East Bend from DP&L for $12.4 million.[3] At the time of the acquisition, the original cost of the interest acquired from DP&L was $214 million, with an accumulated depreciation balance of $138 million, leaving a net book value of $76 million.[4]

In support of its request, Duke Kentucky states in its Application that, pursuant to KRS 278.220, the system of accounts established by the Commission for electric companies must conform as nearly as practicable to the system adopted or approved by FERC, and that FERC requires the use of a systematic and rational depreciation methodology by all utilities subject to its jurisdiction, including Duke Kentucky. Due to a

[2] Case No 2014-00201, *Application of Duke Energy Kentucky, Inc. for (1) A Certificate of Public Convenience and Necessity Authorizing the Acquisition of the Dayton Power & Light Company's 31% Interest in the East Bend Generating Station; (2) Approval of Duke Energy Kentucky, Inc.'s Assumption of Certain Liabilities in Connection with the Acquisition; (3) Deferral of Costs Incurred as Part of the Acquisition; and (4) All Other Necessary Waivers, Approvals, and Relief* (Ky. PSC Dec. 4, 2014).

[3] Prior to the acquisition of the 31 percent interest, Duke Kentucky owned the other 69 percent interest in East Bend.

[4] Application at 2.

ruling by FERC issued on December 22, 2014, in a case involving several of the Company's affiliated operating companies,[5] Duke Kentucky has concluded that FERC will require the application of the depreciation rate currently applied to Duke Kentucky's original 69 percent share of East Bend to also be applied to the $214 million original plant cost for the recently acquired 31 percent interest in East Bend, rather than to the $12.4 million net purchase price, as Duke Kentucky had originally intended.[6]

Duke Kentucky states that applying its current 1.79 percent depreciation rate for East Bend to the $214 million original plant cost of its newly acquired 31 percent interest in the unit, as required under FERC's "systematic and rational methodology," would result in fully depreciating the $12.4 million cost of the East Bend interest acquired from DP&L over a period of approximately four years. This is well short of the expected remaining service life of East Bend, which is 27 years, based on currently approved depreciation rates.[7] The Company had intended to depreciate the $12.4 million cost of the acquired interest by applying its current depreciation rate over the 27-year remaining service life of East Bend, but due to the FERC ruling, will be unable to act as it intended and stated in Case No. 2014-00201.[8]

Duke Kentucky states that in practical terms, the FERC ruling will dictate that it record approximately $3.833 million in annual depreciation expense on its books in 2015, 2016, and 2017, and $902,000 in 2018. Thus, in 2018, Duke Kentucky's $12.4

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[5] *See In the Matter of Carolina Power and Light Co., Duke Energy Progress, Inc.* Docket Nos. ER 13-1313-000, ER 13-1313-001, ER 13-2186-001, EL 14-2-000, EL 14-2-001 (Consolidated) and AC 13-170-000, 149 FERC ¶ 61,266 (Dec. 22, 2014).

[6] Application at 3.

[7] *Id.*

[8] *Id.*

million cost to acquire the remaining 31 percent interest in East Bend will be fully depreciated for FERC's purposes.[9] These annual depreciation expense amounts vastly exceed $222,000, the amount Duke Kentucky originally intended to include as the annual depreciation expense over East Bend's expected remaining service life. The $222,000 was based on application of the applicable depreciation rate to the $12.4 million net purchase price of the 31 percent East Bend interest over the expected 27 years remaining service life of East Bend.[10]

Duke Kentucky maintains that the FERC mandated depreciation expense will understate its true financial performance for the first four years and then overstate its financial performance for the next 23 years.[11] Because of this, FERC's accounting will lead to a mismatch on the Company's ratemaking accounts, and, if left unchanged, would be inconsistent with the intended results of the stipulation regarding the purchase of the additional interest in East Bend.[12] Further, Duke Kentucky states that strict application of FERC's accounting method will result in a distortion of sound depreciation principles inasmuch as the depreciation of its $12.4 million investment will not be recognized over the remaining life of the asset.[13]

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[9] *Id.*

[10] *Id.* at 3-4. In response to Commission Staff's First Request for Information, Item 2, Duke Kentucky explained the $222,000 was calculated by multiplying the currently approved East Bend weighted average composite depreciation rate of 1.79 percent by the $12.4 million investment cost. Over 27 years, that would result in approximately $6 million in depreciation. The Company anticipates this rate will change once its next depreciation study is approved.

[11] *Id.* at 4.

[12] *Id.*

[13] *Id.*

In further support of its Application, Duke Kentucky points to a FERC precedent which held that state regulatory actions that differ from FERC requirements should be reconciled through the employment of regulatory assets and liabilities.[14] The Company proposes to record the difference between the FERC-mandated annual depreciation expense and the $222,000 annual depreciation expense it originally intended as a regulatory asset until its $12.4 million investment in the acquired East Bend interest is fully depreciated (over four years) under FERC's accounting. Thereafter, it will amortize the regulatory asset over the following 23 years, which should correspond with the estimated remaining service life of East Bend.[15] Duke Kentucky states that it will record $3.611 million as a regulatory asset in 2015, 2016, and 2017, and $680,000 in 2018, which equals the depreciation expense under FERC's methodology minus the originally intended annual depreciation expense of $222,000 set forth in Case No. 2014-00201.[16] The Company states that its proposed approach will allow it to comply with FERC's depreciation ruling while also spreading the depreciation expense, for ratemaking purposes, over the remaining life of East Bend.[17] Finally, Duke Kentucky states that until such time as its application may be granted, it will have to continue to record the East Bend depreciation as mandated by FERC.[18] The Company states that if it

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[14] *Id.*

[15] *Id.* at 4-5.

[16] *Id.* at 5.

[17] *Id.*

[18] *Id.* at 6.

receives Commission approval to create a regulatory asset, it will make retroactive changes to its monthly 2015 income statements.[19]

DISCUSSION

A regulatory asset is created when a utility is authorized to capitalize an expenditure that would be recorded as an expense under traditional accounting rules. The utility would then have the opportunity to request rate recovery of the capitalized amount in a future rate proceeding. A utility's authority to establish a regulatory asset comes from the Commission's authority to regulate utilities under KRS 278.040 and KRS 278.220. Utilities must obtain Commission approval for accounting adjustments before establishing any expense as a new regulatory asset.[20]

The Commission has previously approved regulatory assets for jurisdictional utilities[21] when a utility has incurred: (a) an extraordinary, nonrecurring expense which could not have been reasonably anticipated or included in the utility's planning; (b) an expense resulting from a statutory or administrative directive; (c) an expense in relation

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[19] *Id.*

[20] Case No. 2001-00092, *Adjustment of Gas Rates of the Union Light, Heat and Power Company* (Ky. PSC Jan. 31, 2002).

[21] The Commission approved the establishment of regulatory assets for Asset Retirement Obligation-related depreciation and accretion expenses for Louisville Gas and Electric Company and Kentucky Utilities Company when those utilities adopted Statement of Financial Standards No. 143, *Accounting for Asset Retirement Obligations*, respectively, in Case No. 2003-00426, *Application of Louisville Gas and Electric Company for an Order Approving an Accounting Adjustment to be Included in Earnings Sharing Mechanism Calculations for 2003* (Ky. PSC Dec. 23, 2003), and Case No. 2003-00427, *Application of Kentucky Utilities Company for an Order Approving an Accounting Adjustment to be Included in Earnings Sharing Mechanism Calculations for 2003* (Ky. PSC Dec. 23, 2003).

to an industry-sponsored initiative; or (d) an extraordinary or nonrecurring expense that over time will result in savings that fully offset the cost.[22]

The Commission notes that although the FERC proceedings were pending during our review of Case No. 2014-00201 and, in fact, the FERC proceedings were decided only a few weeks after our final Order was issued in Case No. 2014-00201, the Commission was not made aware of this issue until several months subsequent to the issuance of the final order in Case No. 2014-00201. Nonetheless, the Commission agrees with Duke Kentucky's position that, due to FERC's accounting directive regarding depreciation on acquisition adjustments and the commitments the Company made in Case No. 2014-00201 regarding depreciation expense, establishing a regulatory asset for the greater FERC-required portion of the depreciation expense is consistent with the second listed example. The Commission finds that establishing a regulatory asset under the circumstances presented here will lead to a reasonable result by ensuring that the net depreciation expense recorded on Duke Kentucky's income statements is consistent with the remaining life of East Bend. Further, the recording of a regulatory asset will result in the amounts ultimately recovered from ratepayers that will be based on the $12.4 million cost to the Company of the 31 percent interest in East Bend (not the $214 million original plant cost) and will be consistent with the commitments made by Duke Kentucky and accepted by the Commission in Case No. 2014-00201. For these reasons, we will approve Duke Kentucky's proposal.

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[22] *See* Case No. 2008-00436, *The Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting from Generation Forced Outages* (Ky. PSC Dec. 23, 2008). *See also* Case No. 2010-00449, *Application of East Kentucky Power Cooperative, Inc. for an Order Approving the Establishment of a Regulatory Asset for the Amount Expended on its Smith 1 Generating Unit* (Ky. PSC Feb. 28, 2011).

IT IS THEREFORE ORDERED that:

1. The accounting treatment as requested by Duke Kentucky and as set forth in its Application to record a regulatory asset for the amount of the greater FERC-required portion of depreciation expense associated with the 31 percent acquired interest in East Bend is approved.

2. Once Duke Kentucky has fully depreciated its 31 percent acquired interest in East Bend using the FERC-required depreciation methodology, Duke Kentucky shall begin to amortize the regulatory asset over the remaining service life of East Bend.

3. Duke Kentucky shall, within 14 days of the date of this Order, file with the Commission the accounting entries made on its books to effectuate the creation of the regulatory asset.

4. At the time of its next electric base rate case, Duke Kentucky shall file an updated depreciation study and provide a detailed description of how it proposes to recover the regulatory asset and the remaining balance of its investment in East Bend.

5. Any document filed in the future pursuant to ordering paragraph 3 herein shall reference this case number and shall be retained in the utility's general correspondence file.

By the Commission

ENTERED

AUG 20 2015

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

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