

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

O R D E R

On November 3, 1989, the Commission issued its Order in this proceeding wherein it found insufficient evidence of mismanagement, negligence, or bad faith to warrant a finding of imprudence on the part of Kentucky Utilities Company ("KU") in its fuel procurement practices. On November 27, 1989, the Utility and Rate Intervention Division of the Attorney General's Office ("AG") filed a petition for rehearing of the Commission's findings and conclusions regarding KU's 1973 and 1976 contracts with River Processing, Inc. ("River Processing"). Specifically, the AG alleges that the Commission's Order contains erroneous findings of fact, fails to consider issues raised by the AG in its brief and reply brief, and disregards substantial evidence of mismanagement, negligence, or bad faith presented during the hearing.

On December 8, 1989, KU filed its response to the AG's petition stating that the Commission's findings and conclusions were fully supported by the evidence of record and that the AG's petition should be denied. The Commission herein will address each of the issues raised by the AG concerning the two contracts.

1973 River Processing Contract

The AG objects to various Commission findings that are based on the report of the independent consultant RCG/Hagler, Bailly, Inc. ("Hagler, Bailly"). Hagler, Bailly was retained by the Commission to analyze and report on KU's fuel procurement practices since the early 1970s. The first instance cited by the AG is Hagler, Bailly's finding that in 1972-1973 none of the coal available from the Eastern United States could be determined to meet the emission standard of 1.2 pounds of SO₂ per MMBTU. The AG points to a July 1972 letter from W. G. Coal Sales ("W.G.") to KU offering seven sources of coal, three of which would meet the emission standard. The AG also notes that 20 million tons of compliance coal were produced in Central Appalachia by 1984 and concludes that in 1973 this coal was still in the ground. The AG states that any finding that KU failed to contract for compliance coal in 1973 cannot be premised on the non-existence of such coal and that, on rehearing, the Commission should find that KU was offered compliance coal by W.G.

KU's response points out that despite W.G.'s 1972 letter offering compliance coal by 1973, W.G. was unwilling to enter a contract to supply compliance coal. KU also argues that the evidence of record does not support the AG's claim that compliance quality coal was available to KU in 1973.

The AG's argument does not warrant a modification of the Commission's previous opinion. The fact that compliance coal existed in the ground in 1973 does not mean that it was available to KU. The November 3, 1989 Order found that "The AG has not

demonstrated that lower sulfur [compliance] coal was available in the marketplace in adequate tonnages in 1973 to meet KU's needs. . . ." The offer by W.G. was later modified and W.G./River Processing ultimately refused to sign a contract for compliance coal. W.G./River Processing insisted that the contract with KU be signed for 1 percent sulfur coal which is non-compliance coal. Neither the initial offer by W.G. in July 1972 nor the mining of compliance coal in Appalachia in later years has any bearing on the market conditions in 1973 or KU's coal needs at that time. The Commission made no finding premised on the non-existence of compliance coal in 1973 or that ignored the W.G.'s initial offer to KU. W.G.'s modification of its offer, the analysis by Hagler, Bailly of coal contracts entered into in 1972-1974, and the results of the 1972 solicitation by the American Electric Power Company for compliance quality coal all support the conclusion that lower sulfur, compliance quality coal was not available in the marketplace in 1973 in adequate tonnages to meet KU's needs.

The AG's second point alleges that the Commission misunderstands the implications of the emission standards promulgated in 1971-1972. The AG cites the Commission's Order at page 8, which states that "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," and claims that the inclusion of the word "continued" shows the Commission misunderstands the environmental regulations then in effect. The AG further claims such misunderstanding affected the Commission's conclusion as to the reasonableness of KU's contracting strategy.

In its response, KU argues that the quotation from the Hagler, Bailly report is accurate; that the use of the word "continue" is proper because the Amax coal was already being burned in Ghent 1 and because the emission standard would not apply until 1978. KU opines that whether or not the standard was relaxed, the Amax coal could be burned at Ghent 1 until the standard became applicable in 1978.

The Commission has no misunderstanding of the environmental regulations or their implications for Ghent 1 and 2. The Commission believes the problem with the language is mainly one of interpretation. In April 1973, when KU entered into the River Processing contract, no coal had yet been delivered under the Amax contract. Literally speaking, the AG is correct to argue that the word "continue" is improperly included in the passage in question. If the standards were relaxed, it was not the burning of the coal that could continue but, rather, KU's intent to burn the coal that could continue. However, KU's point that the Amax coal could be burned in Ghent 1, regardless of the standards, until 1978 is also correct. Consequently, the Commission finds that the sentence in question should be clarified to read, "If the standards promulgated in 1971-72 were relaxed, the Amax coal, as originally intended, could be burned at Ghent 1, and the River Processing coal burned at Ghent 2." Such restatement does not alter the Commission's conclusions regarding KU's contracting strategy. As recited by Hagler, Bailly, KU's strategy under the existing regulations was to burn the River Processing coal at Ghent 1 and burn the Amax coal at Ghent 2, with the addition of a scrubber.

However, if the regulations were relaxed, the Amax coal could be burned at Ghent 1 and the River Processing coal at Ghent 2. The Commission rejects the AG's argument that this strategy resulted in making two contracts for Ghent 1, one of which must be judged superfluous, or in writing a bad contract with River Processing, which must be judged imprudent. It was and is the Commission's opinion that KU adopted a flexible strategy designed to accommodate the then existing regulations as well as the potential relaxation of those regulations. The Commission affirms its finding that the AG has not shown that such strategy placed KU's ratepayers at undue risk.

The third point raised by the AG involves alleged internal inconsistencies in the Commission's Order regarding KU's decision not to install a scrubber at Ghent 2, the point in time when such decision was made, and the timing of the decision to burn compliance coal at Ghent 2. KU, in its response, counters that its decisions were made at different points in time and that it knowingly ran the risk of not having a scrubber in place by 1977 when Ghent 2 was completed.

First, the AG's claim is based on a misunderstanding of the Commission's Order. Contrary to the statement in the AG's petition for rehearing, the Commission's Order at page 12 does not find "Persuasive. . . KU's analysis of (its) options." The finding on page 12 of the November 3, 1989 Order states that "The Commission finds persuasive the Hagler, Bailly findings regarding KU's available options and KU's analysis of those options." Accordingly, the AG's presumption that the finding includes,

". . .KU's assertion that in 1973 there was no foreseeable need for a compliance coal contract," is in error.

The AG compounds its error by contrasting this quotation with the last sentence on page 13 of the Order which reads, "Hagler, Bailly 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." The AG cites Case No. 8057¹ and KU's data response therein where it indicated that it would have had to begin building a scrubber no later than late 1973 to coincide with Ghent 2 operation. The AG then concludes that since KU did not construct such a scrubber beginning in late 1973, it must have, at that time, intended to burn compliance coal at Ghent 2 and, hence, was imprudent for not contracting for compliance coal in 1973.

The Commission finds no merit to this argument. The record in this proceeding is replete with evidence that, as late as early 1975, KU was making plans for the possible installation of a scrubber.² KU's stated position in this proceeding, as in prior proceedings, was to avoid installing scrubbers on the Ghent units if possible, but to plan for such a contingency pending the finalization of environmental regulations.³ In the Commission's

¹ Case No. 8057, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Kentucky Utilities Company Pursuant to 807 KAR 5:056-E, Sections 1(11) and (12).

² Hagler, Bailly's Exhibit No. 1, pages 4-2 and 4-3; Duncan Testimony, page 9.

³ Duncan Testimony, pages 9-11.

view, the fact that KU did not begin building a scrubber in 1973 is consistent with this planning and merely reflects KU's hope to avoid the installation of a scrubber while complying with the applicable emission standards. Had KU decided in 1975 to build a scrubber, there was a risk that Ghent 2 could not enter commercial operation until after 1977. To meet this contingency, KU had alternative plans to seek an emission variance or burn compliance coal until the scrubber was operational. Obviously, until 1975 KU hoped the emission standards would be modified to permit the burning of the River Processing coal at Ghent 2.

The AG's contention that as early as 1973 KU planned to burn compliance coal at Ghent 2 is contradicted by the evidence of record. The record reflects that KU hoped to avoid the need for a scrubber at Ghent 2 and hoped that emission standards would be relaxed so that the 1973 contract coal could be burned at that unit. The final decision not to build a scrubber and to burn compliance coal at Ghent 2 was not made until mid 1975 when the emission standard for Ghent 1 was modified, allowing the Amax coal to be burned at that unit, and the emission standard for Ghent 2, originally issued in 1972, was finalized and made permanent.

The fourth point raised by the AG involves the Commission's summary of Hagler, Bailly's analysis of KU's decision to renegotiate its contract with River Processing in 1976. Specifically, the AG cites the third and fourth sentences of the complete paragraph on page 13 of the Order which states, "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 pounds SO₂/MMBTU." The AG points out that in 1975 the regulation did not change for Ghent 2 and that the 1973 contract coal could not have been burned at Ghent 2 under the regulation existing from 1972-1975. The AG contends that such a finding is in error and shows that either KU was aware, in 1973, that the River Processing coal could not be burned at Ghent 2 under existing regulations or KU was mistaken about the applicable regulation in 1973 and mistakenly believed that 1 percent sulfur coal could be burned at Ghent 2 in compliance with emission standards.

In its response, KU states that the AG is erroneous in contending that the 1975 change in environmental regulations had no basis on KU's ability to burn River Processing coal in Ghent 2. KU contends that the 1975 change eliminated the possibility of stack averaging which, if adopted, would have allowed the River Processing coal to be burned in Ghent 2 without a scrubber. Further, the 1975 change made the Amax coal the clear economic choice for Ghent 1 and eliminated the need for and availability of burning the Amax coal at Ghent 2 with a scrubber.

The Commission finds that its summary of Hagler, Bailly's analysis was incomplete and overly succinct. The summary of Hagler, Bailly's findings should be expanded to state that the 1975 change in environmental regulations allowed the Amax coal to be burned at Ghent 1 but did not result in any modification of the standard for Ghent 2. Therefore, the River Processing coal was no

longer needed as a possible fuel at Ghent 1; however, since the regulation applicable to Ghent 2 had not been relaxed, the River Processing coal could not be burned at that unit without a scrubber. Ghent 2 would have to burn coal that could meet the standard of 1.2 pounds SO₂/MMBTU and KU was then faced with the decision as to how to meet that standard.

This summary reflects the findings of Hagler, Bailly regarding the 1975 change in the emission standard applicable to Ghent 1 and the impact this change had on KU. Furthermore, the 1975 change eliminated Kentucky's proposal to utilize stack averaging to measure emissions. KU had hoped the standards for Ghent 1 and Ghent 2 would be relaxed to allow burning the Amax coal at Ghent 1 and the River Processing coal at Ghent 2. In the event the standards were not relaxed, KU was planning to burn the River Processing coal at Ghent 1 and, after installing a scrubber, burn the Amax coal at Ghent 2. KU's strategy was flexible and reasonable for dealing with the uncertainties regarding environmental regulations in the 1972-1975 period.

The fifth point in the AG's petition is that the Commission's Order misapplies the reasonable utility manager prudence standard regarding the coal washing option that was available to KU in 1975-1976. The AG argues that the Commission relied on "hindsight testimony" from KU's witnesses in rejecting the AG's position that KU should have enforced the 1973 contract and washed the coal rather than enter into the renegotiated 1976 contract. The AG argues that the Commission should reject KU's current estimates of what its washing costs would have been in 1975-1976.

KU argues that the Commission did not utilize the estimates to take a hindsight look at the 1976 decision to renegotiate with River Processing. KU contends that the estimates are relevant as to the validity of its concerns in 1976 about the risks of a washing operation and to the question of potential damages and refunds had the Commission found that KU should have enforced the 1973 contract and washed the coal itself.

The Commission's Order stated only that the current cost estimates were well supported. The Commission's finding that KU's decision to renegotiate in 1976, rather than wash the 1973 contract coal, was reasonable does not rely on this one statement. KU's decision was reviewed on the basis of the contemporaneous information available at the time KU's decision was made. The Commission found that after considering the cost differential between renegotiation and washing, the uncertainties about the washability of the coal, and the risks of installing and operating a washing plant, KU made a reasonable decision based on qualitative as well as quantitative considerations. In the Commission's view, KU presented the current cost estimates as evidence of the lack of any damages in the event it was found imprudent based on its decision to renegotiate rather than wash the 1973 contract coal. The Commission finds no basis for rejecting these estimates.

Finally, the AG contests the Commission's finding that all the 1973 coal would require washing given the differing quality provisions of the 1973 and 1976 contracts. The AG contends that its assumption that one-third of the coal shipped under the 1973

contract would not require washing is consistent with KU's contemporaneous estimates. The AG also states that 18 of 48 shipments made by River Processing to KU's Green River Station under an interim contract were compliance grade and that only three of these shipments were washed. The AG argues that on rehearing its assumption that one-third of the 1973 coal would not require washing should be found reasonable.

KU asserts that the evidence of its witnesses, as cited in the Commission's Order, supports the Commission's conclusion that all the coal supplied under the 1973 contract would have required washing. KU maintains its position is consistent with the washing experience of other utilities in the late 1970s and early 1980s.

The Commission is well aware of the evidence that the AG cites; however, as in the previous discussion, the Commission's conclusion did not rest on this one finding but on the sum of its findings, including and most importantly the finding that given the contemporaneous information at its disposal, KU made a reasonable decision to minimize its risks when the cost differential was relatively minor. The Commission affirms its finding that, based on the differences between the 1973 and 1976 contracts, all the 1973 coal would have required washing. The 1976 contract required a compliance product; the 1973 contract did not. The 1976 contract produced approximately one-third raw compliance coal; however, that contract required River Processing to mine different coal seams than were required by the 1973 contract. In citing the experience of one of the interim contracts, the AG failed to mention that while approximately

one-third of the interim coal received at the Brown and Green River stations was compliance grade in 1973, only 10 percent of the coal received under these contracts in 1974 was compliance quality. Furthermore, there is no evidence to support the AG's argument that the experience at the Green River Station, based on the quantities shipped to that plant under an interim contract, would be duplicated at Ghent 2 during the time after the emission standards were finalized in 1975.

Given the post 1975 compliance coal market and the coal quality specifications of the 1973 contract, the Commission does not find the AG's assumption that one-third of the 1973 contract coal would be compliance grade without washing to be reasonable.

SUMMARY

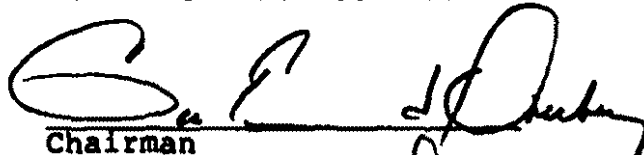
The Commission, having reviewed the AG's petition for rehearing, KU's response, and the evidence of record, finds that the petition raises no issues warranting a rehearing. Therefore, the petition for rehearing should be denied and the Commission's November 3, 1989 Order should be modified to reflect the clarifications noted herein.

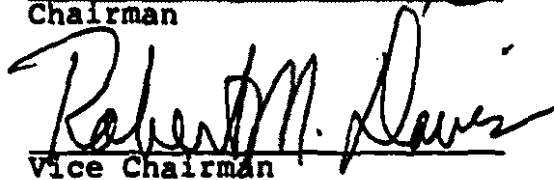
IT IS THEREFORE ORDERED that:

1. The AG's petition for rehearing be and it hereby is denied.
2. The Commission's November 3, 1989 Order be and it hereby is modified to reflect the clarifications set forth herein.

Done at Frankfort, Kentucky, this 15th day of December, 1989.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman

Commissioner

ATTEST:

Executive Director