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

APPLICATION FOR DEVIATION

Pursuant to KRS 278.2207(2) and 278.2219, The Union Light, Heat and Power Company (ULH&P) requests that the Commission grant a deviation from the requirements of KRS 278.2207(1) and 278.2213(6) to allow ULH&P to (1) engage in coal transactions with, purchase lime from, and receive coal and lime transportation services from its affiliate, The Cincinnati Gas & Electric Company (CG&E), at fully distributed cost; (2) enter into an agreement with CG&E to operate, on ULH&P's behalf, the Miami Fort 6 electric generating facility; and (3) to enter into an agreement with CG&E to provide gas and propane O&M services to ULH&P at the Woodsdale Electric Generating Station (Woodsdale). This application is based on the accompanying memorandum.

ULH&P requests that the Commission act on this Application no later than May 31, 2005 so that ULH&P can adequately plan for and manage its coal and lime supply needs, the operation of Miami Fort 6, and the operation and maintenance of Woodsdale-

related gas and propane facilities in advance of its acquisition of certain generating assets from CG&E, currently targeted for July 1, 2005.

Respectfully submitted,

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MEMORANDUM IN SUPPORT OF APPLICATION FOR DEVIATION

I. INTRODUCTION

On July 21, 2003, The Union Light, Heat and Power Company (ULH&P) filed an application for an Order pursuant to KRS 278.020 and 807 KAR 5:001 Sections 8 and 9 granting ULH&P, among other relief, a Certificate of Public Convenience and Necessity (CPCN) to acquire ownership of, and operate, 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).[1] ULH&P hereby requests additional relief related to the transfer of the Plants. First, ULH&P seeks approval to engage in coal transactions with, purchase lime from, and receive coal and lime transportation services from its affiliate, CG&E, at fully distributed cost. Second, ULH&P seeks approval of an Operation Agreement with respect to the operation of Miami Fort 6. Third, ULH&P seeks approval of a Gas and Propane Services Agreement for the gas and propane facilities at Woodsdale.

II. COAL AND LIME TRANSACTIONS, TRANSPORTATION OF COAL AND LIME

In testimony supporting its application in Case No. 2003-00252, ULH&P stated that Cinergy[2] would work with each of its coal suppliers to amend its coal supply

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[1] *See In the Matter of the Application of the Union Light, Heat and Power Company for a Certificate of Public Convenience 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 (hereinafter "Case No. 2003-00252") (Application filed July 21, 2003).

[2] In this context, Cinergy refers to Cinergy Services, Inc., ("Cinergy Services") a service company organized under the Public Utilities Holding Company Act of 1935, as amended, and provides general and administrative services to the subsidiaries of Cinergy Corp., ULH&P's ultimate parent company. Specifically, this testimony refers to Cinergy Services' Commercial Fuels group, which is responsible for planning and sourcing coal and lime supply for CG&E's generating stations.

contracts in order to make ULH&P a party to these agreements.[3] ULH&P further stated that when these existing contracts expire, ULH&P would be made a party on future contracts.[4] In this way, ULH&P would receive the benefits of Cinergy's purchasing coal for the entire Cinergy System.

As described in the Compliance Filing made March 21, 2005 in this proceeding, ULH&P is working with CG&E in an attempt to optimize the procurement of coal for each respective party, and hence may in the near future be in a position to request Commission approval of a Coal and Lime Supply and Transportation Agreement.[5] In the interim, ULH&P requests the relief described herein so that it will be able to secure a supply of coal and lime, and transportation thereof, for the Plants after its expected Plant transfer closing date, July 1, 2005.

A. Current Coal Supply Process

Currently, each of the Plants is owned by CG&E. Cinergy Services' Commercial Fuels group ("Commercial Fuels"), on behalf of CG&E, negotiates contracts for the purchase of coal and, as applicable, lime, for these Plants, and the remainder of CG&E's coal-fired fleet. Although Commercial Fuels generally targets coal from specific supply contracts to specific plants, Cinergy Services' Portfolio Optimization group (PortOps), daily runs models that dictate the quantity of coal and lime, and specifically which coal, is to be delivered to which plant based on planned operation of the plants. These models

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[3] *See Case No. 2003-00252* (Direct Testimony of J. Thomas Mason, filed July 21, 2003, at 8).

[4] *Id.*

[5] In the event that ULH&P and CG&E cannot so agree on such a Coal and Lime Supply and Transportation Agreement, or this Commission or the Public Utilities Commission of Ohio do not approve such a Coal and Lime Supply and Transportation Agreement, ULH&P will enter into its own coal, lime and transportation agreements with third parties.

consider such factors as the market price of power, the market price of coal, emission allowance price, coal BTU content, coal sulfur content, plant heat rates, plant outages, lime cost, and environmental control equipment status. PortOps' and the Commercial Fuels group's aim is to assign coal and lime to plants in the most economic manner to minimize its overall fuel costs. This assignment of coal and lime to specific plants can take place even as the coal and lime-laden barges are on the Ohio River en route to the Cincinnati/Northern Kentucky area where CG&E's coal-fired plants are located.

CG&E also enters into coal and lime transportation agreements with river barge companies to transport coal and lime from suppliers to its stations, including the Plants.

B. Proposed Relief

As stated above, ULH&P is currently workin g with CG&E to determine the optimum means of procuring coal for their respective plants. Until such time as the parties can conclude this effort, ULH&P requests that it be permitted to engage in coal and lime supply and transportation transactions for its Plants with CG&E at fully distributed cost. Specifically, ULH&P proposes that (1) CG&E continue to supply coal to the Plants, after their transfer to ULH&P, from the same contracts that serve the Plants today, at fully distributed cost; (2) ULH&P be permitted to engage in coal transactions with CG&E at fully distributed cost, where it is economic to do so, as described above; (3) ULH&P be permitted to purchase lime from CG&E at fully distributed cost; and (4) ULH&P be permitted to receive coal and lime transportation services from CG&E at CG&E's fully distributed cost.

C. Request for Deviation.

Kentucky Revised Statutes 278.2207(1)(a) provides that "(s)ervices and products provided to an affiliate by the utility pursuant to a tariff shall be at the tariffed rate, with nontariffed items priced at the utility's fully distributed cost but in no event less than market ..." while KRS 278.2207(b) requires that "(s)ervices and products provided to the utility by an affiliate shall be priced at the affiliate's fully distributed cost, but in no event greater than market..." ULH&P's requested relief requires ULH&P to obtain a deviation from Kentucky's affiliate transaction pricing laws in several regards.

First, with respect to purchases of coal from CG&E, in that CG&E locks in prices for coal when negotiating coal supply agreements, it could, over the life of the coal supply agreement, pay above prevailing spot market rates for coal. Where CG&E supplies coal to ULH&P at CG&E's costs, ULH&P could end up paying above prevailing spot market prices for its coal supply. However, ULH&P will not pay more than it otherwise would pay had it entered into long-term coal supply agreements itself. ULH&P is not harmed, but rather is able to take advantage of being part of a larger system, being relieved of the administrative burden of negotiating, managing and operating under separate coal supply agreements.

Second, with respect to the sale of coal to CG&E, ULH&P will be made whole by CG&E. ULH&P will be reimbursed its fully distributed cost for coal that it sells to CG&E. It should be noted that this symmetrical at-cost pricing would see ULH&P selling coal to CG&E at the same price it paid CG&E for such coal.

Third, with respect to purchases of lime from CG&E, in that CG&E locks in prices for lime when negotiating lime supply agreements, it could, over the life of the

long-term lime supply agreement, pay above prevailing market rates for lime. And as with coal, where CG&E supplies lime to ULH&P at CG&E's costs, ULH&P could end up paying above prevailing market prices for its lime supply. However, ULH&P will not pay more than it otherwise would pay had it entered into long-term lime supply agreements itself. Here again, ULH&P is not harmed, but rather is able to take advantage of being part of a larger system, being relieved of the administrative burden of negotiating, managing and operating under separate lime supply agreements.

Fourth, with respect to CG&E providing coal and lime transportation services at cost to ULH&P, where the prevailing price for such transportation services has changed, ULH&P could find itself reimbursing CG&E for transportation services at a rate higher than market value. That is, when CG&E enters into a transportation agreement, it locks in a price that it pays for this service for the term of the agreement. At that time, that price represents the market price. This becomes CG&E's cost over the life of the transportation agreement. If the market price for such transportation services falls over the life of the long-term transportation agreement, CG&E ends up paying something above market for such services. In providing transportation services to ULH&P at CG&E's cost under these long-term transportation agreements, then, if transportation prices later fall, CG&E would technically be providing such services to ULH&P at a rate above market. Of course, these rates are the same rates that ULH&P would pay if it were to have entered into the long-term transportation agreements itself. So ULH&P in this example, while technically paying above market at the time it receives such services from CG&E, is not paying any more than it otherwise would had ULH&P entered into the long-term transportation agreements itself, and is thus not harmed by this arrangement.

Finally, ULH&P notes that the at-cost pricing proposed herein will have no effect on customers' rates. ULH&P's fuel adjustment clause (FAC) rate, through which would flow ULH&P's coal costs, and ULH&P generation-related base rates, through which would flow ULH&P's lime and transportation costs, are frozen through December 31, 2006. Thus, no harm can come to ratepayers by approving ULH&P's requested relief.

Therefore, in accordance with KRS 278.2207(2), and for the reasons described herein, ULH&P requests a deviation from the requirement of KRS 278.2207(1) (b) with respect to engaging in coal transactions with, purchasing lime from, and receiving coal and lime transportation services from, its affiliate, CG&E, at fully distributed cost.[6]

Further, KRS 278.2213(6) requires that "all dealings between a utility and an affiliate shall be at arm's length." In that CG&E would not likely engage in the transactions described above with an unaffiliated entity at cost, it can be assumed that these transactions are not at arm's length. Therefore, in accordance with KRS 278.2219(1), ULH&P hereby requests a deviation from the requirements of KRS 278.2213(6) for the reasons provided herein.

III. OPERATION OF MIAMI FORT 6

While ULH&P intended to operate the Plants, including Miami Fort 6, after it acquired these from CG&E,[7] further analysis of the transaction has persuaded ULH&P that it would be in its, and ratepayers', best interest to allow CG&E to continue to operate

[6] ULH&P notes that Ohio law, to which its affiliate CG&E is subject, requires that transactions between affiliates be priced at fully allocated cost. *See* Ohio Admin. Code § 4901:1-20-16(J)(5).

[7] See Case No. 2003-00252 (Direct Testimony of Gregory C. Ficke, filed July 21, 2003, at 17-18).

Miami Fort 6 due to the complexities of air permitting if ULH&P were to both own and operate Miami Fort 6.

A. Miami Fort Generating Station Air Permit

Miami Fort 6 is part of the larger Miami Fort Generating Station, jointly owned by CG&E and the Dayton Power and Light Company (DPL). The Station, which is composed of four generating units including Unit 6, is a "major stationary source" for purposes of the Clean Air Act. The four generating units at the Station are considered to be separate emissions units at a single stationary source which is subject to the permitting requirement. Consequently all four generating units are covered by the same air permit. Under the Clean Act and its implementing regulations, the owner or operator of a stationary source must obtain an air permit.[8] Because CG&E operates the station on behalf of itself and DPL, the air permit is held in CG&E's name.

In the event ULH&P was both owner and operator of Miami Fort Unit 6, it is unlikely that the Ohio Environmental Protection Agency (EPA) would consider Unit 6 to be a separate major stationary source, subject to a separate permit, based on a transfer of ownership from CG&E to ULH&P. Under the relevant regulations, facilities are deemed to be part of the same stationary source if (1) they are located on the same property or on contiguous or adjacent property; (2) they are owned or operated by the same person or persons under common control; and (3) they belong to a single major industrial group. (i.e., have the same two digit SIC).[9] Under this test, Unit 6 would be considered part of the Miami Fort Generating Station, and subject to the permit issued to the source, regardless of transfer of ownership of the single unit to ULH&P.

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[8] 40 CFR 70.5.

[9] See definition of major source in 40 CFR 70.2.

Furthermore, the air permit for Unit 6 cannot be readily transferred to ULH&P because there is no separate permit for Unit 6 and the single generating unit is considered to be part of the Station, which has been issued a permit in the name of CG&E. It is unclear whether operation of Unit 6 by ULH&P might be deemed to be a technical violation of the applicable air regulations as the unit would be operated pursuant to a CG&E permit, although arguably neither owned nor operated by CG&E. Continued operation of Unit 6 by CG&E would render this issue moot as it is permissible for an air permit to be held in the name of the operator.

In any event, even if ULH&P could obtain a separate air permit for Unit 6, obtaining and administering a separate air permit for Unit 6 would substantially complicate environmental compliance burdens and could potentially result in significant additional costs. Miami Fort 6 shares various plant and equipment with Miami Fort Unit 5, including the exhaust stack containing the required continuous emission monitoring system (CEMS) which monitors emissions from the stack. Obtaining separate air permits for two generating units sharing a common stack might potentially trigger additional requirements as drastic as relocation of existing CEMS equipment. Relocation of CEMS equipment would be an additional capital expenditure that would be passed along to ULH&P and CG&E's customers, while providing no additional value. Even if Ohio EPA did not require changes in the existing CEMS, administering two air permits for generating units sharing a common stack would certainly result in ongoing reporting and other administrative burdens that would provide no corresponding benefits.

Alternatively, continued operation of Unit 6 by CG&E would alleviate any need to pursue a separate air permit for Unit 6 and eliminate the risk of potential capital

expenditures, in the form of CEMS relocation costs, and additional administrative burdens. For this reason, ULH&P is proposing to allow CG&E to continue to operate Miami Fort 6 under the terms and conditions of an Operation Agreement.

B. Miami Fort 6 Operation Agreement

ULH&P proposes to enter into the Miami Fort 6 Operation Agreement (Operation Agreement) with CG&E, a copy of which is attached as Exhibit A. The Operation Agreement provides that CG&E shall operate and maintain Miami Fort 6 and any facilities or equipment used in connection therewith, and make additions, replacements, and retirements thereto, in accordance with good utility practice.

Further, under the Operation Agreement, CG&E shall keep ULH&P reasonably informed of present and anticipated operational issues that may reasonably be expected to be material to ULH&P. CG&E shall reasonably endeavor to obtain advance approval of ULH&P of CG&E's proposed courses of action with respect to Miami Fort 6.

Under the Operations Agreement, ULH&P shall reimburse CG&E for CG&E's total costs, including overheads, incurred in operating Miami Fort 6. ULH&P shall also be responsible for all costs and expenses related to the maintenance of inventories of fuel and plant material and operating supplies, as well as expenses related to additions, replacements, and retirements relating to construction accounts and directly assignable to Miami Fort 6.

C. Request for Deviation

As noted above, KRS 278.2207(1) (b) requires that "products provided to the utility by an affiliate shall be priced at the affiliate's fully distributed cost, but in no event greater than market..." While ULH&P has no reason to believe that any costs incurred on

its behalf by CG&E under the Operation Agreement would be greater than market, in accordance with KRS 278.2207(2), ULH&P requests a deviation from the requirement of KRS 278.2207(1) (b) to the extent necessary to enter into the Operation Agreement.

Additionally, KRS 278.2213(6) requires that "all dealings between a utility and an affiliate shall be at arm's length." Although the Operation Agreement is modeled after the operating agreement between CG&E and DPL for CG&E's operation of Miami Fort Units 7 and 8 on its own and DPL's behalf, the Operation Agreement was not awarded to CG&E through a competitive bid or other solicitation process, and could arguably be denied arm's-length status in a future proceeding. To the extent that the Operation Agreement is not an arm's length agreement, as required by KRS 278.2213(6), ULH&P requests a deviation from the requirements of KRS 278.2213(6), in accordance with KRS 278.2219(1), for the reasons provided herein.

ULH&P submits that its request for these deviations is reasonable, on several grounds. First, by permitting CG&E to operate Miami Fort 6 on ULH&P's behalf, and continue to hold the air permit for the greater Miami Fort Generating Station, ULH&P avoids the potential for capital expenditures associated with relocating the CEMS and the certainty of increased administrative burdens in holding separate air permits for two generating units sharing a common stack. This approach inures to the benefit of ULH&P's customers, who will avoid the need to reimburse ULH&P for any additional expenditures to address these environmental permitting complications.

Second, the personnel that would operate Miami Fort 6 for ULH&P are the same personnel that will operate the plant for CG&E on behalf of ULH&P under the Operation Agreement. As ULH&P has explained in informal conferences before the Commission

Staff and Assistant Attorney General in this proceeding, management personnel involved with the operation of the plant will be employees of Cinergy Services, while bargaining unit personnel will be employees of CG&E. This structure does not change with the implementation of the Operation Agreement at Miami Fort 6. The same Cinergy Services employees will make decisions regarding Miami Fort 6, and the same CG&E bargaining unit employees will physically operate and maintain the plant. The plant will be operated under the Operation Agreement with the same drive for efficiency and reliability as it would be if operated directly by ULH&P.

Finally, the Commission and intervening parties to ULH&P's future rate cases will have full access to ULH&P's and CG&E's books with respect to the matters addressed by the Operation Agreement. CG&E's books and records are open to Commission review under the Commission's Order in Case No. 91-104 approving the Cinergy merger.[10] Hence, the costs incurred and capital expended on Miami Fort 6 under the Operation Agreement will be fully transparent, and ULH&P's recovery of these costs will be subject to Commission review and approval.

IV. GAS AND PROPANE O&M SERVICES

CG&E's Gas Operations Department (Gas Ops), which operates CG&E's natural gas distribution system, currently provides, through an intra-company, inter-departmental agreement, CG&E's Generating Resources Department (Generating Resources) with operation and maintenance services related to certain natural gas and propane facilities

[10] *See In the Matter of the Application of the Cincinnati Gas & Electric Company and Cinergy Corp. for Approval of the Acquisition of Control of The Union Light, Heat and Power Company by Cinergy Corp.*, Case No. 94-104 (Order issued May 13, 1994) ("A summary of the commitments offered to the Commission by Applicants include: 1. Access to the accounts and records of CINergy, CINergy Services, and any affiliate and subsidiaries controlled by CINergy to verify transactions with ULH&P...")

associated with Woodsdale. These services are provided by Gas Ops due to the necessary expertise residing in Gas Ops, and the close geographic proximity of Woodsdale to CG&E's gas distribution facilities. ULH&P desires CG&E personnel, who provide these services today on an intra-company, inter-departmental basis, to provide these same services to ULH&P on an inter-company basis. Thus, the parties propose entering into a Gas and Propane Services Agreement, attached hereto as Exhibit B.

A. Gas and Propane Services Agreement.

Under the proposed Gas and Propane Services Agreement, CG&E will provide O&M services to ULH&P related to the natural gas and propane facilities associated with the Woodsdale Station. These services include, among others:

- Conducting regular inspections;
- Performing leak survey and line patrol;
- Performing corrosion survey;
- Checking odorant equipment;
- Supplying odorant to odorizers, monitor pressures, flows and odorization rates;
- Performing DOT Integrity Management.

CG&E will provide these services to ULH&P at CG&E's fully distributed cost.

B. Request for Deviation

As noted above, KRS 278.2207(1) (b) requires that "products provided to the utility by an affiliate shall be priced at the affiliate's fully distributed cost, but in no event greater than market..." While ULH&P has no reason to believe that any costs incurred on its behalf by CG&E under the Gas and Propane Services Agreement would be greater than market, in accordance with KRS 278.2207(2), ULH&P requests a deviation from the

requirement of KRS 278.2207(1) (b) to the extent necessary to enter into the Gas and Propane Services Agreement.

Additionally, KRS 278.2213(6) requires that "all dealings between a utility and an affiliate shall be at arm's length." CG&E does not typically provide the types of services delineated in the Gas and Propane Services Agreement to other gas-fired power plants, and most certainly does not do so at cost. Further, the Gas and Propane Services Agreement was not awarded to CG&E through a competitive bid or other solicitation process, and could arguably be denied arm's-length status in a future proceeding. To the extent that the Gas and Propane Services Agreement is not an arm's length agreement, as required by KRS 278.2213(6), ULH&P requests a deviation from the requirements of KRS 278.2213(6), in accordance with KRS 278.2219(1), for the reasons provided herein.

ULH&P submits that its request for these deviations is reasonable, on several grounds. First, by permitting CG&E personnel, who are familiar with the Woodsdale gas and propane facilities, to continue to provide these services, ULH&P gets immediate access to expert personnel that it would otherwise have to hire and train.

Second, ULH&P's use of these personnel will be on an as-needed basis, and ULH&P will only pay for the services rendered. If ULH&P were to hire employees to provide these services, it could very well find itself in the position of paying employees for down time, when O&M services had been performed and no more such services were immediately necessary. Using CG&E's Gas Ops personnel, and only paying for the services actually rendered, provides a more economical use of personnel, and can be expected to save ULH&P and ratepayers some expenses.

Third, CG&E will provide the gas and propane-related O&M services at CG&E's fully distributed cost. Given the similarity in organization and cost structure between these two affiliated entities, CG&E's fully distributed costs, on an hour by hour basis, are sure to be close to, if not exactly the same as, ULH&P's costs if ULH&P employees were to perform these services.

Finally, the Commission and intervening parties to ULH&P's future rate cases will have full access to ULH&P's and CG&E's books with respect to the matters addressed by the Operation Agreement. CG&E's books and records are open to Commission review, as noted above, under the Commission's Order in Case No. 91-104 approving the Cinergy merger.[11] Hence, the costs incurred by CG&E under the Gas and Propane Services Agreement will be fully transparent, and ULH&P's recovery of these costs will be subject to Commission review and approval.

V. CONCLUSION.

Given the nature of the coal and lime transactions and transportation services described herein, and the benefits available to ULH&P and its ratepayers flowing from the Operation Agreement and the Gas and Propane Services Agreement, along with the transparency of the underlying transactions, ULH&P's request for a deviation of the Commonwealth's affiliate pricing requirements is clearly reasonable, and will not interfere with "the commission's requirement to ensure fair, just and reasonable rates for utility services."[12]

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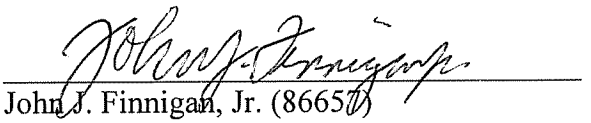
[11] *See In the Matter of the Application of the Cincinnati Gas & Electric Company and Cinergy Corp. for Approval of the Acquisition of Control of The Union Light, Heat and Power Company by Cinergy Corp.*, Case No. 94-104 (Order issued May 13, 1994) ("A summary of the commitments offered to the Commission by Applicants include: 1. Access to the accounts and records of CINergy, CINergy Services, and any affiliate and subsidiaries controlled by CINergy to verify transactions with ULH&P...")

[12] *See* KRS 278.2207(3).

WHEREFORE, in accordance with KRS 278.2207(2) and KRS 278.2219, The Union Light, Heat and Power Company requests a deviation from the provisions of KRS 278.2207(1)(b) and KRS 278.2213(6) to the extent necessary to allow ULH&P to (1) engage in coal transactions with, purchase lime from, and receive coal and lime transportation services from its affiliate, CG&E at fully distributed cost; (2) enter into an agreement with CG&E to operate, on ULH&P's behalf, the Miami Fort 6 electric generating facility; and (3) to enter into an agreement with CG&E to provide gas and propane O&M services to ULH&P at the Woodsdale Electric Generating Station.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby give notice that on this 9th day of May, 2005, I have filed an original and 10 true copies of the foregoing Application for Deviation of the Union Light, Heat and Power Company 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 listed below by overnight-delivery.

John J. Finnigan, Jr.

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