COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

JOINT APPLICATION OF LOUISVILLE GAS AND ELECTRIC COMPANY AND KENTUCKY UTILITIES COMPANY FOR APPROVAL OF MERGER) CASE NO. 97-300

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<u>O R D E R</u>

On July 14, 1997, Louisville Gas and Electric Company ("LG&E") and Kentucky Utilities Company ("KU") filed a joint application, pursuant to KRS 278.020(4) and 278.020(5), for approval of: 1) the transfer of ownership and control of LG&E and KU in accordance with an Agreement and Plan of Merger dated May 20, 1997; and 2) a five year credit to customers' bills to reflect an allocation of the net five year merger savings. The joint application was supported by extensive exhibits and the prepared testimony of 10 witnesses.

The Applicants gave advance notice of their target filing date and in reliance thereon the Commission established a procedural schedule on July 9, 1997. The procedural schedule was designed to allow for a full investigation of the merits of the merger and the issuance of a final order within the 60-day time limit prescribed in KRS 278.020(5). That procedural schedule provided for two rounds of discovery, an opportunity for Intervenors to file testimony, a public hearing, and an opportunity to file post-hearing briefs. The Commission granted full intervention to the following entities: Attorney General's Office of Rate Intervention ("AG"); Kentucky Industrial Utility Customers ("KIUC"); Kentucky Association of Plumbing, Heating and Cooling Contractors ("KAPHCC"); International Brotherhood of Electrical Workers; Metro Human Needs Alliance ("Metro"), People

Organized and Working for Energy Reform ("POWER"), Anna Shed, collectively; Department of the Army; Lexington-Fayette Urban County Government; Community Action Councils of Lexington-Fayette, Bourbon, Harrison and Nicholas Counties; Kentucky Association of Community Action ("KACA"); and Kentucky Conservation Committee. A public hearing was held on August 19-21, 1997, at the Commission's offices in Frankfort, Kentucky, and post-hearing briefs were filed on September 2, 1997.

OVERVIEW OF THE TRANSACTION

The merger is intended to allow the Applicants to successfully position themselves in the new competitive environment that is emerging in the electric industry. More specifically, the Applicants contend that by merging they will be able to better control their costs and achieve economies of scale. Many businesses in the energy industry have merged in the 1990's in recognition of the need to become and remain competitive. The Applicants believe that their merger will create a Kentucky-based enterprise that will be better able to serve their ratepayers as well as their shareholders and employees. The merger will create a combined company with consolidated assets in excess of $4.8 billion and consolidated revenues in excess of $4.7 billion. This increase in size will result in improved financial strength and stability. By merging, the utilities will enhance their ability to offer competitive rates, reduce operating costs, and increase economic development efforts in their service areas. In addition, both utilities have committed to continue their traditional charitable contributions and community activities at the same levels and with the same efforts as in the past.

Under the merger, LG&E Energy Corp. ("LG&E Energy"), the holding company for LG&E, will acquire all the outstanding shares of KU Energy Corporation ("KU Energy"), the holding company for KU. Current shareholders of KU Energy will receive 1.67 shares of LG&E Energy stock for each share of KU Energy stock. After the merger, KU Energy will be dissolved, leaving LG&E Energy as the holding company for both LG&E and KU. LG&E Energy will continue to be an exempt holding company under the Public Utility Holding Company Act of 1935. LG&E will continue its corporate existence under the laws of Kentucky, while KU continues its dual corporate existence under the laws of Kentucky and Virginia.

The LG&E Energy board of directors, now consisting of 11 members, will be expanded and reconstituted to 15 members, eight to be selected by LG&E Energy and seven to be selected by KU Energy. The current Board Chairman and Chief Executive Officer of LG&E Energy and LG&E, Roger Hale, will after the merger remain in that position and serve in the same capacity for KU. The current Board Chairman and Chief Executive Officer of KU Energy and KU, Michael Whitley, will after the merger become Vice Chairman and Chief Operating Officer of LG&E Energy, LG&E, and KU. On May 20, 1997, the current directors of LG&E Energy and KU Energy unanimously voted to approve the proposed merger and a shareholder vote has been scheduled for October 14, 1997.

The Applicants anticipate that the merger will over time produce significant savings in both their fuel-related and non-fuel-related costs to provide electric service. All fuel savings will flow directly to ratepayers through the fuel adjustment clause, while the Applicants propose that the non-fuel savings be partially credited to ratepayers for the first five years after the merger. The Applicants were reluctant to reflect any merger savings in rates beyond five years due to the uncertainty of their costs and revenues at that time. Thus, they proposed that upon expiration of the five-year credit, they would meet with the Commission to discuss the need to reflect merger savings in rates.

STATUTORY STANDARD FOR MERGER

Under KRS 278.020(4), no person may acquire or transfer control of a utility until the Commission has determined that the acquirer has the financial, technical, and managerial abilities to provide reasonable service. In addition, under KRS 278.020(5), no individual may acquire control of a utility unless the Commission has determined that the acquisition is made in accordance with the law, for a proper purpose, and is consistent with the public interest.

Intervenor Metro, POWER, and Shed renew in its brief the due process objections it previously raised during the hearing. Basically, this Intervenor argues that the merger should be summarily denied because the 60-day review period authorized in KRS 278.020(5) does not afford adequate time to prepare for the hearing and, thus, violates its due process rights. The Commission overruled the objections during the hearing, and we now do so again for the same reasons. The Commission established a procedural schedule for this case even before the application had been filed to make maximum use of the statutory review period. No objections were raised to the procedural schedule and Metro, POWER, and Shed did participate in two rounds of discovery, did file prepared expert testimony, did participate in the hearing, and did file a post-hearing brief. The Commission is confident that the procedural schedule in this case afforded all parties their procedural due process rights. To the extent that Metro, POWER, and Shed claim that

KRS 278.020(5) is unconstitutional because it violates procedural due process requirements, such claim is beyond the jurisdiction of the Commission.

No party challenged the financial, technical, or managerial abilities of LG&E Energy, LG&E or KU to continue to provide reasonable utility service in their respective service territories. The Commission finds that the uncontested evidence conclusively demonstrates that LG&E Energy, LG&E and KU possess the requisite financial, technical, and managerial expertise to continue to provide the high quality utility service currently received by customers of LG&E and KU. Furthermore, the merger is for a proper purpose and is in accordance with the law, subject to the Applicants obtaining all other necessary regulatory and shareholder approvals. The remaining portions of this Order discuss the merger in the context of the public interest standard. With the relatively few changes and modifications discussed below, the Commission finds that the merger is in the public interest and should be approved.

PUBLIC COMMENT

At the commencement of the hearing, Dick Moore, Mayor Pro Tem of the City of Owensboro, Kentucky, presented a statement in opposition to the merger. The City of Owensboro owns electric generating facilities used by Owensboro Municipal Utilities ("OMU") to serve retail customers in the Owensboro area. OMU also sells at wholesale to KU under a long-term contract all available capacity not needed by OMU's retail customers. Mr. Moore, as a customer of OMU, claims that OMU's rates are adversely affected by the OMU/KU contract and he believes that if the LG&E/KU merger is approved by the Commission, KU will be less likely to renegotiate that contract.

The Commission finds that while Mr. Moore has raised claims that, if true, might warrant regulatory action, there is no evidence in this record to support any of his claims. In addition, there is no basis to believe that KU's merger with LG&E will adversely affect OMU's rights arising under its contract with KU.

Bob Cashier, City Manager of Paris, Kentucky, also spoke in opposition to certain practices of KU. Paris owns and operates a retail electric distribution system and purchases its power at wholesale from KU. KU also operates a retail distribution system within Paris, thereby creating what Mr. Cashier alleges is competition for customers and duplication of facilities. In addition, Mr. Cashier objects to the form of franchise agreement offered by KU and KU's unwillingness to negotiate the terms of a franchise. Mr. Cashier concluded his comments by noting that he does not object to the merger, but urges the Commission to be more vigilant in its review of the aspects of KU business.

The Commission was not previously aware of the specific problems affecting the City of Paris. We note, however, that city-owned utilities are statutorily exempt from our jurisdiction and, thus, any disputes involving a boundary with KU would have to be presented to the Court of Justice, not this Commission. Similarly, although KU must receive our approval to bid on a franchise, the terms of KU's bid and the terms of the franchise itself are not subject to Commission jurisdiction.

COMPETITIVE EFFECTS OF MERGER

The Applicants presented an analysis of the likely effects the proposed merger would have on competition in the generation, transmission, and distribution of electric power in both the retail and wholesale markets.[1] Their analysis concluded that the proposed merger will have no adverse affect on competition in either the retail market or the wholesale market.[2] In reaching this conclusion for the retail market, the Applicants correctly assert that, at the present time, regulation, not competition, determines prices, service territories, and market shares in the retail market.[3] In effect, the Applicants contend that the high level of uncertainty regarding the future course of developments in the electric industry and whether retail competition will ever exist means that any analysis of merger implications for future competition is merely conjectural and theoretical.[4]

The AG argues that market power is an issue in the instant case and that the Applicants have not provided sufficient evidence on this issue. The AG explains how, in his opinion, a market power study should have been conducted, although such a study was not sponsored by the AG.[5] Unfortunately, the AG's description of his preferred methodology of conducting a market power study does not address the fundamental issue raised by the Applicants: the lack of any direct competition in Kentucky's existing retail electric market that a merger might adversely affect. As explained by the AG, the first necessary step of his preferred methodology requires the definition of the relevant

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1 Haywood Testimony at 6-10.

2 Id. at 10.

3 Id. at 8.

4 Id. at 9.

5 Kahal Direct Testimony at 12-14.

product markets and geographic markets.[6] Unfortunately, he does not explain how such a definition is possible in the current regulated retail environment.

Intervenor Metro, POWER and Shed also raised the market power issue.[7] This Intervenor contends that a merger between LG&E and KU would eliminate potential competition within Kentucky, and would result in higher utility costs for Kentucky ratepayers if retail competition ever becomes a reality. This postulation is based on a theory that LG&E and KU would raise their prices to a higher market price established by high cost, out-of-state producers.[8] However, there is no evidence in the record to conclusively demonstrate that such an elimination of competition will occur in the event LG&E and KU merge.

The Commission concurs with the Applicants' position on the issue of market power. Any contention at this point in time that the merger of LG&E and KU will result in inappropriate market power is highly conjectural and theoretical. The total absence of direct competition in Kentucky's existing retail electric market makes implausible any attempt to prove market power and obviates the need, at this time, to consider this issue. The Commission also notes and will consider the AG's recommendation that we intervene in the merger case to be filed by LG&E and KU at the Federal Energy Regulatory Commission ("FERC") and request the issue of market power in a retail competitive environment be investigated in that forum.

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[6] Id. at 12.

[7] Brown Kinloch Testimony at 5-6.

[8] Id. at 5.

QUANTIFICATION OF MERGER SAVINGS

LG&E and KU retained Deloitte & Touche Consulting Group, LLC ("Deloitte & Touche") to perform an analysis to quantify potential merger savings and costs based on specific facts or expectations regarding existing and planned costs for each utility. This analysis indicated that the potential gross non-fuel savings would escalate each year with an expected cumulative 10-year total of $764,521,000, while the costs to achieve those savings were estimated to be $77,220,000.[9] LG&E and KU indicated that the estimated costs to achieve the merger savings would all be incurred during the first two years after the merger. Based on the results of the Deloitte & Touche analysis, the first five years of the merger should produce cumulative gross non-fuel savings of $313,087,000,[10] with an offset for the five-year amortization of the estimated costs of $77,220,000. The five year annual net non-fuel savings of $235,867,000 would then be allocated between shareholders and ratepayers, with the ratepayers' share reflected as a billing credit, termed the "surcredit mechanism" by the Applicants. LG&E and KU proposed to prepare and file a report five years after the merger to begin the analysis of whether and to what extent non-fuel merger savings should continue to flow to ratepayers.[11]

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9 Van den Berg Testimony, Exhibit AJV-1.

10 Id. The cumulative amount reflects the sum of the line titled "Gross Savings" for the years 1999 through 2003.

11 The LG&E/KU Brief, at 6, states that due to concerns raised by intervenors, the utilities were willing to amend the proposed surcredit tariffs to remove the five year expiration terms, thus leaving the credit mechanism in place until subsequent Commission action.

None of the Intervenors challenged the estimated amounts for non-fuel savings and costs determined by the Deloitte & Touche analysis. KIUC proposed modifications relating to the amortization of the costs to achieve the merger savings and the period over which the net non-fuel savings should be returned to ratepayers.

KIUC contended that the costs should be amortized over 10 years rather than the proposed five years, thereby achieving equity and symmetry. KIUC argues that the impact on ratepayers of the utilities' proposal is to "front-load the cost recovery and to backload and off-load the future savings."[12] KIUC proposed to credit the first five years of savings over just three years to enhance the probability that ratepayers receive at least five years of non-fuel savings. The basis for KIUC's concern is that future electric industry restructuring could result in a premature termination of the proposed surcredit. Finally, KIUC proposed that if the surcredit period is shortened to three years, the net non-fuel savings for the first five years should be levelized and matched to its proposed three-year surcredit period.

The Commission recognizes that a restructuring of the electric industry could affect the ability of LG&E and KU to provide the full amount of net non-fuel savings to ratepayers during the first five years after the merger. However, the likelihood of that happening is minimal since broad-based industry restructuring is at least several years away. In any event, should that happen the ratepayers would not be required to bear any additional costs of the merger and the Applicants' proposed credit, while effective, will have benefitted the ratepayers by tens of millions of dollars. Under the

[12] KIUC Brief at 11.

circumstances, the Commission is not persuaded that KIUC's proposed modifications are appropriate. The utilities have indicated that the costs to achieve the merger savings will be incurred within two years after the merger and KIUC has not adequately demonstrated that a 10 year cost recovery period is reasonable.

SHARING OF MERGER SAVINGS

The Applicants proposed to share with ratepayers the net merger savings during the first five years with no adjustments to base rates for the same period. Under the savings sharing, the identifiable savings for the first five years after the merger, net of implementation costs, are shared on a 50/50 basis between shareholders and ratepayers. The ratepayers' portion is to be split on a 50/50 basis between LG&E's and KU's ratepayers. Thus, LG&E's ratepayers are to receive 25 percent of the non-fuel savings each year for the first five years after the merger. Similarly, KU's ratepayers will receive 25 percent of such savings during the same time period.

The ratepayers' share of the net savings is to be paid in the form of a monthly credit that will be separately identified on customers' bills. For each of the first five years, the sum of the monthly credits is intended to reflect the estimated amount of net savings for that year. The credit is estimated to be approximately two percent of LG&E's and KU's combined annual electric revenues over the first five years after the merger.

The Applicants also propose to not adjust their base rates for five years in the absence of extraordinary circumstances. Although the Applicants did not provide a written definition of "extraordinary circumstances," they stated that their intent was to not increase base rates unless necessitated by unforeseen changes in federal tax laws or environmental requirements.[13] The existing adjustment clauses for the recovery of environmental costs, Demand Side Management costs, and fuel costs would not be subject to the freeze. During the hearing the Applicants agreed that while they have characterized their no rate adjustment pledge as a freeze, it would in actuality operate as a cap. It would prohibit either utility from requesting an increase absent extraordinary circumstances, but would not prohibit the Commission from initiating a proceeding upon a complaint or on its own motion.[14]

The AG and Metro, POWER, and Shed proposed that the non-fuel merger savings be flowed through to ratepayers by a reduction in base rates, rather than the proposed surcredit mechanism. The Applicants opposed a base rate reduction due to their concerns that the actual level of savings for years 6 through 10 may vary from their projections and, thus, they are unwilling to guarantee the projected levels to ratepayers.

The Intervenors proposed that the identifiable merger savings be shared on a basis that would give a larger portion of the savings to the ratepayers. KIUC proposed a 60/40 sharing, while the Attorney General proposed a 75/25 sharing. They argue that a larger portion of the savings should be shared with the ratepayers due to the Applicants' current earnings. The Applicants, however, claim that their earnings should not be investigated in a merger case. In addition, the Applicants argue that such an investigation in this case would require them to terminate the merger because it is a fully

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13 Transcript of Evidence ("T.E."), Vol. I, August 19, 1997 at 83.

14 Applicants' Response to AG's First Data Request, Item 40.

priced transaction and any reduction in their earnings would result in an unacceptable loss of shareholder value.[15]

The Applicants did, however, acknowledge that the Commission's statutory jurisdiction to regulate utility rates encompassed the authority to investigate and review LG&E's and KU's earnings.[16] The Applicants urge that any review of their earnings take place after consummation of merger due to the volume of work associated with both a merger and an earnings review.[17] The AG agreed that an earnings review should not be a condition of merger,[18] while KIUC acknowledged that an earnings review could be considered separately from the merger.[19] The Commission notes that prior to the Applicants filing this merger case, none of the parties had filed a complaint setting forth a prima facie case that either LG&E's or KU's rates were unreasonable, and the Commission had made no decision to do so on its own motion.

LG&E strenuously maintains that its 1996 earnings are a "high water mark," and that they have already started to drop. All of the parties did agree that taking a snapshot look at earnings, rather than conducting a full rate investigation, was inappropriate for determining whether the Applicants' earnings are reasonable. One factor complicating an earnings analysis is the differing time periods used by the parties. While the AG and

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15 T.E., Vol. I, August 19,1997, at 147.

16 T.E., Vol. I, August 19, 1997, at 33.

17 T.E., Vol. I, August 19, 1997, at 149-152.

18 T.E., Vol. III, August 21, 1997, at 145.

19 T.E., Vol. III, August 21, 1997, at 53.

KIUC have analyzed the Applicants' earnings for the 12 months ending December 31, 1996, the Applicants presented more recent financial information for the 12 months ending June 30, 1997. Another complicating factor is the need to separate LG&E's electric earnings from those of its gas and non-regulated operations. Similarly, KU's Kentucky retail earnings must be separated from its Virginia and wholesale operations. Further complicating such analysis is the absence of the dozens of detailed pro forma adjustments needed to ensure that the test period is representative for rate-making purposes.

In conclusion, the Commission finds that to determine whether a utility is currently overearning requires an economic analysis of two factors: 1) what is a reasonable cost of equity in today's economic conditions; and 2) what is the utility currently earning on its equity. The record in this case contains no analysis of the reasonable cost of equity for either LG&E or KU and, with the limited evidence on current earnings, no definitive finding of overearning can be made. The Commission will continue to monitor LG&E's and KU's financial reports and retains its statutory authority to initiate action which may include an investigation of rates should circumstances warrant.

Thus, the Commission is not persuaded to adjust the Applicants' proposed ratio for sharing merger benefits. Nor do we believe that a reduction in base rates, rather than a billing credit, is necessary or appropriate to ensure an uninterrupted sharing of merger savings with ratepayers. Further, the Commission finds that it is not appropriate in this instance to establish an earnings review as a precondition to the merger. The Applicants' proposed rate credits will provide significant future benefits to ratepayers, and the parties as well as the Commission retain the ability under KRS 278.260 to review the utilities' earnings.

The Commission does, however, find a serious shortcoming in the Applicants' proposal to reflect the merger savings for only five years, with a vague commitment to thereafter discuss with the Commission the need to continue to reflect such savings. While in their brief the Applicants have changed position and now agree to waive the five-year expiration date on their proposed surcredit tariff, such waiver still comes up short. Beginning in the sixth year of the merger, the annual levels of non-fuel merger savings are projected to increase significantly. Thus, the Commission finds that LG&E and KU should initiate formal proceedings, no later than midway through the fifth year of the merger, to present a plan for sharing with ratepayers the then projected levels of merger savings. This requirement, coupled with the Applicants' waiver of the expiration date on their surcredit tariff, will ensure an uninterrupted sharing of merger savings.

ALLOCATION OF CREDIT TO CUSTOMERS

The Applicants propose to split non-fuel merger savings between utilities on a 50/50 basis. The savings available to KU's ratepayers are then allocated among its Kentucky, Virginia, and FERC jurisdictions based on total revenue. The savings available to KU's Kentucky jurisdictional customers and LG&E's electric customers are then allocated to customer classes based on kilowatt hour usage.

The AG recommends that non-fuel merger savings be allocated among utilities, jurisdictions, and customer classes using shares of non-fuel revenue.[20] Metro, POWER,

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20 Kahal Testimony at 33.

and Shed contend that a kilowatt-hour based allocation among customer classes is unfair to small customers, especially low-income residential customers, since larger, high-volume customers would receive the "lion's share" of the merger savings.[21] Metro, POWER, and Shed recommend an allocation based on total revenue. Both Intervenors contend that, once merger savings are allocated to customer classes using a percentage-of-revenue-based allocation factor, allocations within customer classes based on kilowatt hour usage are acceptable. KIUC contends that the allocation methodology proposed by the Applicants is reasonable given the lack of cost-of-service data and the lack of certainty as to the source of the savings in future years.[22]

During the hearing, the Intervenors announced that they had unanimously agreed to allocate the net non-fuel savings to customer classes[23] using an allocation factor based on the total revenue of each utility. The Applicants stated that they had no objection to the methodology agreed to by the Intervenors and on September 8, 1997 filed an exhibit illustrating the agreed-upon methodology. The agreement of the parties is without waiver of their respective positions on the distribution of savings between the two utilities.

Metro, POWER and Shed contend that the savings should be allocated between the two utilities based on total revenues and that LG&E's revenues should include

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21 Brown Kinloch Testimony at 7.

22 Kollen Testimony at 22.

23 T.E., Vol. III, August 21, 1997, at 7-9.

natural gas revenues in addition to electric revenues.[24] The AG asserts that adding LG&E's gas revenues into the equation would favor LG&E customers simply because they also receive gas service from the same provider. Certainly, KU has customers who also are natural gas customers albeit from an unassociated utility. The Commission agrees with the AG. This is a merger of electric utilities and if not for that, there would be no savings for any customers as a result of this transaction. Any allocation based on revenues should be on the basis of electric revenues only.

The AG contends that in theory the allocation of merger savings should be guided by a detailed allocation study. However, the merger savings relate in large degree to consolidation economies in administrative functions and corporate overhead. They generally are derived from overall electric utility operations of the two utilities. Thus, a revenue-based allocation is appropriate.[25] The Applicants also sanction a revenue-based approach.[26] The AG's formula produces a split of approximately 53 percent to KU and 47 percent to LG&E.[27] The AG points out that, "KU is far larger in terms of kwh sales, revenues and number of customers," yet the arbitrary 50/50 split produces a larger credit for LG&E customers without demonstrating why it is a fair allocation.[28]

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24 Metro, POWER and Shed Brief at 7.

25 Kahal Testimony at 28.

26 T.E., Vol. II, August 20, 1997, at 325-326

27 T.E., Vol. II, August 20, 1997, at 326.

28 Kahal Testimony at 22.

The Commission accepts the agreement of the Applicants and Intervenors to use 1996 total revenues as the basis for allocating the merger savings to customer classes and to each customer within each class on the basis of total revenues. We also accept the revenue-based allocation of savings among KU's Kentucky, Virginia, and FERC jurisdictions. The Commission finds that the AG's revenue-based allocation of merger savings between utilities is equitable. The split between utilities of merger savings should be allocated 53 percent to KU and 47 percent to LG&E.

POWER SUPPLY SYSTEM AND TRANSMISSION COORDINATION AGREEMENTS

The Power Supply System Agreement ("PSSA") and Transmission Coordination Agreement ("TCA") establish the post-merger relationships between KU and LG&E with respect to the operation and planning of their generation and transmission systems. These agreements, which will be filed with and subject to the exclusive jurisdiction of the FERC, establish revenue and cost allocation procedures between the two utilities, as well as procedures for third-party and affiliate transactions. Both of the agreements establish an independent contractor rather than a partnership relationship between KU and LG&E.

The agreements establish separate committees to oversee the operation and planning of the generation and transmission systems. These committees will be chaired by the chief operating officer of LG&E Energy. The committee chair will appoint an equal number of member representatives of LG&E and KU. Decisions will be made by majority vote, and the chairperson will vote only in case of a tie.

After the merger, the generation and transmission systems of KU and LG&E will be operated and planned on an integrated basis. Planning objectives will be to maximize the economy, efficiency, and reliability of the system as a whole. Generation units with the lowest variable operating costs will be dispatched first, irrespective of ownership. Costs will be allocated to each operating company by first assigning that company's lowest cost generation to serving its pre-merger load responsibility. Once a company's generation output has been matched to its load responsibility, excess output will be matched to the other operating company's load responsibility. Pricing will be based upon a "split-the-difference" approach wherein the purchasing company pays one half the difference between the cost it would have incurred to generate energy and the actual cost of the other company to generate, plus the other company's cost to generate. The economic dispatch procedure should ensure that the other company's units will be dispatched only if its costs are less than any available unit owned by the company requiring the generation.

The PSSA anticipates the possibility that future generating units may be jointly owned. If the companies agree to joint ownership, the agreement requires that each company be responsible for its pro rata share of the costs

KIUC has expressed concern over the federal pre-emptive effect of the PSSA and the fact that it is preliminary and subject to major revisions prior to filing with the FERC. KIUC feels that it would be less productive to identify specific changes than to issue general conditions with respect to the PSSA. KIUC recommends that the merger be conditioned upon the Commission either: 1) finding that nothing in the PSSA will preempt the Commission's authority to determine the appropriate Kentucky retail rate-making treatment of costs and revenues; or 2) requiring the PSSA be finalized through negotiation and consultation with the Commission and the parties before the PSSA is filed with FERC.

The Applicants' position is that these agreements relate solely to the provision of transmission and wholesale electric service and, thus, are subject to the exclusive jurisdiction of the FERC. Since the Applicants have not consented to a waiver of their right to be regulated by the FERC on these issues, they assert that the Commission is precluded from reviewing or asserting any jurisdiction over these issues. Further, the Applicants argue that since the Commission is already preempted from exercising jurisdiction over these issues, neither the merger nor the FERC agreements will lessen the Commission's regulatory authority or existing consumer protections.

The Commission recognizes that the PSSA and TCA are drafts which were intended to only reflect some of the basic concepts of the operating relationships of LG&E and KU after the merger. Moreover, the Commission acknowledges that the provision of transmission and wholesale electric service are FERC jurisdictional, and therefore some of the issues more properly addressed in that forum. However, by this merger the issues of power supply and allocations of generating costs will pass from our exclusive purview to that of the FERC. In addition, the FERC agreements go beyond the provision of transmission and wholesale electric service and include provisions that relate to generation and transmission system planning. The inclusion of these provisions should not be interpreted as a surrender of Commission jurisdiction over generation and transmission system planning, or a pre-emption of Commission jurisdiction over determining whether public convenience and necessity require the construction of new generation and transmission facilities.

Other aspects of these agreements also directly relate to whether the merger is in the public interest. For example, integrated system planning may be the single most important benefit of the merger. Elimination of this requirement would have a major impact on the Commission's determination of whether the proposed merger is in the public interest.

Although the Commission is precluded from asserting jurisdiction over these agreements, the Intervenors and the Commission clearly have a strong interest in their provisions. Despite the Applicants' assertion that the Commission is precluded from even reviewing these agreements, the Commission is confident that KU and LG&E recognize that the Commission's concerns may be more efficiently resolved outside of a FERC proceeding. Thus, the Commission finds reasonable the suggestion from KIUC that before these agreements are filed with the FERC they be finalized through consultation and negotiation with the parties and the Commission. A similar process of negotiation was successfully utilized by The Cincinnati Gas and Electric Company and PSI Energy, Inc. in their merger.

REGULATORY ASSET AND LIABILITY ACCOUNTING TREATMENT

As part of the proposed credit mechanism, LG&E and KU requested that the Commission approve the establishment of a regulatory asset to reflect the unamortized balance of the ratepayers' portion of the merger costs. The Applicants proposed to recover from ratepayers one half of the estimated $77,220,000 in costs to achieve the merger savings, with their shareholders absorbing the other half. The ratepayers' share is to be divided evenly between LG&E and KU, resulting in $19,305,000 to be amortized by each utility over the first five years following the consummation of the merger. The annual amortization of $3,861,000 would be offset against the estimated savings to be achieved during each of the first five years after the merger. This will result in a net annual credit to ratepayers, with approximately one twelfth applied to billings each month. LG&E and KU did not propose any special accounting treatment, such as establishing a regulatory liability, relating to the merger savings to be shared with ratepayers.

KIUC proposed that, along with the establishment of a regulatory asset, LG&E and KU be required to establish a regulatory liability equal to the unamortized balance of the ratepayers' share of the estimated gross savings from the merger. KIUC claimed that equity required the creation of the regulatory liability since the utilities were seeking to create a regulatory asset. KIUC argued that the establishment of a regulatory asset was an attempt by the utilities to assure that they would recover the merger costs from ratepayers regardless of the future of the credit or industry restructuring activities. A regulatory liability, KIUC contends, will provide additional assurance that the ratepayers will actually receive their share of the merger savings. KIUC also acknowledged that if a performance based rate-making mechanism were established, merger savings could effectively be captured and flowed through to ratepayers without the credit mechanism.[29]

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[29] Id. at 104.

LG&E and KU opposed KIUC's recommendation, contending that it would not be proper to establish a regulatory liability for the estimated savings. LG&E and KU argued that the credit mechanism they proposed for the merger savings does not meet the requirements of the Financial Accounting Standards Board, and specifically the requirements of Statement of Financial Accounting Standards ("SFAS") No. 71,[30] for the creation of a regulatory liability.

The Commission finds that although SFAS No. 71 does not address the specific credit mechanism proposed in this proceeding, the situation is covered in paragraph 79 of that statement, which addresses the imposition of a liability on a regulated enterprise:

> c. For rate-making purposes, a regulator can recognize a gain or other reduction of overall allowable costs over a period of time. Paragraphs 35-37 illustrate that possibility. By that action, the regulator obligates the enterprise to give the gain or other reduction of overall allowable costs to customers by reducing future rates. Accordingly, the amount of the gain or cost reduction is the appropriate measure of the obligation.[31]

The Applicants have committed to a specific dollar amount of merger savings to be credited to ratepayers over a five-year period. This commitment represents an obligation to offset rates by the amount of the credit for five years. Such a rate offset reduces revenues and is equivalent to a reduction in an allowable cost. Regulatory action that either reduces revenues or expenses results in less net income. Thus, it

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[30] SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*, effective for fiscal years beginning after December 15, 1983. LG&E and KU specifically cited paragraph 11, concerning the rate actions of a regulator which could impose a liability on a regulated enterprise.

[31] SFAS No. 71, paragraph 79(c). Paragraphs 35-37 address the application of SFAS No. 71 general standards to the specific situation of the early extinguishment of debt. However, as noted in the text, this example only illustrates that possibility.

appears that SFAS No. 71 supports the establishment of a regulatory liability in the amount of the unamortized merger savings.

The Commission notes that LG&E and KU did not include in their discussion of a proposed regulatory asset or their opposition to a regulatory liability the requirements of the FERC's Uniform System of Accounts ("USoA"). In 1993, FERC revised the USoA to include the following definition of regulatory assets and liabilities:

> 30. Regulatory Assets and Liabilities are assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains, or losses that would have been included in net income determinations in one period under the general requirements of the Uniform System of Accounts but for it being probable:
>
> A. that such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services; or
>
> B. in the case of regulatory liabilities, that refunds to customers, not provided for in other accounts, will be required.[32]

The 1993 FERC revision further stated that regulatory assets would be recorded in Account No. 182.3, Other Regulatory Assets,[33] and that regulatory liabilities would be recorded in Account No. 254, Other Regulatory Liabilities. For Account No. 254, the USoA states in part:

> B. The amounts included in this account are to be established by those credits which would have been included in net income

32 18 CFR Part 101, Definitions, No. 30. Docket No. RM92-1-000, effective date January 1, 1993.

33 LG&E and KU have incorrectly indicated that the proposed regulatory asset would be recorded in Account No. 186, Miscellaneous Deferred Debits. See LG&E/KU Post Hearing Data Request Responses, Item 6 and the response to KIUC's Second Data Request, Item 2.

determinations in the current period under the general requirements of the Uniform System of Accounts but for it being probable that: 1) such items will be included in a different period(s) for purposes of developing the rates that the utility is authorized to charge for its utility services; or 2) refunds to customers, not provided for in other accounts, will be required. When specific identification of the particular source of the regulatory liability cannot be made or when the liability arises from revenues collected pursuant to tariffs on file at a regulatory agency, Account 407.3, Regulatory Debits, shall be debited. The amounts recorded in this account generally are to be credited to the same account that would have been credited if included in income when earned except: 1) all regulatory liabilities established through the use of Account 407.3 shall be credited to Account 407.4, Regulatory Credits; and 2) in the case of refunds, a cash account or other appropriate account should be credited when the obligation is satisfied.

Concerning the accounting for the merger savings and the costs incurred to achieve those savings, the Commission expects LG&E and KU to make all accounting entries necessary for both utilities to be in conformity with the requirements of the FERC USoA and SFAS No. 71. Within 30 days of finalizing these accounting entries, LG&E and KU should submit the entries to the Commission.

REGULATORY CONCERNS

LG&E and KU requested approval of their Corporate Policies and Guidelines for Intercompany Transactions ("Guidelines") which will govern their merged activities. The Applicants stated that the proposed Guidelines were based upon, and consistent with, the Policies and Guidelines adopted by both LG&E/LG&E Energy and KU/KU Energy and endorsed by the Commission. In addition, the proposed Guidelines were expanded to cover transactions which would occur between the two regulated utilities. Under the proposed Guidelines, transactions between the two utilities will be priced at cost to ensure that neither utilities' customers are disadvantaged by transfers between the utilities.

The Orders which approved the creation of holding companies for LG&E[34] and KU[35] included extensive discussions of the Commission's concerns and objectives with regard to the protection of ratepayer interests. The Commission's concerns related to three areas:

> 1. The protection of utility resources;
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> 2. The ability to adequately monitor the corporate activities of the utility, the holding company, and any other subsidiaries established by the holding company; and
>
> 3. The establishment of reporting requirements to assist the Commission in its monitoring activities.[36]

Those Orders also contained a detailed list of the conditions and requirements necessary to protect ratepayers' interests.

LG&E and KU stated that they would continue to adhere to the applicable conditions established when their respective holding companies were approved in Case Nos. 89-374 and 10296. The conditions for each utility are in many respects the same, but there are some differences. Those differences, none of which were addressed by

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[34] Case No. 89-374, Application of Louisville Gas and Electric Company for an Order Approving an Agreement and Plan of Exchange and to Carry Out Certain Transactions in Connection Therewith, final Order dated May 25, 1990.

[35] Case No. 10296, The Application of Kentucky Utilities Company to Enter Into an Agreement and Plan of Exchange and to Carry Out Certain Transactions in Connection Therewith, final Order dated October 6, 1988.

[36] Case No. 89-374, May 25, 1990 Order, at 4 and Case No. 10296, October 6, 1988 Order, at 3 - 4.

LG&E or KU, are in the areas of Commission access to books and records and the timing and nature of special reporting requirements.

The Commission has reviewed the conditions established for LG&E's and KU's holding companies, as well as for the CINergy merger in Case No. 94-104.[37] Concerning the access to books and records, the Commission stated in Case No. 89-374:

> In its application, LG&E stated that it will provide the Commission access to the books and records of Holding Company and its affiliates and subsidiaries. The Commission will have access, as necessary in the exercise of its statutory duties, to the books and records of Holding Company and its other affiliates and subsidiaries as the books and records may be related to transactions with LG&E. If the subsidiaries or affiliates of Holding Company do not transact business with LG&E, LG&E will verify, if necessary, the lack of such transactions through independent sources.[38]

The Commission made similar statements in its Order in Case No. 94-104.[39] The Commission believes that this access and verification are still appropriate in the circumstances of today's changing environment, and we will require its continuation for the post-merger LG&E Energy.

The Order in Case No. 89-374 outlined seven types of additional information LG&E had agreed to provide periodically to the Commission.[40] This information has been useful to the Commission in its monitoring of LG&E and LG&E Energy and it should continue to be provided after the merger is consummated.

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[37] Case No. 94-104, Application of the Cincinnati Gas & Electric Company and CINergy Corp. for Approval of the Acquisition of Control of The Union Light, Heat & Power Company by CINergy Corp., final Order dated May 13, 1994.

[38] Case No. 89-374, May 25, 1990 Order, at 15.

[39] Case No. 94-104, May 13, 1994 Order, at 18.

[40] Case No. 89-374, May 25, 1990 Order, at 18-19.

LG&E also annually files its Securities and Exchange Commission ("SEC") Form U-3A-2, which the Commission has found to be valuable in monitoring the activities of LG&E Energy. After the merger, this SEC report should continue to be filed along with the other annual filing requirements established for LG&E Energy. In the event that LG&E Energy is granted an SEC exemption from filing Form U-3A-2, LG&E will be required to file the same information with the Commission annually. Until the merger is consummated or in the event the merger is terminated, LG&E should continue to file the SEC Form U-3A-2, and KU should prepare a report similar to Form U-3A-2 and include it with the its annual information filing to the Commission.

In approving holding companies for LG&E and KU, the Commission acknowledged that many aspects of their respective business activities were unknown and could not then be reasonably anticipated. Over the years, both holding companies have expanded their operations beyond their traditional regional markets, and they have done so through the use of innovative business practices. In addition, the nature of the natural gas and electric industries has changed significantly in the 1990's in ways which could not have been anticipated. For these reasons, the Commission finds it necessary in the exercise of our statutory duties to require additional information be filed by the holding companies and the utilities.

In the joint application, KU indicated that KU Energy was comprised of the parent company and two levels of subsidiary companies, while LG&E indicated that LG&E

Energy was comprised of the parent company and four levels of subsidiary companies.[41] A useful tool in understanding the structure of the holding company is a corporate organization chart. As part of its annual information filing after the merger, LG&E Energy should provide a detailed organization chart as of the end of the calendar year showing all subsidiaries referenced in the SEC U-3A-2 filing. As part of its quarterly information filing after the merger, LG&E Energy should disclose and describe any changes to its corporate structure since the annual filing. In lieu of submitting an organization chart each quarter, a supplemental chart should be filed showing the extent of any changes. Until the merger is consummated or terminated, KU Energy and LG&E Energy should annually file corporate organization charts, reflecting the level of detail described for the post-merger filing, with a quarterly supplemental disclosure as needed.

Currently, LG&E and KU file monthly financial reports, which provide financial information on a monthly, year-to-date, and 12-month-ending basis. While both utilities' reports provide useful information, the LG&E report provides most of its information on a combined-utility basis, and the KU report is on a total-company basis. The Commission finds that changes occurring in the gas and electric industries necessitate supplemental information which better identifies the nature of the utilities' operations, including the separation of gas and electric operations and the separation of Kentucky jurisdictional and other jurisdictional operations. Therefore, the Commission will require 12-month income statements and balance sheets which for LG&E will separately report

41 The 1996 SEC Form U-3A-2 also indicates that many of LG&E Energy's fourth-tier subsidiaries are general or limited partners in other ventures related to the development of exempt wholesale generators.

gas and electric operations and for KU will separately report Kentucky jurisdictional operations and other jurisdictional operations. These financial statements should be filed quarterly and follow the formats used in the utilities' responses to data requests in this proceeding.[42] These supplemental financial statements should be submitted along with the utilities' current monthly financial reports. The first supplemental financial statements should be filed for the last quarter of 1997.

KAPHCC proposed that the Commission require an amendment to the Guidelines to provide that a non-regulated affiliate of the utility pay the higher of cost or market for goods and services obtained from the utility. The amendment proposed by KAPHCC would require that all goods and services provided by LG&E or KU to LG&E Energy or any of its non-utility subsidiaries will be billed at the higher of cost or market. The guidelines proposed by LG&E and KU would require those transactions to be priced at cost. KAPHCC also asked the Commission to begin an administrative proceeding in which a comprehensive review of the activities of unregulated affiliates can be examined in detail outside the time constraints applicable to this proceeding.

The approach to pricing transfers of goods and services from the regulated utility to an unregulated affiliate proposed by KAPHCC would be the same as that applied to transfers of assets in the proposed guidelines. These transactions should be priced in

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[42] For the income statement format for LG&E and KU, see the responses to the Commission's July 24, 1997 Order, Items 2(c) and 2(d), respectively. For the balance sheet format for KU and LG&E, see the responses to the Commission's August 6, 1997 Order, Items 2(a) and 2(b), respectively. In addition, LG&E should provide the 3 percent investment tax credit and Job Development Investment Tax Credit information that was submitted in response to the Commission's July 24, 1997 Order, Item 3.

a manner that provides the maximum benefit to the regulated company and does not result in the regulated company subsidizing its non-regulated affiliates. There are some elements of value in establishing the cost of goods and services that are difficult if not impossible to measure. The market-based pricing would to some extent give recognition of the value of those costs. This is also recognized by LG&E in the pricing arrangement it currently has with its affiliate, LG&E Home Services, Inc., where the regulated company prices goods and services at 10 percent above cost.

The Commission does not believe that the issue of pricing goods and services between the regulated company and its affiliates at the higher of cost or market has been explored to the fullest extent in this proceeding. The Commission does concur with KAPHCC to the extent this is a concern that should be addressed in another proceeding.

The proposed Guidelines for the merged companies will not be effective until the merger is consummated, which is anticipated to be in 12 to 18 months. Moreover, in response to a request made outside this case, the Commission had already been considering the merits of opening an administrative proceeding to explore Affiliate Transaction and Code of Conduct rules for all jurisdictional utilities. The Commission has recently decided to initiate such a proceeding and anticipates opening a docket in the near future. Thus, this new docket will most likely be completed before the proposed Guidelines are implemented by the Applicants. Therefore, KAPHCC will have the opportunity to pursue these issues in the new administrative proceeding.

DEMAND SIDE MANAGEMENT

The KACA, Metro, POWER, and Shed proposed that as a condition to the approval of the merger, the existing LG&E demand side management ("DSM") programs be expanded into KU's service territory. KACA also contended that LG&E and KU should commit to doubling the current DSM program budget. These Intervenors expressed the concern that after the merger, the LG&E DSM programs may not be continued.

As was correctly noted by LG&E and KU, the current LG&E DSM programs are the subject of a separate Commission investigation that was initiated prior to the announcement of the merger.[43] It will be in that proceeding that the LG&E DSM programs will be evaluated. While the DSM issue is important, such programs are highly complex and technical and not appropriate for consideration in this proceeding. Therefore, the Commission will neither require the expansion of LG&E's DSM programs into the KU service territory nor require the doubling of the DSM program budget as conditions to the approval of the merger.

UNIVERSAL SERVICE FUND

Metro, POWER and Shed recommended that the Commission require LG&E and KU to establish a universal service fund as a condition of the merger. The purpose of the fund would be to provide supplemental energy assistance payments and

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[43] Case No. 97-083, The Joint Application of the Members of the Louisville Gas and Electric Company Demand-Side Management Collaborative for the Review, Modification, and Continuation of the Collaborative, DSM Programs, and Cost Recovery Mechanism.

conservation measures for targeted low-income households.[44] KACA also suggested that the utilities consider starting a universal service fund to help low and moderate income customers.[45] In this context, universal service is taken to mean aid for households that already have connections to utility service as opposed to assuring that extensions of facilities are priced to ensure households have access to affordable service. Universal service, under either meaning, is a timely issue that has been raised before many utility regulatory agencies.

The Commission well recognizes that universal service will be an essential requirement in an environment that includes retail competition. However, we are not persuaded by the evidence in this record that in today's regulatory environment the merger should be conditioned upon the establishment of such a fund. This issue is one that needs to be considered on a state-wide, rather than local, basis. The Commission finds it inappropriate to mandate a universal service fund that will benefit only the customers of LG&E and KU.

OTHER APPROVALS

LG&E and KU have indicated that numerous approvals are necessary in order for the merger of KU Energy into LG&E Energy to be in accordance with the law. The shareholders of both holding companies must approve the merger. LG&E and KU must also receive the approval of the FERC, SEC, and the Virginia State Corporation Commission ("Virginia Commission"). LG&E and KU will file notifications required under

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44 Metro Brief at 5.

45 Bowman Testimony at 2.

the provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, with the Federal Trade Commission ("FTC") and the U.S. Department of Justice ("DOJ"). LG&E and KU will also file notification with the Tennessee Regulatory Authority ("TRA").

LG&E and KU have indicated that the shareholder vote for both companies will be held on October 14, 1997.[46] LG&E and KU provided a copy of the application filed with the Virginia Commission[47] and a draft copy of the filing with the FERC.[48] None of the other filings or notifications have been provided in this case.

On or before October 24, 1997, LG&E and KU should inform the Commission of the results of the shareholders' votes. Copies of applications or notifications not previously submitted in this case should be filed with the Commission within 10 days of the filing with the respective agency. LG&E and KU should submit any amendments to its filing with the Virginia Commission and a final copy of its application to the FERC within 10 days of the filing. LG&E and KU should also submit copies of any approvals or other responses from the various regulatory agencies within 10 days of receipt.

FUTURE REGULATION

LG&E and KU are recognized as efficient and high quality providers of electric service at rates that are among the lowest in the nation. Both companies also are well positioned financially and enjoy high debt ratings due to numerous factors including their low cost generation, desirable service territories and efficient management structures.

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46 T. E., Vol. I, August 19, 1997, at 91.

47 Response to the Commission's July 24, 1997 Order, Item 18.

48 Response to the Commission's August 6, 1997 Order, Item 17.

This creates a balance of regulatory goals in the current environment of low rates and reliable service to ratepayers, and healthy returns for stockholders. However, proposals to deregulate the electric industry and the emergence of competition in both the wholesale and retail markets will create a new environment. The Commission finds that this merger is a significant and positive step to allow LG&E and KU to better address the new environment. At the same time, the Commission recognizes that as we enter this new era, traditional rate-making techniques may not ensure that ratepayers and stockholders share in the benefits of competition in the same balance as in the current environment.

Therefore, LG&E and KU shall file by September 14, 1998 or the consummation of the merger, whichever is later, detailed plans to address any future rate regulation. If either utility elects to remain under traditional rate of return regulation, it should state the reasons and include an analysis and proposals relative to its earnings at that time. Alternatively, if either utility elects non-traditional regulation, the reasons for this choice should be disclosed, along with the details of a proposal and how it will achieve the Commission's goals of providing incentives to utilities and a sharing of resulting benefits with ratepayers. These filings will be docketed separately as new cases and subjected to investigations to the full extent necessary. The Commission will then determine, based on all relevant financial information, as well as then current economic and regulatory conditions, whether changes should be made to the existing regulation of LG&E and KU.

SUMMARY OF FINDINGS

The Commission, after consideration of the evidence of record and being advised, in summary finds that:

1. LG&E Energy, LG&E, and KU will, after the consummation of the merger, continue to have the financial, technical, and managerial abilities to provide reasonable utility services

2. LG&E Energy will not, by reason of its ownership of all outstanding shares of common stock of LG&E and KU, be a utility as defined in KRS 278.010(3).

3. The proposed merger and transfer of control of KU Energy into LG&E Energy, and of KU and LG&E to a newly constituted LG&E Energy, is in accordance with law, for a proper purpose, and with the conditions and assurances established herein consistent with the public interest.

4. The merger credit mechanism as modified herein should become effective with the first full billing month that begins 30 days after consummation of the merger.

5. The accounting by LG&E and KU for the amortization of the costs incurred to achieve merger savings and the savings to be returned to ratepayers through the credit mechanism should be in accordance with the requirements of the FERC USoA and SFAS No. 71.

6. The interests of LG&E, KU, and its ratepayers should be given first priority in the business decisions of LG&E Energy.

7. LG&E and KU should maintain adequate supporting documentation of all costs, regardless of their origin.

8. LG&E and KU should develop, implement, and maintain cost allocation procedures that will prevent cross-subsidization.

9. The pricing of intercompany transactions should not result in an adverse impact on the ratepayers of LG&E or KU.

10. In future rate proceedings, LG&E and KU should be able to show that no cross-subsidization has occurred by disclosing all allocated costs, the portion allocated to each segment of LG&E Energy, complete details of the methods of allocation, and justification for the amount and the method.

11. Any amendment to LG&E's, KU's, or LG&E Energy's policies and guidelines should be filed with this Commission, along with its effective date and the accounting periods affected.

12. LG&E's and KU's boards of directors should not allow their respective dividend policies to adversely affect the utilities' financial integrity nor the rates of LG&E's or KU's customers.

13. LG&E and KU should take whatever protective measures necessary, including divestiture, to ensure that each utility maintains its present level of services and operations.

14. LG&E Energy and its subsidiaries should provide open access to all books, records, and personnel as discussed in this Order.

15. LG&E and KU should file the details of significant transfers of utility assets, business ventures of LG&E Energy, and other major transactions as they are completed.

16. LG&E and KU should file the reports and other information as specifically set out in either the May 25, 1990 Order in Case No. 89-374 or in this Order.

17. LG&E and KU should provide copies of the applications, notices, final approval orders, or other regulatory notifications received from FERC, SEC, the FTC, DOJ, the Virginia Commission, and the TRA, to the extent these documents have not already been provided in this case.

18. The Commission will continue to monitor LG&E's and KU's financial reports and retains its statutory authority to initiate action which may include an investigation of rates should circumstances warrant.

IT IS THEREFORE ORDERED that:

1. The transfer of ownership of LG&E and KU to LG&E Energy is approved.

2. The acquisition of control by LG&E Energy, upon the merger of KU Energy into LG&E Energy, of LG&E and KU is approved.

3. The proposed credit mechanism as modified herein is approved and within 20 days from the date of this Order LG&E and KU shall file revised tariffs reflecting the approved credit.

4. LG&E's and KU's obligations to provide adequate, efficient and reasonable utility service shall not be impaired by LG&E Energy.

5. LG&E and KU are prohibited from guaranteeing the debt of LG&E Energy and its affiliates without the prior approval of the Commission.

6. LG&E, KU, and each related company shall after the merger comply with LG&E Energy's <u>Corporate Policies and Guidelines for Intercompany Transactions</u>.

7. LG&E and KU shall comply will all reporting requirements described herein.

8. Access to the books and records of LG&E Energy and its other affiliates and subsidiaries shall be provided as described herein.

9. LG&E and KU shall consult and negotiate with the parties to this case and the Commission prior to finalizing and filing with FERC the PSSA and TCA.

10. LG&E and KU shall file copies of the applications, notices, final approval orders, or other regulatory notifications received from FERC, SEC, FTC, DOJ, the Virginia Commission, and the TRA, to the extent these documents have not already been provided in this case, within 10 days of their filing or receipt.

11. LG&E and KU shall within five days of the consummation of the merger file a written notice setting forth the date of merger and the effective date of the merger credit tariffs.

12. LG&E and KU shall submit the final accounting entries developed to account for the amortization of the costs incurred to achieve merger savings and the savings to be returned to ratepayers through the credit mechanism within 30 days of finalization.

13. By September 14, 1998 or the consummation of the merger, whichever is later, LG&E and KU shall file detailed plans to address any future earnings situations and any proposed incentives to achieve the highest possible levels of performance.

14. LG&E and KU shall by the middle of the fifth year after the merger file plans to address the future sharing of merger savings with ratepayers.

Done at Frankfort, Kentucky, this 12th day of September, 1997.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director