

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF LOUISVILLE GAS AND ELECTRIC )	
COMPANY AND KENTUCKY UTILITIES COMPANY )	CASE NO.
FOR A CERTIFICATE OF PUBLIC CONVENIENCE )	99-056
AND NECESSITY FOR THE ACQUISITION OF TWO )	
164 MEGAWATT COMBUSTION TURBINES )	

O R D E R

Louisville Gas and Electric Company and Kentucky Utilities Company ( LG&E and KU ) filed their application on February 11, 1999 for a Certificate of Public Convenience and Necessity for acquisition of two 164 Megawatt ( MW ) combustion turbines. LG&E and KU subsequently amended their application to include a request for a Certificate of Environmental Compatibility pursuant to KRS 278.025. The total estimated cost is \$125 million. An unregulated affiliate of LG&E and KU, LG&E Capital Corp. ( Capital Corp. ), purchased the two turbines from Asea Brown Boveri ( ABB ) and began construction of the two units at KU's E.W. Brown generating station in Mercer County. LG&E and KU stated that the turbines are needed to reliably supply increasing customer loads, and the acquisition of the two turbines is the most reasonable least cost option compared to relying only on purchase power to serve the projected loads. The turbines will have dual fuel capabilities (oil and gas), but will be operated on gas. One turbine is expected to be in service by mid July and the second two to three weeks later. The Attorney General ( AG ) and Kentucky Industrial Utility

Customers ( KIUC ) were granted intervention, and a hearing was held at the Commission s offices on June 1, 1999.

The AG s position is that Capital Corp. paid a high price for the two turbines, and that LG&E and KU failed to explore all reasonable alternatives. The AG compared the price of the CT in the 1996 KU Integrated Resource Plan ( IRP ) (\$198/KW) with the price of the CT under construction (\$381/KW) and recommended that LG&E and KU perform an analysis of other peaking alternatives such as battery storage and compressed air storage. KIUC did not submit testimony.

LG&E and KU issued a request for proposal ( RFP ) on February 10, 1999 for firm peaking capacity. The RFP was sent to 107 potential suppliers, including IOUs, electric cooperatives, large municipal organizations, and marketing entities. Several responses were received by LG&E and KU, which requested and were granted confidentiality for all the proposals. The present value analysis shows that the CTs are the least cost option. On April 1, 1999, the utilities sent an RFP for CTs to the three major turbine manufacturers. Bids were received from the three manufacturers. The bid prices show that the CTs under construction are the least cost option. LG&E and KU requested confidentiality for all the bids. LG&E and KU stated at the hearing that the total construction cost of the two CTs will be \$118 million instead of the estimated cost of \$125 million.

LG&E and KU s analysis in the record supports the construction of the two CTs as the least cost option to meet future loads instead of relying on purchase power. The AG s suggestion that LG&E and KU paid a high price for the CTs is based on prices filed in KU s 1996 IRP. Since that IRP filing was made, the cost of CTs has increased

substantially due to industry demand following the capacity shortages experienced last summer. The recent turbine manufacturer bids demonstrate conclusively that the prices in KU's 1996 IRP are now unavailable. The AG filed no analysis to support his suggestion that other peaking options such as battery storage or compressed air storage would have a lower cost than the proposed CTs. The Commission finds that the acquisition of the two 164 MW turbines is the least cost option to reliably serve LG&E and KU's customer loads.

The Natural Resources and Environmental Protection Cabinet indicated that it had no objection to the issuance of a Certificate of Environmental Compatibility by the Commission.

Transfer of Turbines from LG&E Capital Corp.

LG&E Energy Corp.'s ( LG&E Energy ) Corporate Policies and Guidelines for Intercompany Transactions ( Corporate Guidelines ) state that transfers of assets from non-utility affiliates to LG&E or KU must be done at the lower of cost or fair market value. The transfer of the two combustion turbines from Capital Corp. to LG&E and KU is such a transaction. The Commission notes that the AG has challenged certain cost components and observes that the Corporate Guidelines provide no guidance as to how fair market value is to be determined.

Determining Cost. LG&E and KU indicated that construction costs for the two turbines have been recorded in accordance with the requirements of the Uniform System of Accounts ( USoA ).<sup>1</sup> As part of the construction process, the turbines will be tested and electricity will be generated. Since Capital Corp. will be the owner of the

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<sup>1</sup> Transcript of Evidence ( Tr. ), at 63.

turbines during this testing period, the test energy will be sold in the wholesale market. In order to sell the test energy, Capital Corp. sought and received approvals from the Federal Energy Regulatory Commission (FERC) for exempt wholesale generator (EWG) status and permission to sell energy at market-based prices.<sup>2</sup> These authorizations were also needed if, during the period between the completion of construction and the transfer of the turbines, Capital Corp. desired to sell energy from the turbines. LG&E and KU estimated that the cost to obtain these approvals was between \$10,000 and \$20,000<sup>3</sup> and indicated that the cost would be included in the capitalized construction costs.

The AG has objected to the inclusion of the costs associated with the FERC applications as part of the capitalized cost of the turbines. The AG contends that the need for the FERC approvals was the result of LG&E and KU manipulating the traditional certification process. The AG argues that had LG&E and KU followed the traditional approach in seeking a Certificate of Public Convenience and Necessity for the turbines, the FERC-related costs would not have been incurred. The AG states that ratepayers should not have to pay for these extra costs, and he recommends that all costs associated with the EWG status should be kept with Capital Corp. and should not be transferred to ratepayers.<sup>4</sup>

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<sup>2</sup> EWG Application, FERC Docket No. EG99-103-000, Letter Ruling dated May 14, 1999 and Market-based Pricing Application, FERC Docket No. ER99-2108-000, Order dated April 28, 1999.

<sup>3</sup> Tr. at 64-65. KU and LG&E revised this estimate to \$5,700; see Response to Information Requested at June 1, 1999 Public Hearing, filed June 4, 1999, Item 3.

<sup>4</sup> Brown Kinloch Testimony, at 17-18.

The Commission rejects the AG's arguments. The USOA's Electric Plant Instructions concerning earnings and expenses during construction require that the revenues earned and expenses incurred for energy produced and sold during the construction period are components of the construction cost.<sup>5</sup> Thus, the capitalized revenues from the sale of the test energy will offset the FERC application costs and expenses incurred to produce and sell test energy. Capital Corp. will not benefit at the expense of KU's and LG&E's ratepayers if the USOA capitalization rules are followed. Therefore, the Commission will require that LG&E and KU determine the cost of the two turbines following the requirements of the USOA.

Determining Fair Market Value. As noted previously, the Corporate Guidelines do not prescribe how fair market value is to be determined, and LG&E and KU have not indicated how it will be determined for the turbines. The Commission will require LG&E and KU to thoroughly explain how they determined the fair market value of the turbines to be transferred and whether the valuation includes an appraisal. If an appraisal is not included, LG&E and KU should explain why this was not done. Finally, in order to make a valid comparison with the cost, LG&E and KU should not include turbine components that are already owned by KU in the fair market valuation.

Therefore, the Commission finds that LG&E and KU should file their determination of the cost<sup>6</sup> and the fair market value of the transferred turbines within 30 days after the date of the transfer. All accounting entries made to the books of LG&E

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<sup>5</sup> 18 CFR 101, Subchapter C, Electric Plant Instructions, Item 3 Components of Construction Cost, paragraph 18.

<sup>6</sup> The cost of the turbines should be shown with the same level of detail as was provided in the original application at pages 4 and 5.

and KU relating to the transfer of the turbines and the allocation between LG&E and KU of the turbines should also be filed with the Commission within 30 days of the transfer. Finally, LG&E and KU should provide explanations of how turbine components<sup>7</sup> already recorded on the books of KU have been allocated to LG&E.

#### Governing Service Agreement

LG&E and KU initially informed the Commission of the situation with Capital Corp. and the turbines by a letter dated October 30, 1998. In that letter, LG&E and KU stated:

KU or LG&E involvement in the project will be limited to providing oversight during the construction and installation of the combustion turbines and will be performed pursuant to a service agreement that is consistent with LG&E Energy Corp.'s Corporate Policies and Guidelines for InterCompany Transactions. LG&E and KU Capital Corp. expect to enter into this agreement following the decision on the use of the machines.<sup>8</sup>

KU and Capital Corp. never executed the referenced service agreement.<sup>9</sup> And while KU's role was initially envisioned to involve only project oversight, KU has actually incurred construction costs for facilities related to the turbines.<sup>10</sup> LG&E and KU contend that while no formal service agreement was established between KU and Capital Corp.,

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<sup>7</sup> KU already owns the land on which the turbines are sited, and has accumulated certain construction costs on a series of work orders.

<sup>8</sup> Response to the Commission's March 16 and 19, 1999 Orders, Item 5, page 3 of 4.

<sup>9</sup> Tr. at 21-22.

<sup>10</sup> Response to the Commission's March 16 and 19, 1999 Orders, Item 18(d). KU and LG&E stated at the public hearing that the current costs recorded by KU on work orders for the turbine project totaled \$921,804; see Tr. at 66.

all costs incurred by KU have been properly recorded to work orders coded for the turbine project and that these procedures comply with the Corporate Guidelines. LG&E and KU argue that a service agreement would have provided no additional safeguards beyond what has been accomplished by the accounting and record keeping procedures of KU and Capital Corp.<sup>11</sup>

LG&E Energy's Corporate Guidelines consist of five double-spaced pages that describe the basic concepts to be followed in transactions between KU, LG&E and LG&E Energy affiliates. The Corporate Guidelines do not address the specific actions required by LG&E Energy affiliates to implement these basic concepts. The governance over a project such as this turbine construction requires a document more detailed than the Corporate Guidelines. While work order accounting and record keeping can adequately track and accumulate costs, they are not designed to address all the responsibilities, obligations, and rights of the parties involved in the project.

The Commission believes that had the turbine project involved an unaffiliated company, KU would have insisted upon, and executed, a service agreement or some other governing document that would have detailed the responsibilities, obligations, and rights of the parties. The fact that the party was an affiliate is not sufficient reason to deviate from sound business practices. The use of such a document would have also acknowledged and recorded KU's changed role in the construction of the turbines.

The Commission finds that KU and Capital Corp. should have executed a service agreement or some other governing document that would have detailed the responsibilities, obligations, and rights of each party. Such a step would not have been

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<sup>11</sup> LG&E and KU Brief, at 9.

unreasonable, considering the nature and dollar value of the turbine project. In the future, should LG&E or KU enter into similar projects with other LG&E Energy affiliates, a service agreement or some other governing document should be executed. The document should be based on the Corporate Guidelines and detail the responsibilities, obligations, and rights of all parties to the document.

IT IS THEREFORE ORDERED that:

1. LG&E and KU are granted a Certificate of Public Convenience and Necessity and a Certificate of Environmental Compatibility for the acquisition of the two 164 MW CTs from Capital Corp.

2. The cost of the turbines to be transferred from Capital Corp. to LG&E and KU shall be determined in accordance with the capitalization rules of the USoA.

3. LG&E and KU shall explain in detail how the fair market value of the turbines to be transferred is determined. The determination of the fair market value shall not include any turbine component already included in KU s accounting records. If an independent, third-party appraisal is not utilized, LG&E and KU shall also explain why such an appraisal was not possible.

4. Within 30 days of the date of the transfer of the turbines, LG&E and KU shall file the determination of the cost and fair market value of the turbines.

5. Within 30 days of the date of the transfer of the turbines, all accounting entries made to the books of LG&E and KU to record the transfer and allocation of the turbines shall be filed. In addition, LG&E and KU shall file an explanation of how turbine components already recorded on KU s books have been allocated to LG&E.



6. In the event LG&E or KU enters into a project with another LG&E Energy affiliate in the future, similar to the turbine project, LG&E or KU shall execute a service agreement or some other governing document that is based on the Corporate Guidelines and that outlines the responsibilities, obligations, and rights of the parties.

Done at Frankfort, Kentucky, this 23<sup>rd</sup> day of July, 1999.

By the Commission

ATTEST:

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Executive Director