

COMMONWEALTH OF KENTUCKY

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BEFORE THE PUBLIC SERVICE COMMISSION

SEP 16 2005

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) Case No. 2003-00252
 of Certain Accounting Treatment; and for)
 Approval of Deviation from Requirements)
 of KRS 278.2207 and 278.2213(6))

**SEPTEMBER 2005 COMPLIANCE FILING OF
 THE UNION LIGHT, HEAT AND POWER COMPANY**

The Commission’s June 17, 2005 Order in this case required The Union Light, Heat and Power Company (“ULH&P”) to make an update filing every 90 days on the status of certain matters related to The Cincinnati Gas & Electric Company’s (“CG&E”) transfer of three generating stations to ULH&P. ULH&P supplies below the updated information requested by the Commission. ULH&P notes that some significant changes have occurred because, since the Commission’s Order, Cinergy Corp. (“Cinergy”) has determined that it must separate its regulated and non-regulated supply functions. Consequently, CG&E and PSI Energy, Inc. (“PSI”), its Indiana operating company affiliate will terminate the Joint Generation Dispatch Agreement (“JGDA”), and ULH&P and CG&E will also terminate the Purchase Sale and Operation Agreement (“PSOA”).

The JGDA provides for joint dispatch, off-system purchase, and off-system sales functions between the generating facilities owned by CG&E and PSI. The JGDA also

provides a pricing mechanism for energy transfers between CG&E and PSI. The PSOA provides similar terms for transactions between ULH&P and CG&E. Cinergy's reasons for separating its regulated and non-regulated supply functions, and the impacts on these agreements, are explained below.

Termination of JGDA and PSOA

CG&E and PSI entered into the JGDA to provide for joint dispatch, off-system purchase, and off-system sales functions, and for pricing of energy transfers between the two companies. ULH&P was not party to the JGDA because it did not own generation at the time, and was served under a full-requirements wholesale contract by CG&E. The Federal Energy Regulatory Commission ("FERC") approved the JGDA in 2002.¹ The JGDA benefited CG&E and PSI customers under then-existing market conditions, because customers of each company were able to obtain access to the other company's generating facilities at market prices. In the present proceeding, ULH&P obtained Commission approval to enter into the PSOA between CG&E and ULH&P.² ULH&P also obtained FERC approval for the PSOA.³ The PSOA provides for pricing of energy transfers between CG&E and ULH&P at market. The PSOA was intended to provide the same types of economic benefits for ULH&P customers which the JGDA provides for CG&E and PSI customers.

Earlier this year, the Midwest Independent Transmission System Operator, Inc. ("Midwest ISO") implemented its day-ahead and real-time electric energy markets

¹ *Cinergy Services, Inc.*, 98 FERC ¶ 61,306 (2002).

² *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 (Interim Order at 23) (December 5, 2003).

³ *Union Light, Heat and Power Company and The Cincinnati Gas & Electric Company*, Docket No. ER04-1248-000 (Order Accepting Filing) (March 3, 2005).

(known as the “Day 2 Markets”).⁴ These markets provide for pricing of energy based on locational marginal pricing principles. Generation owners sell energy into the markets, and load-serving entities purchase energy in the markets. After the three generating plants are transferred from CG&E, ULH&P will be both a seller and a buyer in these markets.

The Day 2 Markets provide for market participants to schedule their expected energy supply and energy requirements, by submitting supply offers and demand bids to the Midwest ISO. The day-ahead market identifies congestion costs, which would occur when scheduled transmission transactions exceed the transmission facilities’ capabilities. This provides price signals based on projected market conditions for the following day. The real-time energy market provides for balancing of supply and demand. The Day 2 Markets use locational marginal pricing and financial transmission rights (“FTRs”) allocated by the Midwest ISO to allow market participants to mitigate the congestion costs which would otherwise occur from scheduling energy transfers in the day-ahead market.

Prior to the Day 2 Markets, CG&E and PSI jointly dispatched their generating facilities subject to the JGDA’s terms and conditions. ULH&P contemplated that it would jointly dispatch its generating facilities with CG&E, pursuant to the PSOA’s terms and conditions. The Day 2 Markets provide for the Midwest ISO to do reliability-based unit commitment and economic dispatch for all market participants, including ULH&P, CG&E and PSI, across the Midwest ISO’s entire territory. This has essentially

⁴ The terms and conditions for the Midwest ISO’s Day 2 Markets are set forth in its FERC-approved Transmission and Energy Markets Tariff. This tariff approved the Midwest ISO’s previous Open Access Transmission Tariff.

superseded the JGDA, because MISO is now conducting economic dispatch over the entire region. The utility of the PSOA would be similarly limited.

The Day 2 Markets effectively supersede and render obsolete the JGDA and the PSOA because the Day 2 Markets provide for Midwest ISO-wide economic dispatch. Additionally, CG&E is non-regulated, while ULH&P and PSI are regulated.⁵ Joint dispatch between CG&E and ULH&P, as well as between CG&E and PSI, therefore could become more unwieldy in the future, due to evolving information-sharing restrictions between regulated franchised utilities, such as ULH&P and PSI, and non-regulated affiliates power marketers under FERC's code of conduct. Accordingly, Cinergy is taking steps to terminate these agreements. In place of these agreements, Cinergy will implement market-based wholesale tariffs for ULH&P, CG&E and PSI.

The other major function of the JGDA and the PSOA was to price transfers of energy between the affiliates at market. The necessity for these agreements has been superseded by the implementation of the MISO Day 2 Markets, which provides a transparent market price for all wholesale transactions.

Although no specific regulatory approvals are required, Cinergy must follow certain procedures to terminate the JGDA and PSOA. CG&E and PSI have scheduled the JGDA termination for January 1, 2006, and ULH&P and CG&E anticipate terminating the PSOA at the same time. Cinergy has already begun the process to terminate these agreements. First, ULH&P, CG&E, and PSI have applied to the FERC for approval of

⁵ The terms "regulated" and "non-regulated" in this context refers to the price at which the entities sell electric power to retail customers. CG&E, being an Ohio utility, sells power to retail customers at a market-based rate (*see* Ohio Revised Code Chapter 4928, *et seq.*). PSI and ULH&P each operate in states in which retail prices for electric power are regulated by state utility commissions.

market-based rates.⁶ This FERC filing provides extensive detail about the parties' plans to implement wholesale market-based rates, and ULH&P is filing a copy of the FERC filing in this docket (hereinafter "ULH&P market-based rates tariff"). Second, after these new tariffs are approved, Cinergy Services, Inc. will file notice with the FERC to terminate the JGDA and PSOA, as required under 18 C.F.R. § 35.15. Third, ULH&P hereby provides notice to this Commission of its intent to terminate the PSOA effective January 1, 2006.⁷

ULH&P's market-based rates tariff contains terms governing sales of energy to affiliates, as well as a code of conduct. Similar to the market pricing required by the PSOA, the tariff provides that sales by ULH&P to CG&E or other marketing affiliates will be at a price no lower than the Midwest ISO locational marginal price for the Cinergy Hub. This will protect ULH&P's retail customers because it ensures that sales by ULH&P to marketing affiliates will be made at a price no lower than the prevailing market price. Sales between ULH&P and PSI will be at the Midwest ISO Cinergy Hub locational marginal price. Similarly, sales by CG&E or other marketing affiliates to ULH&P will occur at a price no higher than the Midwest ISO Cinergy Hub locational marginal price. The code of conduct will prevent sharing of non-public market information between ULH&P/PSI and CG&E. As required by FERC's Code of Conduct, ULH&P/PSI and CG&E will operate separately, with no shared employees making business decisions for the companies' generation or marketing functions or sharing market information. These provisions protect ULH&P's customers by ensuring that

⁶ See *Union Light, Heat and Power Company*, Docket No. ER05-1368-000 and consolidated cases (Notice of Filing of Market-Based Rate Tariffs) (August 19, 2005).

⁷ ULH&P will implement the PSOA as originally planned, from the effective date of transfer of the plants from CG&E, through December 31, 2005. Termination of the PSOA will coincide with Cinergy's full separation of regulated and non-regulated operations.

ULH&P will not pay an affiliate higher than the prevailing market price for power, and will not sell power to an affiliate at below the prevailing market price.

Back-up Power Supply Contract

ULH&P initially proposed, and the Commission approved, for ULH&P to enter into a back-up supply agreement with CG&E under which CG&E would supply power to ULH&P when ULH&P's generating facilities were not available to serve ULH&P's load.⁸ Based on subsequent FERC orders on affiliate transactions, ULH&P subsequently concluded that it could more easily obtain FERC approval of this transaction by putting the back-up power supply agreement out for competitive bid.⁹ The Commission concluded that this would not harm ULH&P's customers because ULH&P's rates were frozen through 2006. The Commission therefore issued final approval of CG&E's transfer of the three plants to ULH&P, but required ULH&P to periodically report on the status of the back-up power supply agreement, and to obtain Commission approval for the back-up power supply agreement.¹⁰

As ULH&P discussed with the Commission and the Attorney General during the March 24, 2005 informal conference, ULH&P and CG&E are in the process of re-pricing the back-up power supply agreement to reflect a change in the receipt point for the power, resulting from the Midwest ISO Day 2 markets.¹¹ Per the informal conference discussion, the current agreement is priced as an "Into Cinergy" product, which would

⁸ *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 (Interim Order at 5) (December 5, 2003).

⁹ *See Allegheny Energy Supply Company, LLC*, Docket No. ER04-730-000, 108 F.E.R.C. ¶61,082, 2004 FERC LEXIS 1569 (Order Granting Authorization to Make Affiliate Sales) (July 29, 2004).

¹⁰ *Id.* (Order at 11) (June 17, 2005).

¹¹ This informal conference is the subject of the Commission Staff's Memorandum filed on March 31, 2005.

allow the seller to deliver the power to a low-priced commercial pricing node. This could cause ULH&P to incur significant congestion costs. As discussed at the meeting, ULH&P and CG&E are revising and re-pricing the contract so that CG&E is required to deliver the power to the ULH&P load zone and thus assumes the congestion cost/risk, and will file the revised agreement with the Commission.

CG&E has not re-priced the contract yet, because it is still evaluating the congestion prices from the Midwest ISO's Day 2 markets to determine representative levels of congestion costs. These markets began to operate on April 1, 2005. The congestion prices from the early months of the markets' operation are not representative of ongoing congestion costs, because during the start-up, the market participants didn't have enough experience with actual congestion costs for these delivery nodes. As a result, the congestion costs during market start-up are generally viewed as more volatile than the expected long-run congestion costs. CG&E expects to have an adequate, representative sample of congestion cost data soon to be able to re-price the contract, and anticipates filing the revised contract with the Commission when it has completed this process.

Coal and Lime Supply Agreements

On May 10, 2005, ULH&P filed an application in this proceeding, seeking a deviation from the affiliate pricing rules under KRS 278.2207(2) and KRS 278.2219, to allow ULH&P to enter into certain coal and lime transactions with CG&E. Specifically, ULH&P sought approval to purchase and sell coal to CG&E, purchase lime from CG&E, and receive coal and lime transportation services from CG&E, all at fully distributed cost. ULH&P reasoned that it was working to develop an optimal process for CG&E and

ULH&P to procure coal, lime and transportation services at the lowest cost, and that procuring these commodities and transportation services from CG&E at fully distributed cost was a reasonable procedure during the interim.

As part of separating ULH&P's and PSI's generation and dispatch functions from CG&E's generation and dispatch functions, Cinergy will develop separate portfolio optimization functions for its regulated and for its non-regulated operations. Accordingly, Cinergy has determined that ULH&P and CG&E will have to each obtain their own coal, lime and transportation services. CG&E will therefore revert to its original plan of assigning existing CG&E coal contracts to ULH&P. ULH&P will procure its own lime and its own transportation services. This will restrict the information-sharing between Cinergy's regulated and non-regulated operations, in accordance with FERC's code of conduct regulations. Since ULH&P does not plan to obtain these commodities or transportation services from an affiliate after full separation, no issues will arise with respect to Kentucky's statutory requirements for affiliate transactions.¹²

Status of Final Contracts

Finally, Ordering Paragraph 3 of the Commission's June 17, 2005 Order requires ULH&P to periodically report on the status of the final agreements which ULH&P will need to effectuate the transfer of the three generating facilities.¹³ ULH&P reports that these contracts are substantially completed. The contracts cannot be executed, however, until the SEC approves the transaction. After SEC approval is obtained, the parties will

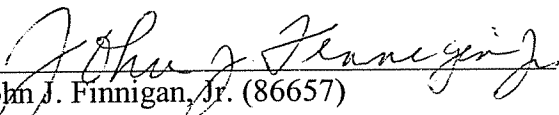
¹² As with the PSOA, ULH&P anticipates obtaining fuel, lime and transportation services from CG&E at fully-distributed cost, through the date of full separation, January 1, 2006, in reliance on this Commission's previous grant of ULH&P's deviation request. *Id.* (Interim Order at 30) (December 5, 2003).

¹³ *Id.* (Order at 11) (June 17, 2005).

execute the closing documents. ULH&P will file executed copies of these documents in the docket of this proceeding, as required by the Commission's Order. Finally, as ULH&P identifies the need for any additional contracts through its continued planning for the actual transfer of the generating stations, it will notify the Commission in future compliance filings or, if necessary, through applications requesting deviations from affiliate transaction rules.

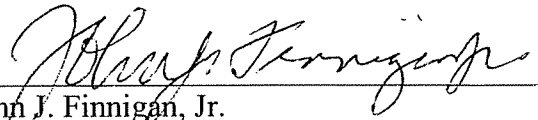
WHEREFORE, ULH&P hereby submits this compliance filing as required by the Commission's June 17, 2005 Order.

Respectfully submitted,


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CERTIFICATE OF SERVICE

I hereby give notice that on this 15th day of September, 2005, I have served a copy of the foregoing September, 2005 Compliance Filing of The Union Light, Heat and Power Company on the parties listed below by overnight delivery.



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