

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE )  
GAS AND ELECTRIC COMPANY FOR )  
AN ORDER APPROVING CERTAIN ) CASE NO. 96-089  
ACCOUNTING TREATMENT FOR AND )  
AUTHORIZING RECOVERY OF COAL )  
CONTRACT TERMINATION COSTS )

O R D E R

On March 11, 1996, Louisville Gas and Electric Company ("LG&E") filed an application with the Commission seeking approval of its proposed method of accounting for a \$3.5 million payment to Andalex Resources, Inc. ("Andalex"), for early termination of a 1993 coal supply agreement. LG&E proposes to amortize and recover the prepayment of fuel costs through the fuel adjustment clause ("FAC").

The Andalex contract, executed on December 30, 1993, provided for a supply of 750,000 tons of coal annually over a six year term commencing January 1, 1994. The contract included provision for a price review during the fourth quarter of 1996 and an automatic termination by December 31, 1996 if the parties were unable to agree to a new price. In the event of such termination, neither party would incur any contractual liability. In addition, the Andalex contract provided for early termination by LG&E upon the payment of an amount determinable under the contract.

Due to the availability of coal from other sources at prices below the Andalex contract, LG&E elected to exercise the early termination provision in 1995. As a result, the contract ended on December 31, 1995 and LG&E was required to make a \$3.5 million lump sum payment to Andalex.

The evidence presented by LG&E showed that by terminating the Andalex contract LG&E's customers will receive the benefits of lower current coal prices and anticipated lower future coal prices. LG&E estimated that the total fuel cost savings of the early termination is approximately \$4.65 million, for a net savings in fuel expense of approximately \$1.15 million after deducting the \$3.5 million payment. The present value of the net savings was estimated to be \$1.12 million.

LG&E proposed to treat the \$3.5 million termination payment as a prepayment of fuel expense to be recorded as a deferred debit in Account No. 186, Deferred Debits. The payment would be charged each month on a pro rata basis to Account No. 151, Fuel Stock, beginning with the date of Commission approval and continuing through December 31, 1996. This treatment will allow LG&E to recover the termination cost through the FAC during the period that coincides with what would have been the remainder of the Andalex contract due to its automatic termination at the end of 1996 absent the parties' agreement on a new price. LG&E further stated that the net savings from the Andalex buy-out would only be realized in 1996, thus it should be allowed to recover its cost in 1996. The Commission finds LG&E's proposal to be reasonable and will allow the termination payment to be recovered during the remainder of 1996.

In its application, LG&E stated that a new coal contract was signed with Peabody Coal Sales Company ("Peabody") to replace the quantities that would have been purchased in 1996 from Andalex. All the cost benefit analyses submitted by LG&E were prepared as if the new Peabody contract had replaced the Andalex contract. However, LG&E subsequently acknowledged that despite its focus on a specific contract

replacement, it actually purchases its coal supply as a portfolio. Consequently, no single contract represented a replacement for the Andalex contract. Upon termination of the Andalex contract, LG&E made numerous adjustments to its portfolio to secure the same quantity of coal. The Peabody contract was used as the replacement coal in the cost benefit analyses because, in LG&E's opinion, it provided a conservative estimate of the savings and the Peabody coal, like the Andalex coal, was delivered by rail. LG&E explained that a conservative approach was taken in order to ensure that the net savings from the contract buy-out were calculated on a worst case scenario. LG&E claimed that had the cost benefit analyses been based on the actual circumstances of the Andalex coal being replaced by coal from LG&E's portfolio, the savings would have been higher.<sup>1</sup>

While LG&E was able to achieve net savings by terminating the Andalex contract, the Commission finds LG&E's approach to quantifying those savings to be troublesome. A cost benefit analysis should be based on the actual circumstances of the transaction rather than attempting to model a "worse case" scenario or "conservative" approach. In this proceeding, LG&E should have based its cost benefit analysis on its portfolio before and after the Andalex termination. LG&E's failure to timely disclose the exact nature of this transaction has unnecessarily delayed the review in this proceeding.

In future coal contract proceedings, LG&E will be expected to perform cost benefit analyses that accurately reflect the nature of the transaction. If one or more contracts are replaced, this fact should be reflected in the cost benefit analyses. Similarly, if the portfolio is being reconfigured, this too should be reflected in the cost benefit analyses.

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<sup>1</sup> Response to the Commission's June 12, 1996 Order, Item 1.

LG&E's case is similar to the coal contract buy-out case decided by the Commission in Case No. 10214.<sup>2</sup> The \$3.5 million paid to Andalex represents a prepayment of fuel costs for the purpose of obtaining a current and future reduction in fuel expense. The buy-out results in an immediate benefit to LG&E's customers and this benefit will continue through the remaining life of the contract. Denying FAC recovery of the buy-out cost would tend to discourage utilities from renegotiating existing coal contracts. Therefore, the Commission finds that LG&E's proposal to create a deferred debit in Account No. 186, Deferred Debits, and charge this debit to Account No. 151, Fuel Stock, over the remaining months of 1996, should be approved.

In approving FAC recovery of the Andalex contract buy-out, the Commission is not establishing a precedent for automatic FAC recovery of such costs. Contract buy-outs differ in terms and circumstances. Eligibility for FAC recovery can be determined only after review of a formal application.

The Commission, having reviewed the evidence of record and being otherwise sufficiently advised, HEREBY ORDERS that:


1. The \$3.5 million paid by LG&E is in effect a prepayment of fuel costs to obtain current and future coal market price benefits for its customers and, therefore, the FAC regulation, 807 KAR 5:056, provides for the recovery of such a prepayment.
2. LG&E shall amortize the prepayment for recovery through the FAC, beginning with August 1996 through the remaining months of 1996.


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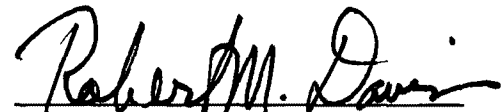
<sup>2</sup> Case No. 10214, Application of Kentucky Utilities Company for an Order Approving Certain Accounting Treatment of Amounts Paid for Coal Contract Release, Interim Order issued October 1, 1988.

Done at Frankfort, Kentucky, this 21st day of August, 1996.

PUBLIC SERVICE COMMISSION

  
Chairman

  
Vice Chairman

  
Commissioner

ATTEST:

  
Executive Director