COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

Drop Box

In the Matter of:

| | | |
|---|---|---|
| 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 |

**POST HEARING BRIEF OF THE ATTORNEY GENERAL**

On July 7, 2003, the Union Light, Heat and Power Company ("ULH&P") filed an application for the approval of the purchase of certain generating assets from its sister company Cincinnati Gas and Electric Company ("CG&E); for the approval of a purchased power agreement between ULH&P and its sister companies, CG&E and Cinergy Services; for the approval of a backup power purchase agreement from its sister company, CG&E; for the approval of specific accounting treatment pertaining to the assets transferred and contracts executed; and, for a deviation from the governing statutory requirements addressing affiliate transactions. On July 29, 2003, the Attorney General was granted intervention in this action. Discovery was conducted and the Attorney General filed Direct Testimony. An amended Application changing certain terms of the proposed purchase was filed on October 29, 2003, and the hearing was conducted on October 29-30, 2003. Responses to data requests posed to both parties were filed on November 7, 2003. This post hearing brief of the Attorney General follows.

## ARGUMENT

## I

## ULH&P HAS FAILED TO DEMONSTRATE THAT THE PROPOSED TRANSACTIONS MEET THE REQUIREMENTS OF KRS 278.2207 AND 278.2213(6) GOVERNING AFFILIATE TRANSACTIONS, OR THAT A DEVIATION FROM THOSE REQUIREMENTS SHOULD BE GRANTED UNDER KRS 278.2219 OR KRS 278.2207(2). THE PROPOSED PURCHASE OF GENERATING ASSETS, SPECIFIED ACCOUNTING TREATMENT, AND REQUEST FOR A DEVIATION SHOULD BE DENIED.

Because the proposed purchase of generating assets and the various associated contracts are affiliate transactions between ULH&P and various sister companies within the Cinergy framework, the Commission must determine whether ULH&P has successfully met its burden in proving that the transaction, in all of its parts, merits a deviation from affiliate transaction rules under KRS 278.2219 or KRS 278.2207(2) as a prerequisite to approval. ULH&P has not met this burden.

KRS 278.2213(6) requires transactions between affiliate companies to be arm's length. 278.2219 allows deviations from this requirement if the utility can prove that "compliance with the provisions of KRS 278.2201 to 278.2213 is impracticable or unreasonable." KRS 278.2207(2) allows deviations from those specific affiliate transaction rules that require that products sold (generating assets) or services provided (power sales agreements and backup power agreements) to a utility by an affiliate be priced at the affiliate's "fully distributed cost but in no event greater than market" if the utility meets its burden to "demonstrate that the requested pricing is reasonable." ULH&P has not demonstrated that compliance with the provisions of KRS 278.2213(6) is impracticable or unreasonable; it has not demonstrated that its pricing is at the affiliate's

fully distributed costs, but in no event greater than market; and, it certainly has not demonstrated that the requested pricing is reasonable.

While ULH&P maintains that the generating assets are priced below market price, no Request for Proposal ("RFP") was undertaken to confirm this proposition. We are left to speculate that market price for these assets is greater than net book price plus retention by the seller of the benefits of below-the-line accounting for ADIT and ADITC and of the retention of a portion of off-system sales, elements of the transaction that dramatically increase the price of the assets being acquired over simple net book value.[1] Given the market price of new CTs acquired by other utilities in cases recently conducted before this Commission, the merit of that transaction is suspect. ULH&P has failed to meet its burden under KRS 278.22078(2) of showing that the price is reasonable.

By like token, despite the Commission's exhortation that ULH&P should do so,[2] no RFP was undertaken to determine what purchased power and assets might be acquired for ULH&P from parties that are not affiliates. This deficiency also leaves the Commission with no alternative but to speculate concerning the availability of alternatives, the market price of alternatives and the reasonableness of the price of the package offered to ULH&P by her affiliates.

While ULH&P has shown that this deal was more reasonable than the most expensive exposure ULH&P could face through market power purchases exclusively on the spot market or through the purchase of generation inclusive of the most expensive generation (Zimmer) CG&E has to offer, it did not show that the price as increased by the

[1] See, AG response to hearing data request 1 in which Mike Majoros demonstrated that continuation of the practice of accounting for ADIT and ADITC below-the-line will result in ratepayers paying an added $317,650,236 over the life of the assets.

[2] See, *The Matter of the Application of the Union Light, Heat and Power Company for Certain Findings Under 15 U. S. C. § 79Z,* Case No. 2001-058, pp. 13 and 14 (page number omitted in original order).

proposed accounting treatment and retention of off-system sales proceeds - when considered from the perspective of ULH&P only - is reasonable. In fact, Steve Harkness, manager of CG&E's energy marketing business unit and participant in the construct of the offer, said that in developing the proposal, efforts were made to choose assets such the ratepayers of ULH&P did not experience a significant increase in rates or, for the benefit of the other stakeholders, a significant rate decrease.[3]

If ULH&P and its witnesses sponsoring testimony concerning the reasonableness of the proposal and price were independent (all witness testifying to the reasonableness of the price and format of the transaction were either employees of affiliates or employees who held responsibilities for ULH&P and affiliates) and not concerned with CG&E's or Cinergy's interests, ULH&P would have made every attempt to secure the best deal and lowest commensurate rates, regardless of the ramifications to other corporate siblings.

In the absence of RFPs and any other effort to determine what is available to ULH&P outside of affiliate transactions, ULH&P stays locked in the circular logic of the affiliate transaction, the sum of which is that the deal is neither the most expensive CG&E could have offered to ULH&P nor is it the least expensive, and we have no idea of what alternatives might be available or any objective comparison by which the value or reasonableness of the affiliate transaction can be determined. ULH&P has not satisfied those requirements of KRS 278.2207 and/or KRS 278.2219 that allow a deviation from affiliate transaction rules.

## II
## ULH&P HAS NOT COMPLIED WITH THE COMMISSION'S ORDER IN 2001-058; HENCE, ITS REQUEST FOR A DEVIATION MUST BE DENIED.

[3] Transcript of Evidence ("TE"), page 117, lines 7-12.

The Commission's directive in Case No. 2001-00058 is unequivocal. The company was directed to explore purchase power bids as well as construction of generation, not simply one or the other. In light of ULH&P's failure to comply with the order, the Commission must find that ULH&P has not dispelled the Commission's deep concern about ULH&P's less than arm's length transactions with CG&E.

Were this transaction to be approved, a new long-term high water mark of intertwined business activities between ULH&P, CG&E, and Cinergy would ensue. It is imperative that the request for the deviation from KRS 278.2219 and KRS 227.2207 not be granted absent clear grounds to do so. As was set forth in the preceding argument, those clear grounds are not present; ULH&P has not met its burden. Given the Commission's pre-existing concerns, the deviation should not be granted.

## III.
## THE PROPOSAL SET FORTH IN THE AMENDED APPLICATION IS MORE FAVORABLE TO ULH&P THAN WAS THE ORIGINAL PROPOSAL, BUT IS STILL UNACCEPTABLE AND REQUESTS RELIEF THE COMMISSION IS NOT AUTHORIZED TO GIVE. THE APPLICATION AS AMENDED SHOULD BE DENIED.

Nothing can compensate for the lack of the sort of objective evidence that would be gained from conducting an RFP to determine what is available and at what price so that a determination of the reasonableness of the proposal, as amended, can be made. Nevertheless, it is necessary to address the proposal as it now stands.

Several aspects of the proposed transaction between ULH&P and CG&E were changed in the amended application. While the amended application represents movement in favor of ULH&P on several issues, the amended application still contains provisions that must be rejected. The unacceptable elements of the original proposal were

addressed in the direct testimonies of the Attorney General's witnesses. To the extent that the proposal contained in the amended application contains unacceptable elements, those will be addressed here.

### A. The Commission is without authority to grant ULH&P's requested ratemaking treatment of various aspects of the transaction.

The transfer of the assets is conditioned on receipt of specific and guaranteed rate treatment by the Commission.[4] While the amended application uses more gently framed language than the original proposal (which demanded that the Commission pre-approve a return transfer of the assets to CG&E should the requested rate treatment not be granted), its effect is the same. It is asking this Commission to engage in ratemaking in an action that is not a rate case and seeks to bind the Commission when it does look at rates in 2006.

This is not a rate case. No request to change the rates now in effect is made. Therefore, this question arises: Can the Commission engage in rate making that will bind it in the future by guaranteeing future rate treatment to be accorded ADIT and ADITC, by fixing the value of the plants now for future ratemaking purposes, and by dictating the future treatment of off-system sales as a part of its authority in this action to examine whether a certificate of convenience and necessity should issue, as a part of its authority in this action to determine whether a deviation from affiliate transaction rules is warranted, or as a simple function of being asked to do so in this action in the absence of a rate filing? The answer is no.

The Courts have pointed out repeatedly that the Commission must act in accord with its enabling legislation and may not blend its authority over several different aspects

[4] See, Section 3.a of the Amended Application.

of regulation improperly. In *South Central Bell Telephone Telephone Co v Utility Regulatory Com'n*, Ky., 637 S.W.2d. 649 (1982) the Court held that the Commission could not blend its authority to regulate rates and service by lowering rates from those found to be fair, just and reasonable to give the utility incentive to remedy deficiencies in service or to penalize it for continued poor performance. The Court pointed out that the Commission clearly was given authority over both rates and service, but that the areas of rates and service are two "distinct areas and, therefore, are subject to separate procedures, standards and remedies[5]" in the statutory scheme. The Court went on to say,

> In fixing rates, the Commission *must* give effect to all factors which are prescribed by the legislative body, but may not act on a matter which the legislature has not established, *id.*, Sec. 41, (c)(aa) p. 1093. We have held that the Commission's powers are purely statutory. *City of Olive Hill v. Public Service Commission*, 305 Ky. 249, 203 S.W.2d 68 (1947). When a statute prescribes a precise procedure, an administrative agency may not add to such provision. *Union Light, Heat & Power Co. v. Public Service Commission*, Ky., 271 S.W.2d 361 (1954).[6]

In a similar vein, in *Blue Grass State Tel. Co. v. Public Service*, Ky., 382 S.W.2d 81 (1964), the Commission denied a request for a certificate of convenience and necessity because of its concern over the disparity between the price paid for the assets by the applicant for the certificate and the depreciated original cost of the system. The Court held that consideration of the price was not a proper basis on which to deny the certificate saying,[7]

> Since, in the instant case, the Commission was not asked to approve an increase in rate and since, as indicated herein, they are not inflexibly bound by the purchase price whenever an increase in rates is considered, the holding of the Commission was premised on an improper conclusion regardless of whether $120,000 was an unreasonable price.

---

[5] Id., at 652.
[6] Id., page 653.
[7] Id., at 83.

Instead of looking at the price of the transfer in a certificate case, the Court said the Commission must look only at the statutory criteria established for the grant of a certificate, and must reserve its examination of the price and the potential impact of price on rates to a rate case.

This Commission continues to be bound by its statutory authority. It cannot approve ratemaking treatment outside of a rate case either in connection with its authority to determine whether the requested certificate should be issued in this case or in connection with its authority to examine whether a deviation from affiliate transaction rules should be granted because that ratemaking treatment is not germane to the findings the Commission must make under KRS 278.020, KRS 278.2219, or KRS 278.2207(2). The area of ratemaking is separate and distinct from the area of granting a certificate or of granting a deviation from affiliate transaction rules. Each of them has their own separate procedures, standards and remedies. Statutory authority governing ratemaking is laid out elsewhere[8] and the consideration of the ratemaking treatment of the assets is appropriate only in connection with rates based on those assets. Therefore, the Commission cannot approve guaranteed ratemaking treatment as an adjunct to the request for a certificate and for a deviation from affiliate transaction rules in the absence of a rate case just because the utility asks that it do so.

While the general proscription against determining the ratemaking treatment to be given covers all of the items for which ratemaking treatment is requested by ULH&P in this proceeding, there is a further specific statutory proscription against fixing the value of the plants. ULH&P asks the Commission,[9] in this proceeding, to fix the value of the

[8] See, for example, KRS 278.030, KRS 278.270, KRS 278.260, KRS278.180, and KRS 278.190.
[9] See, Section 3.i of the Amended Application.

plants for ratemaking purposes at the original cost less accumulated depreciation at the time of transfer to ULH&P, under the authority granted to the Commission by KRS 278.290. Section (2) of that statute provides that;

> 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. . .

This is not a rate case and it is not a case pertaining to service or the issuance of securities. No change is being made to rates now in effect until 2006. Therefore, under Section (2), this Commission does not have authority to value the property under KRS 278.290 in this case.

**B. Even if the Commission had the authority to accept the ratemaking treatment proposed by ULH&P, it should not do so with respect to the treatment of ADIT and ADITC and with respect to off-system sales.**

ULH&P asks this Commission to gaurantee that in its next rate case off-system sales be paid for and their profits be divided in accord with the request made in Section 3.g of the amended application. In this proposal ratepayers will get the first million of off-system sales and anything over the first million is to be divided between the ratepayers and the utility on a 50-50 basis. The amended proposal is an improvement over the original proposal which suggested that ULH&P should retain the proceeds of all off-system sales. Still, however, the Commission has no authority to approve that provision and the provision is not reasonable.

The determination of what should be done with the costs and profits from off-system sales is purely a ratemaking concern, and this is not a rate case. The Commission has no authority to make that determination here. Further, the proposal is not reasonable.

While the proposed treatment of off-system sales is posited as a mechanism to increase the price of the assets being transferred through the retention of a stream of income to which the utility would not normally be entitled, and thus may be considered an element of the "price" of the assets transferred, the request is not limited to the proceeds of sales accomplished solely from the transferred assets. Should ULH&P acquire other assets while the provision is in place, it would apply equally to off-system sales derived from those assets as well as from these assets. That result would be absurd. The provision is not reasonable and should be denied.

The same is true of ULH&P's proposal to amortize ADIT and ADITC below-the-line. ULH&P continues its original proposal to amortize ADIT and ADITC accrued prior to the transfer below-the-line for income, rate base, and rate of return purposes. This portion of the proposal suffers the same problems as those discussed above; the Commission has no authority to grant this request as a function of a certificate case and outside a rate case. Further, even if it could do so, it should not approve this request.

If granted, this element of the transaction will cost the ratepayers an added $317,650,236 over the lives of the assets, or approximately $12.8 million per year in added revenue requirement.[10] This represents a significant increase in the price to ULH&P of the plants over the net book value for which they will not receive standard ratemaking treatment or benefit while the seller simultaneously receives a tax benefit it

[10] See AG response to Hearing Data Request filed November 7, 2003. The annual revenue requirement is derived by dividing the total of $317,650,236 by 24.75, the average remaining life span of the units shown on line 9 of that response.

could not obtain in an arm's length transaction.[11]

Were the Commission to approve the transaction as proposed, it would be setting an extremely poor precedent. The accrued ADIT and ADITC are monies gained from ratepayers – monies which the utility has not invested. If granted the requested treatment, they are amounts on which the utility will not only earn a return, but will also collect again from Kentucky ratepayers. The proposed transaction takes advantage of Kentucky ratepayers based on the Commission's expressed desire for ULH&P to have long term solutions to its source of supply problem. The leverage being sought here would never have been contemplated had the plants not passed out of regulation for a short time. It also ignores the gain for the Cinergy group arising from the return of these plants to the earnings safety represented by regulation. The earning risk reduction associated with the return of the plants to the regulated utility is enticing in today's market.

With this proposal, ULH&P is engaging in a first; a transaction in which previously long regulated plant has been transferred briefly to the unregulated side of the company and is now being transferred back to a regulated utility within that company accompanied by a request for the Commission to guarantee ratemaking treatment as a condition of the purchase.[12] Those aspects of the proposal seeking approval of future rate treatment outside of a current rate case must be denied. Even if the Commission had the authority to consider those requests, it should refuse to approve the transaction.

---

[11] Were this an arm's length transaction, the price would be established, the seller would take the gains directly rather than continuing to get the tax benefit of ADIT and ADITC after the transfer, and the buyer would be justifying the amount of the acquisition adjustment. The value to the affiliate seller is greater with the transaction structured as it is than it would be were it an outright sale to a stranger.

[12] While Mr. Steffan indicated that the same treatment was sought for a transfer of plant in Indiana, it was clarified that the plants in question had never been regulated, but instead were purchased from a merchant generator.

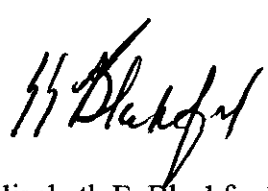
**CONCLUSION**

ULH&P failed to demonstrate that compliance with the requirements of KRS 278.2213(6) that all transactions between affiliates be at arm's length is impracticable or unreasonable so as to permit a deviation under KRS 278.2219, and it has not met its burden to prove that the sale and service proposed is priced at the affiliate's "fully distributed cost but in no event greater than market" or to "demonstrate that the requested pricing is reasonable" to permit a deviation under KRS 278.2207(2) No deviation can be granted.

Further, it has not complied with the Commission's directive to conduct an examination of what purchase power and addition of generation assets is available from non-affiliated parties to satisfy ULH&P's needs.

Finally, the Commission is without authority to grant rate making treatment under the guise of a certificate case and outside of a rate case. The transaction as originally proposed and as modified in the amended application should be denied, or if approved, should be approved contingent only on those changes as would eliminate the problems discussed in Argument III.

Respectfully submitted,



Elizabeth E. Blackford
Dennis G. Howard II
Assistant Attorneys General
1024 Capital Center Drive, Suite 200
Frankfort, Kentucky 40601-8204
(502) 696-5453
betsy.blackford@law.state.ky.us
dennis.howard@law.state.ky.us

NOTICE OF FILING AND CERTIFICATION OF SERVICE

I hereby give notice that I have filed the original and ten true copies of the foregoing with the Executive Director of the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601 this the 19th day of November, 2003, and certify that this same day I have served the parties by mailing a true copy, postage prepaid, to the following:

JOHN J FINNIGAN ESQ
MICHAEL J PAHUTSKI ESQ
139 EAST FOURTH STREET
CINCINNATI OH 45201