COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO THE FUEL PROCUREMENT PRACTICES OF KENTUCKY UTILITIES COMPANY	)))	CASE NO. 9631

O R D E R

The Commission initiated this investigation on July 10, 1986 for the purpose of reviewing the fuel procurement practices of Kentucky Utilities Company ("KU") from the early 1970s. Questions about the prices KU was paying under its compliance coal contracts with River Processing, Inc. ("River Processing") and South East Coal Company ("South East") were initially raised by the Commission in 1983 in Case No. 8590.[1] At KU's request, those questions and the review of these coal procurement issues were held in abeyance to avoid any prejudice to KU's then pending contract litigation with River Processing and contract reviews with South East. The Commission determined that, until its review was concluded, no findings would be made on the reasonableness of KU's fuel costs recovered through the Fuel Adjustment Clause

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1 Case No. 8590, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company from November 1, 1980, to October 31, 1982, Order Dated May 19, 1983.

("FAC").[2] Since November 1, 1980, all of the revenue collected by KU pursuant to its FAC has been collected subject to refund.

Intervenors in this case are the Attorney General's Office, Utility and Rate Intervention Division ("AG"), Kentucky Industrial Utility Customers ("KIUC"), Lexington-Fayette Urban County Government, Mr. Don Wiggins, and Westvaco. Hearings were held at the Commission's offices in Frankfort, Kentucky, from March 14, 1989 through April 5, 1989.

The following witnesses testified at the hearing on behalf of their sponsor:

SPONSOR	WITNESS
RCG, Hagler Bailly, Inc.	Linda S. Rathbun, Senior Vice President, RCG, Hagler Bailly, Inc.
	Larry L. Goldstein, Vice President, Harris, Goldstein Associates, Inc.
Public Service Commission	Thomas H. Petersen, Manager, Electric and Gas Rate Design Branch
AG	Peter R. Steenland, Associate with LMSL, Inc.
	Gary C. Harpster, Vice President-Energy Division, LMSL, Inc.
Don Wiggins	Don Wiggins
KU	William A. Duncan, former President, KU

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2 Case No. 8590, Interim Order dated August 12, 1983.

Ernest W. Stepp, coal mining consultant

Gerhard Haimberger, Consulting Engineer with Capstone Engineering Company

Ted D. Haley, Consulting Engineer

Edmund M. Carney, Partner, Law Firm of Rose, Schmidt, Hasley & DiSalle

James W. Tipton, Senior Vice President of Engineering, Construction, and Production, KU

Robert M. Hewett, Vice President of Rates, Budget and Financial Forecasts, KU

Robert C. Kelsey, President of Robert Kelsey Associates, Inc.

Malcolm Y. Marshall, Partner, Law Firm of Alagia, Ray, Marshall, Mintmire & Chauvin

Charles F. Haywood, Professor of Finance, University of Kentucky

BACKGROUND

This proceeding was established for the purpose of conducting a broad investigation of KU's fuel procurement practices. However, as the record developed it became evident that the River Processing and South East contracts would be the major areas of investigation. Each of these contracts has been the subject of litigation by KU--River Processing in 1983 and South East in 1984. The River Processing litigation was eventually settled and resulted in a renegotiated contract with River Processing's

successor, Coal Ridge Fuels, Inc. The South East litigation is still pending, Kentucky Utilities Company v. South East Coal Company, No. 84-CI-1703 (Fayette Circuit Court, Filed June 19, 1984), but an initial judgment has been rendered which entitles KU and its customers to receive price reductions from South East retroactive to July 1, 1984 based on past overcharges.

These coal contracts have also been the subject of a prudency proceeding at the Federal Energy Regulatory Commission ("FERC"). On May 24, 1984, several of KU's wholesale customers filed a complaint at the FERC alleging that KU's coal procurement practices were imprudent. On November 29, 1988, a FERC Administrative Law Judge issued an initial decision finding that KU was prudent in its coal procurement practices as related to the River Processing and South East contracts. This initial decision is now pending review by the FERC.

INDEPENDENT CONSULTANT'S REPORT

On July 10, 1986 and May 1, 1987, the Commission issued Orders finding that an independent consultant should be retained to conduct a thorough and independent analysis of KU's fuel procurement practices. In September 1987, the Commission selected Energy and Resource Consultants, Inc. to perform a comprehensive investigation of KU's coal procurement practices. Prior to the start of its investigatory work, Energy and Resource Consultants, Inc. merged with RCG/Hagler, Bailly, Inc. ("Hagler, Bailly"). Hagler, Bailly subcontracted coal transportation issues to Harris, Goldstein Associates, Inc. ("Harris, Goldstein").

In August 1988, Hagler, Bailly issued its final report ("Hagler, Bailly Report")[3] wherein it concluded that KU's fuel procurement decisions were reasonable and in conformance with standard industry practice at the time the decisions were made. Hagler, Bailly found no basis for finding KU to be imprudent.

Hagler, Bailly based its findings on the "reasonable utility manager" prudence standard which has been used by the FERC and other state commissions. The definition of the standard, as used by Hagler, Bailly, is that (1) the utility's decision-making should reflect the skill and knowledge of an expert or specialist in the appropriate trade or profession, (2) decisions are presumed to be prudent unless evidence of mismanagement, negligence, or bad faith is discovered, and (3) decision-making must be viewed under the circumstances existing at the time of the decision without application of hindsight in evaluating the results of the decision. No party objected to Hagler, Bailly's utilization of this prudency standard.

SUMMARY OF DECISION

This decision encompasses numerous issues arising from KU's coal procurement practices since 1973 in general and the River Processing and South East coal contracts in particular. These coal procurements were intended to produce long-term coal supplies for the second and third generating units at the Ghent Generating Station in Ghent, Kentucky. The Ghent Generating Station consists

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3 Designated in the record as "Consultant's Exhibit No. 1."

of four 500 megawatt generating units: Ghent No. 1 began operating in 1974; Ghent No. 2 began operating in 1977; Ghent No. 3 began operating in 1981; and Ghent No. 4 began operating in 1984. Based on the evidence of record, the Commission does not find such evidence of mismanagement, negligence, or bad faith given the conditions and circumstances at the time the fuel procurement decisions were made as would overcome the presumption of KU's prudency.

ISSUES OF THE CASE

Based on the evidence of record in this proceeding, the Commission has identified four major issues to be adjudicated. Those issues are as follows:

1. KU's prudence in entering into its 1973 coal contract with River Processing: Was KU's solicitation and negotiation preceding the contract imprudent? Was KU's decision to enter into a contract that did not specify compliance coal imprudent?

2. KU's prudence in renegotiating its coal contract with River Processing in 1976: Was KU's solicitation and negotiation preceding the new River Processing contract imprudent? Was KU's decision to enter the renegotiated contract with an increased base price imprudent?

3. KU's prudence in entering into its 1978 coal contract with South East: Was KU's solicitation and negotiation preceding the contract imprudent? Was KU's decision to enter into a contract with the escalation provisions and price review provisions of the South East contract imprudent?

4. KU's prudence in 1980 of choosing not to invoke the price review provisions of the South East contract: Was KU's decision to forego a price review in 1980 imprudent? Was KU's market price analysis prior to the review notice date deficient to the point of being imprudent?

DISCUSSION OF THE ISSUES

1. KU's Prudence in Entering Into the 1973 Coal Contract With River Processing.

Hagler, Bailly found KU to be prudent in entering into the 1973 River Processing contract. Further, Hagler, Bailly found KU's informal solicitation of coal supply offers to be consistent with industry practice at that time and that the result of KU's solicitation was a contract for low sulfur coal at a competitive price.[4]

KU's decision to contract for 1 percent sulfur coal in 1973 was found to be reasonable by Hagler, Bailly given the conditions existing at the time. Hagler, Bailly's analysis showed that there was a limited supply of low sulfur coal available to utilities in 1972-1973 and that none of the coal available from the eastern United States could be determined to meet the Congressionally mandated emission standard of 1.2 lbs of SO_2 per MMBTU. Coal that could meet this standard came to be known as compliance coal.[5] Hagler, Bailly also found that the costs of transporting

4 Rathbun Exhibits LSR-2 and LSR-3.

5 Id.

coal from the western United States would have been prohibitive during this period of time.[6]

Chapter 4 of the Hagler, Bailly Report details the uncertainties regarding environmental regulations that KU and other electric utilities faced during 1972-1973. Those uncertainties raised questions as to the permissible sulfur content of coal to be burned at Ghent 1 and whether scrubbers would be required on Ghent 2.[7] KU had already entered into a long-term supply contract for high sulfur coal (6.7 lbs. of SO_2/MMBTU) from Amax Coal Company for Ghent 1, which did not have a scrubber. KU, based on state and federal environmental regulations enacted in 1971-1972, chose to contract with River Processing for a low sulfur coal that could meet the new emission standards for Ghent 1, or if the standards for new units were relaxed, could be burned at Ghent 2.[8] If the new standards were not modified, the high sulfur Amax coal intended for Ghent 1 could be burned at Ghent 2 if a scrubber was built. If the standards were relaxed, the Amax coal could continue to be burned at Ghent 1 and the River Processing coal burned at Ghent 2.[9] Hagler, Bailly found KU's contracting strategy to be a prudent and flexible

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6 Goldstein Testimony, Hagler, Bailly No. 4.

7 Consultant's Exhibit No. 1, pages 4-1 through 4-5.

8 Id.

9 Id.

strategy for dealing with the environmental regulations that existed at the time.

The AG, through the testimony of witness Steenland, contends that KU was imprudent: (1) in its 1972-1973 solicitation of a coal supply for Ghent 2; (2) by failing to include a provision in the 1973 River Processing contract obligating River Processing to provide its best coal; and (3) by failing to enforce the coal quality provisions of the contract. The AG argues that KU's solicitation was inadequate due to the low number of bidders that were contacted and the lack of specifics concerning the quality of coal that KU desired.[10] The AG contrasted the KU solicitation with a 1972 coal solicitation by the American Electric Power Company ("AEP") that was sent to 340 potential suppliers.[11]

The AG opines that KU should have obtained a better quality coal in 1973 from River Processing. The initial draft of the 1973 River Processing contract specified coal having a .75 percent average sulfur content with a maximum of 1 percent. This specification was subsequently eliminated at the insistence of River Processing. The AG contends that eliminating this specification severely restricted KU's flexibility to burn the River Processing coal at either Ghent 1 or Ghent 2.[12] The AG argues that KU was imprudent in capitulating to River Processing's

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10 Steenland Testimony, pages 31 and 32.

11 <u>Id.</u>

12 <u>Id.</u>, page 42.

demand that the coal specification be deleted and that this ultimately led to the contract's renegotiation in 1976.

The AG notes that KU was experiencing problems due to excessive ash in the coal River Processing was supplying in 1974-1975 under separate interim contracts for KU's Green River and Brown generating stations. These problems are characterized by the AG as evidence of KU's laxness regarding the quality of River Processing's coal.[13] The AG contends that KU should have taken a stronger position that would have forced River Processing to comply with the contract quality provisions prior to the start-up of coal deliveries to Ghent 2.

By citing selective portions of Chapter 4 of the Hagler, Bailly Report, the AG argues that it is incomplete or less than thorough. The AG also claims that selective portions of Chapter 4 were excised from one of KU's briefs filed in the FERC proceeding.

KU, through the testimony of witnesses Duncan and Tipton, countered the AG's challenges to KU's 1972 coal solicitation and the 1973 River Processing contract. KU states that its informal coal solicitation was consistent with industry standards at the time and that the AG's comparison of KU to a company the size of AEP is inappropriate. KU argued that its decision to enter the 1973 River Processing contract was largely based on its desire for flexibility in meeting the coal supply requirements for Ghent 1

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[13] Id., pages 59-62.

and Ghent 2.[14] KU contends that the 1973 contract met a short-term need by providing a coal supply that could satisfy the requirements of Ghent 1, if needed, and provide KU some time before making a final decision on meeting the emission requirements for Ghent 2.[15]

KU maintains that in 1973 there was no foreseeable need for a compliance coal contract because of the environmental uncertainties and that it obtained some of the lowest sulfur coal available at a competitive price.[16] KU echoes Hagler, Bailly's finding that little, if any, compliance coal was available in 1973 had KU been soliciting such coal.

KU witnesses Stepp and Haley responded to the AG's arguments regarding the coal specification provisions of the 1973 contract. KU claims that, as to coal quality, the contract terms were superior compared to other contracts.[17] KU further contends that of the interim coal supplied by River Processing during 1973-1976, only one-half could have been washed to produce a compliance coal product and that costly, selective mining and blending were required for River Processing to improve the quality of its coal.[18]

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14 Duncan Testimony, page 9.

15 Id.

16 Id.

17 Transcript of Evidence ("T.E."), Vol. XI, pages 12-14.

18 Haley Testimony, page 11.

Findings and Conclusion

The Commission finds persuasive the Hagler, Bailly findings regarding KU's available options and KU's analysis of those options. The fuel procurement issues under investigation are very complex and highly technical. In light of the voluminous evidentiary record in the case, the Hagler, Bailly Report is reasonable.

It is clear from the record that KU's fuel procurement practices were very informal during this period of time and pale in comparison to standard industry practices of the late 1980s. However, the Commission is committed to the principle that an evaluation of prudency in a proceeding such as this must be based on the circumstances and knowledge existing at the time and should avoid any use of hindsight. The contemporaneous evidence in the record indicates that KU's solicitation was consistent with industry standards and produced a contract for a low cost coal supply with terms that were reasonable compared to like contracts of the same vintage.

The AG has not demonstrated that lower sulfur coal was available in the marketplace in adequate tonnages in 1973 to meet KU's needs, nor has it shown that KU's strategy for dealing with uncertain environmental regulations was unreasonable or placed its ratepayers at undue risk. The evidence of record demonstrates that River Processing could not have supplied lower sulfur coal at the 1973 contract price if, through some means, KU was able to insist on stricter contract language as proposed by the AG. Hence, the Commission finds that KU's performance regarding the

1973 contract with River Processing cannot be judged imprudent based on the evidence presented in this proceeding.

2. KU's Prudence in Renegotiating Its Coal Contract With River Processing in 1976.

Chapter 5 of the Hagler, Bailly Report addresses KU's decision in 1976 to renegotiate its contract with River Processing. The Hagler, Bailly Report evaluated the options available to KU during the 1975-1976 period, KU's analysis of its options, and the resulting 1976 contract. The Hagler, Bailly Report found that, based on the 1975 change in environmental regulations, Ghent 2 would be unable to burn the coal to be supplied by River Processing under the 1973 contract. Ghent 2 would need coal with an even lower sulfur content, low enough to emit no more than 1.2 lbs SO_2/MBTU. The 1973 River Processing contract now presented KU with a number of options: (1) enforce the 1973 contract and wash the coal itself to lower the sulfur content; (2) enforce the 1973 contract and install a scrubber on Ghent 2 to reduce the SO_2 emissions; or (3) terminate the 1973 contract and obtain compliance coal from another supplier or from River Processing by a renegotiated contract. The Hagler, Bailly Report made no finding on KU's decision to purchase compliance coal rather than install a scrubber since that decision was previously reviewed by the Commission and was not an issue in this case.[19]

[19] KPSC Staff Report of 4/20/82 - Installing Flue Gas Desulfurization Systems in Lieu of Burning Compliance Coal.

The most significant aspect of KU's choice for obtaining compliance coal was whether the coal provided under the 1973 contract could be washed to compliance quality. Hagler, Bailly opined that it was questionable whether the coal could be washed to achieve compliance quality. The Hagler, Bailly Report found that there were substantial economic risks to KU if it washed the coal itself. In addition to the general risk of being in the coal business as a result of washing, KU would face the additional risk of uncertainty as to the washability of the coal. Hence, the Hagler, Bailly Report found that KU acted reasonably in choosing to terminate the 1973 contract and renegotiate a new contract for compliance coal.[20] Based on this finding, the Hagler, Bailly Report concluded that the decision to renegotiate with River Processing was prudent and that the new delivered price of $31 per ton was a competitive price within the middle of the range of alternatives available to KU during this time frame.[21]

The Hagler, Bailly Report found it reasonable for KU to choose River Processing rather than an alternate supplier given the risk of litigation if KU attempted to terminate the 1973 contract.[22] Hagler, Bailly opined that such risk could have greatly impaired KU's ability to negotiate a contract with a new supplier and found that the price and terms of the 1976 River

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[20] Consultant's Exhibit No. 1, page 5-21.

[21] Consultant's Exhibit No. 1, page 5-17.

[22] Id., pages 5-6 and 5-7.

Processing contract were consistent with comparable contracts from the same time period.

The AG claims that KU was imprudent for not enforcing the 1973 contract and washing the coal itself or bargaining more aggressively and getting River Processing to wash the coal at a price less than the 1976 contract price. The AG contends that sufficient quantities of the coal supplied under the 1973 contract could have been washed to compliance quality and that KU should have enforced the contract rather than renegotiate.

Based on the contemporaneous information available, the AG argues that KU could have washed the 1973 contract coal to compliance quality at a cost of $26.52 per ton and that KU had the information available to reach such a conclusion.[23] This argued course of action would have required an investment cost of $4 million for a washing facility, which was the cost to River Processing for the used washer it acquired to wash the coal supplied under the 1976 contract. This argument also reflected the assumption that one-third of the annual required tonnage--300,000 tons--would not need washing. Alternatively, the AG contends that KU should have effectively used this information in its negotiation with River Processing to obtain a price that was lower than the 1976 contract price. The AG supported this contention by citing various calculations by KU of the costs of washing River Processing's coal.[24]

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23 Steenland Surrebuttal Testimony, page 6.

24 Steenland Testimony, pages 69-71.

The AG argues that KU did not properly consider the legal consequences of attempting to enforce the 1973 contract to obtain specific performance or the financial risk of investing in a coal washing facility.[25] The AG contends that even if litigation with River Processing and installation of a washer had delayed KU's receipt of compliance coal under the 1973 contract, compliance coal was available on the spot market at prices equivalent to the 1976 contract price.[26] In summary, the AG argues that the 1976 renegotiation was inconsistent with KU's objective of minimizing costs and was outside the range of alternatives that would have been chosen by a reasonable utility manager.

KU defends its decision to renegotiate with River Processing in 1976 by stating that the coal called for in the 1973 contract could not be washed to meet compliance coal standards.[27] The testimony of KU is that selective mining and blending of coals by River Processing was necessary in order to start with a low enough sulfur content that could be washed to compliance quality and that the 1973 contract did not require River Processing to do this.[28] KU contends that River Processing was able to produce coal low enough in sulfur to be washed to compliance quality only by mining

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25 Id., pages 80-85.

26 Id., page 86.

27 Stepp Testimony, page 8.

28 Haimberger Testimony, page 3.

the coal seams specified in the 1976 contract, seams that were not specified in the 1973 contract.[29]

KU argues that based on the circumstances in 1976, i.e., the availability of 1.0 percent sulfur coal comparable to the 1973 River Processing coal, litigating the 1973 contract with River Processing to obtain specific performance would likely have been unsuccessful.[30] KU contends that if it had considered installing and operating a washer to be a reasonable option, it would have had difficulty enforcing the 1973 contract.[31]

KU further maintains that the AG's position regarding the cost of washing the coal is erroneous. KU's estimate is that its cost to purchase and install a washer and the related rail, loading, and unloading facilities, along with land acquisition and development, would have been in the range of $20 to $25 million.[32] This reflects KU's position that, as the buyer of coal, it would have little control over the raw input, the coal itself. Consequently, a KU-owned washing plant would, by necessity, require more equipment and more washing circuits to properly wash coals of different washability characteristics.[33] KU presented two independent calculations based on 1976 costs that demonstrated

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29 Tipton Testimony, page 8.

30 Carney Testimony, pages 8-10.

31 T.E., Vol. IX, pages 29-30.

32 Stepp Testimony, pages 4-5.

33 Haimberger Testimony, pages 4-5.

a per ton cost range of $33.27 to $34.41 for KU to have washed the 1973 contract coal to a compliance quality.[34]

KU takes great exception to the AG's assumption that, under the 1973 contract, 300,000 tons per year would be compliance quality without washing. KU asserts that, based on its experience with River Processing under the 1973 and 1976 contracts, as well as interim coal supply contracts, the AG's assumption is an improper basis for evaluating the cost of washing the 1973 contract coal.[35] In order to provide compliance coal, River Processing was mining different seams under the 1976 contract than under the 1973 contract which only required 1.0 percent sulfur coal.[36] KU claims the contemporaneous information shows the expectation that all the coal would require washing,[37] and, as such, the cost to KU to wash the 1973 contract coal would have been significantly greater than the AG's estimate.

Findings and Conclusions

In analyzing KU's option to enforce the 1973 contract and wash the coal itself, the Hagler, Bailly Report focused on KU's legal options. However, Hagler, Bailly's analysis demonstrates that the 1976 River Processing contract was consistent with

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[34] Haley Testimony, page 9; Haimberger Testimony, page 7.

[35] Stepp Testimony, pages 9-10; Tipton Testimony, pages 6-7.

[36] Stepp Testimony, page 6.

[37] T.E., Vol. VIII, page 120.

similar contracts from that same time period.[38] None of the intervenors challenged the terms of the 1976 contract, only whether it should have been entered into in the first place.

KU's decision to not wash the 1973 contract coal itself did close off one option to meet the coal supply needs of Ghent 2. Based on the assumptions in the analysis presented by AG witness Harpster, KU's decision can on first blush be made to give the appearance that higher costs were the results for KU and its customers. However, not all of Harpster's assumptions hold up in light of all the evidence.

KU presented credible evidence that the 1973 contract coal, or a large portion of it, could not be washed to meet compliance standards without selective mining and blending. Likewise, the Commission finds that KU's decision in electing to avoid litigation in any attempt to enforce the 1973 contract was not unreasonable given the attendant circumstances. For example, the abundant availability of 1.0 percent sulfur coal weighed heavily against KU's ability to obtain specific performance.

The record indicates that KU could have made a quantitative decision to install and operate a washer at a savings of approximately $2 per ton, compared to the 1976 contract price, based on its April 1976 analysis of washing costs.[39] However, for other reasons--questions about the washability of the coal,

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38 Consultant's Exhibit No. 1, page 5-21.

39 KU Response to AG Data Request No. 301.

concerns about the financial risks of installing and operating a wash plant--KU made a reasonable qualitative decision to avoid such risks and renegotiate its contract at a mine price of $28 per ton.

The Commission finds that all the 1973 coal would require washing given the differing quality provisions of the two contracts. Further, the estimate of a cost per ton of $5 to $6 greater than the 1976 mine price of $28 was well supported.

Given the coal market conditions that existed in 1976, KU cannot be faulted for making a decision to minimize its risks when the apparent cost differential was relatively minor. KU's decision, based on the contemporaneous information at its disposal, can be questioned but cannot be judged to be unreasonable or to have exposed KU's ratepayers to undue financial risks.

3. KU's Prudence in Entering Into Its 1978 Contract With South East.

The Hagler, Bailly Report concluded that KU's informal solicitation and its evaluation of proposals for supplying Ghent 3 were prudent based on a finding that the terms and conditions contained in the 1978 South East contract were comparable to similar industry-wide contracts from the same time period.[40] The Hagler, Bailly Report also concluded that the base price of $38

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[40] Consultant's Exhibit No. 1, page 8-1.

per ton was a competitive price and resulted in the lowest delivered price (in cents per million Btu) of all the proposals received by KU.[41]

The price escalators in the South East contract reflected a mix of components to be adjusted based on South East's costs as well as a combination of federal labor indices. The Hagler, Bailly Report found this price escalation provision to be similar to ones included in its set of comparison contracts.[42]

The price review provision of the South East contract was characterized by the Hagler, Bailly Report as a confusing compromise between a price reopener and no price reopener. The Hagler, Bailly Report stated that this provision was more like a gross inequity clause in that it required the occurrence of unforeseen events. While finding that the clause could have been stronger, the Hagler, Bailly Report concluded that overall the terms of the 1978 South East contract were reasonable and prudent.[43]

KIUC claims that KU erred in negotiating the terms of the South East contract, particularly regarding the price escalators and the price review clause. KIUC also argues that Hagler, Bailly did not thoroughly analyze the South East contract and performed

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41 Id., page 8-19.

42 Id., page 8-37.

43 Id., page 8-59.

its investigation by utilizing shortcuts and over-relying on KU's current arguments rather than the contemporaneous evidence.

KIUC contends that the EPA-imposed deadline that faced KU during the negotiation of the South East contract contributed to deficiencies in the contract terms.[44] KIUC argues that KU was aware of changing expectations in the compliance coal market resulting from the 1977 Clean Air Act Amendments[45] and presented evidence to demonstrate that the compliance coal market began to soften in the late 1970s and that KU failed to respond to that changing market.

KIUC claims that KU should have recognized the price escalation provisions of the South East contract would work to KU's detriment given the changing conditions in the compliance coal market. KIUC further argues that KU did not fully understand the escalators until after the contract was signed.

KIUC also contends that KU erred in agreeing to the price review clause in the South East contract. Citing the March 9, 1989 Order of the Fayette Circuit Court in Kentucky Utilities Co. v. South East Coal Co., KIUC opines that the price review provisions of the South East contract were wholly inadequate to fairly and equitably adjust the contract price.[46] KIUC argues that KU waited too long to negotiate with South East and did not

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44 KIUC Exhibit 5, page 25.

45 Id., page 28.

46 KIUC Exhibit 47, page 79.

thoroughly involve the proper management personnel in its negotiations.

KU maintains that in 1978, when the South East contract was negotiated, industry expectations were that the demand and price for coal would continue to increase for the next several years.[47] Industry and government forecasts pointed to continued strong inflation,[48] and the Clean Air Act Amendments of 1977 caused only a slowing of the expected rate of increase in compliance coal prices.[49]

KU argues that the final contract terms reflected the result of its negotiations with South East and that it was fully aware of the impact of the contract terms.[50] KU claims that it investigated the performance of the contract's escalation indices and examined the cost components as reflected in South East's books.[51] KU contends that KIUC's arguments reflect a misunderstanding of the escalation provisions and the extent to which any changes in South East's productivity and excess capacity were reflected in South East's billing price. KU opines that the

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47 T.E., Volume XII, page 22.

48 Id.

49 Id., Volume XIV, page 78.

50 Id., Volume XIII, pages 29-42.

51 Id., pages 29, 73-74.

price escalators operated as anticipated, but that the compliance coal market did not fulfill expectations.[52]

KU contends that the contract's price review clause was a compromise between South East and KU which, at KU's insistence, included a reference to market price but was not, at South East's insistence, a pure market price reopener.[53] KU maintains that KIUC's arguments are based on a hindsight analysis of events and that the contemporaneous evidence does not support KIUC's version of the circumstances, conditions, or expectations that prevailed in 1978.

Findings and Conclusions

The South East contract provided KU with a long-term coal supply for Ghent 3 at a competitive base price of $38 per ton. Irrespective of whether the analysis in the Hagler, Bailly Report could have been more detailed, the analysis clearly demonstrates that the general terms and conditions in the South East contract are consistent with comparable contracts of the same vintage.

The Commission does find that KU's negotiation and drafting of the contract was rushed to meet the June 30, 1978 deadline. However, there is no credible evidence that KU did not understand the terms of the contract or that the contract's terms were materially affected by the shortness of time. Likewise, the Commission finds nothing in the record to support assertions that

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52 Id., Volume X, page 54.

53 Id., Volume XIII, pages 35-42.

the compliance coal market in 1978 was crippled by the 1977 Clean Air Act. The record shows that expectations of the coal industry in 1978 were for continued growth and rising prices. While these expectations were not realized, KU cannot be found imprudent for not foreseeing the market changes that occurred in the 1980s.

With the expectations of the coal industry that existed in 1978, the contract's price escalation terms cannot be judged imprudent. Had the market expectations been realized, the evidence shows that the escalators would have equitably balanced the interests of KU and South East, or possibly worked in KU's favor. Likewise, given the expectations in 1978, the price review clause, despite its shortcomings, cannot be judged imprudent. With the aid of hindsight, it is easy to surmise that the price review clause, despite the expectations of the coal industry, possibly should have been written in a manner more favorable to KU based on the 12.5 year term of the contract and the history of cyclical booms and busts in the coal industry.

Although hindsight may be used to fashion remedial steps to prevent the reoccurrence of past errors, it cannot be employed in the Commission's determination of prudency. KIUC's criticisms of KU are rooted in hindsight. Therefore, in view of the contemporaneous information available to KU, and recognizing that the price review clause represents but one weak part of an otherwise well-balanced contract, the Commission finds KIUC's arguments to be unpersuasive.

4. KU's Prudence in 1980 of Choosing Not to Invoke the Price Review Provisions of the South East Contract.

The Hagler, Bailly Report characterized the contract's price review language as confusing and ambiguous, and states that KU's legal concerns about initiating a price review in 1980 because of the contract language were reasonable.[54] The Hagler, Bailly Report found that KU had conducted only a minimal analysis of the coal markets in early to mid-1980 when it determined that its contract price was only $2-$3 above market prices.[55] However, Hagler, Bailly found KU's decision to not seek a price review to be reasonable given the market conditions and expectations that existed in 1980.

Hagler, Bailly states that for the first two years of the contract, South East's price escalation had been below industry averages and that in June 1980, market prices were forecasted to increase at a rate above inflation for the next five years.[56] Given these circumstances, the Hagler, Bailly Report found that KU's perceptions of the generally healthy state of the coal industry in early 1980 were well founded and provided a reasonable basis for its decision to forego a price review.

The Hagler, Bailly Report stated that the amount by which the South East price exceeded market price may have been $4 to $7,

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54 Consultant's Exhibit No. 1, pages 8-59 to 8-60.

55 Id., page 8-61.

56 Id., pages 8-54 through 8-58.

rather than the $2 to $3 difference KU considered when making its decision.[57] The Report concluded that irrespective of what the actual price differential was, the price review clause permitted adjustments based only on material, unforeseen events, or changed conditions and not for normal market price fluctuations.[58] Hagler, Bailly offered no opinion as to whether the 1980 price differential was due solely to market fluctuations but contended that KU was reasonable in being concerned about the outcome of litigation arising from a 1980 price review given the contract language on price reviews.[59] The expense of litigation and the protection of the ratepayers from undue financial risks by the existence of the next scheduled price review in 1983 were also cited by Hagler, Bailly as reasons for not finding KU imprudent.[60]

KIUC claims that the price review clause was so deficient that, for all intents and purposes, KU had no foundation for a price review in 1980. Rather, KIUC opines that in early 1980 KU knew that the contract presented problems and that the coal markets were changing. KIUC argues that KU should have attempted to remedy the defects of the contract by relying on theories of mutual mistake or unfairness.

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57 Id., page 8-59.

58 Id., page 8-53.

59 Id., page 8-60.

60 Id., page 8-62.

KIUC argues that in numerous other proceedings KU personnel testified that the coal markets began changing in 1978-1980 rather than in 1981-1982 as both Hagler, Bailly and KU contended. KIUC supports this argument by citing the testimony of three former KU employees presented at the FERC and this Commission in prior proceedings.[61] KIUC also points to a February 1980 letter from South East to KU which includes a reference to the depressed state of the coal market.[62] Thus, KIUC concludes that the current position of KU and that of the Hagler, Bailly Report regarding the coal markets of the late 1970s are wrong, or, alternatively, KU has promulgated a version of past events that meets its current needs and Hagler, Bailly accepted this version without sufficient independent analysis.

KIUC contends that Hagler, Bailly mistakenly identified the issue as being KU's 1980 decision not to seek a price review and failed to perform a more in-depth legal analysis of the contract terms. KIUC argues that Hagler, Bailly too often accepted KU's version of events and failed to question the appropriate KU employees--past or present--on key matters involving the South East contract.

KIUC argues that the analysis in the Hagler, Bailly Report overlooked numerous contemporaneous KU documents that provided a better understanding of KU's knowledge and objectives at the time

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[61] KIUC Exhibits 31-34 and 43A.

[62] KIUC Exhibit 38.

important decisions were being made regarding the South East contract. KIUC maintains that the personnel involved in preparing the Hagler, Bailly Report were not qualified to make many of the conclusions reached, particularly the one involving KU's legal analysis in 1980 of the South East contract.

KU claims that the price review clause of the South East contract was reasonable and prudent and ultimately protected its ratepayers from undue financial risk as evidenced by the outcome of its litigation with South East in the Fayette Circuit Court. Accordingly, KU opines that its decision to forego a price review in 1980, partly due to concerns about the interpretation of the contract language, does not indicate a deficiency in the contract, but rather caution against testing the language in a case where there was little to be gained and much to be lost.

KU argues that based on the coal market conditions that existed in 1980, its concern that an adverse judicial interpretation could hamper its ability to invoke the price review provision at a later date were well founded.[63] KU argues that its 1980 market analysis determining a price differential of $2 to $3 was reliable and fully supported by its more recent analysis submitted as evidence in the FERC case.[64] KU considered that

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63 T.E., Volume XIII, pages 151-152 and Volume XII, pages 19 and 23.

64 Id., Volume XI, pages 190-194.

despite its calculated price differential in 1980, South East would likely produce a different calculation and the litigation would produce a result somewhere in between.[65]

KU contends that in 1980 it evaluated the coal market for the purpose of analyzing the current price differential and expected future conditions.[66] KU further contends its legal counsel, having thoroughly reviewed the matter, advised that litigation would be necessary to invoke the price review provision and recommended against seeking the review.[67]

Findings and Conclusions

The Commission, based as the evidence of record, views this issue as the weakest link in KU's defense of its fuel procurement practices. Serious questions have been raised regarding the extent of KU's analysis and evaluation prior to its decision to forego a price review in 1980. The Hagler, Bailly Report concluded that KU's market analysis was informal and poorly documented and that the South East contract price was as much as 10 to 19 percent above the market price.[68]

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65 KU No. 17; T.E., Volume XII, pages 19, 23.

66 KU No. 17; T.E., Volume XII, pages 19,23.

67 T.E., Volumes XIII, pages 150-151, 180 and 200.

68 Consultant's Exhibit No. 1, pages 8-60, 8-59.

KU's concerns about litigation were based on the ambiguous and confusing language of the contract's price review clause.[69] However, this is the same clause that KU argues it worked so hard to have included in the contract in order to have some reference to market price.[70] However, the evidence of record does support KU's position, and the finding of the Hagler, Bailly Report, that during the contract's first two years, South East's price escalation had been below industry averages. Furthermore, the evidence confirms KU's contention that in 1980 the price and demand for compliance coal were expected to increase through the mid-1980s. Given these conditions and expectations, it is not unreasonable that KU, based on its 1980 market analysis, anticipated little market price differential before the next scheduled price review in 1983. Furthermore, given the language in the price review clause, it is not surprising that KU's legal counsel, based on KU's market analysis, advised against litigation at that time.

Although the Hagler, Bailly Report speculated that KU would have given more consideration to initiating the review if KU's market analysis had shown a price difference of 10 to 19 percent, there is no contemporaneous evidence that shows what KU would have done. KU opined that at such a differential a court would likely find an actual difference of from 5 to 9 percent.

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69 Id.

70 T.E., Volume XIII, pages 35-42, 80-85, 176-178.

The Commission finds several instances in the record which raise doubt as to the adequacy of KU's market analysis and its decision to forego the price review based on its legal analysis. However, these doubts are overcome by other evidence including the Hagler, Bailly Report that the coal industry and government agencies in 1980 projected increases in the market price of coal which would narrow the differential with the South East contract price. This view is further supported by the experience of the first two years of the contract when South East's price increased at a rate lower than industry averages and lower than published government indices. Consequently, based on the totality of the evidence, the Commission finds that KU was not imprudent in its decision to forego a price review in 1980.

OTHER ISSUES

In addition to the evidence and arguments presented by the AG and KIUC, Mr. Don Wiggins, a customer of KU, testified on the River Processing and South East contracts. Mr. Wiggins argues that KU's contracts with River Processing and South East were flawed because of inadequate solicitations and the absence of a process requiring sealed competitive bids.[71] Mr. Wiggins claims that KU's contracts lacked a clear definition and method for determining current market price.[72] Mr. Wiggins espoused the theory that KU's contract prices should be compared to market prices for sales of spot coal during the same time period and that

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71 Wiggins Testimony, page 1.

72 Id., page 2.

the difference represents KU's overpayments that should now be refunded to ratepayers.[73]

The Commission finds Mr. Wiggins' testimony reflects hindsight and lacks an appreciation of the complex issues involved in this proceeding. Likewise, the Commission finds no reasonable basis to rely upon Mr. Wiggins' arithmetic exercise in determining the prudency of KU's coal procurement decisions.

In addition to the four major issues addressed above, the Hagler, Bailly Report analyzed three additional issues: the 1983 contract with Coal Ridge Fuels, Inc.; KU's spot market purchases for the supply of Ghent 4; and KU's procurement and administration of its coal transportation contracts during the period under review. The Hagler, Bailly Report concluded that KU was prudent on all these issues and emphasized KU's strong performance in transportation-related matters. None of the intervenors contested these conclusions and, based on the Commission's determination that they are reasonable, they are adopted as Commission findings. Consequently, KU is found to have been prudent on these three other issues.

IT IS THEREFORE ORDERED that this investigation be and it hereby is concluded.

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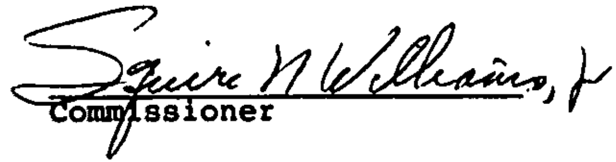
[73] Id., page 3.

Done at Frankfort, Kentucky, this 31st day of October, 1989.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman



Commissioner

ATTEST:

Executive Director