

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 TO) CASE NO. 99-413
EXECUTE A CROSS-BORDER LEASE OF TWO)
164 MEGAWATT COMBUSTION TURBINES)

O R D E R

On October 1, 1999, Louisville Gas and Electric Company (LG&E) and Kentucky Utilities Company (KU) filed a joint application seeking authority to execute a lease of two 164 megawatt combustion turbines (CTs) pursuant to a sale and leaseback transaction. The Joint Applicants requested that this authority be contingent upon receiving a favorable Kentucky sales and use tax determination from the Kentucky Revenue Cabinet (Revenue Cabinet). LG&E and KU also requested expedited Commission action to provide sufficient time for the transaction to be negotiated and consummated by the end of the year. LG&E and KU subsequently filed an amended joint application to reflect certain changes to the transaction.

The Kentucky Industrial Utility Customers, Inc. (KIUC) was granted intervention in this proceeding. An informal conference was held at the Commission s offices on October 18, 1999 to provide additional explanations about the proposed transaction.

The two CTs are located at KU s E. W. Brown Generating Station in Mercer County, Kentucky. The Commission granted LG&E and KU a Certificate of Public Convenience and Necessity and a Certificate of Environmental Compatibility to acquire

the two CTs from LG&E Capital Corp. in Case No. 99-056.¹ The two CTs became commercially operational on August 8 and 11, 1999. On October 5, 1999, LG&E and KU filed required accounting entries showing that 62 percent of the total book cost of the CTs was allocated to KU and 38 percent to LG&E.

LG&E and KU stated in the application that the sole purpose of the proposed transaction is to share in tax benefits available under the laws of certain European countries. The transaction was not to issue any securities or evidences of indebtedness or to raise capital for, or finance the acquisition of, the CTs. Under the tax laws of Sweden, Finland, Germany, or Switzerland, tax incentives relating to certain equipment constructed in those countries are available to investors in those countries. The two CTs were acquired from Asea Brown Boveri, and are eligible equipment under those countries tax laws. The proposed sale and leaseback transaction involves only the tax incentives relating to the two CTs, which is an intangible asset. The physical, tangible assets represented by the CTs are not being sold. LG&E and KU will be financing the acquisition and will be responsible for all operating and maintenance expenses.

The proposed transaction will involve four entities: LG&E and KU, the lessees; a Swedish, Finnish, German, or Swiss investor, the lessor; a lending bank to the lessor; and an affiliated bank of the lending bank, known as the defeasance bank. The proposed transaction involves the following steps, which will occur either simultaneously or in immediate succession. LG&E and KU will transfer the legal title to the intangible

¹ Case No. 99-056, The Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity for the Acquisition of Two 164 Megawatt Combustion Turbines, final Order issued July 23, 1999.

asset to the foreign investor at a transaction price that will be no less than \$125 million. The investor will fund the transaction price with a mix of its own equity and funds borrowed from the lending bank.² LG&E and KU will then lease the intangible asset back from the lessor for a term of approximately 10 to 18 years.

The lease will contain an option for the return of the intangible asset to LG&E and KU at the end of the lease term, and this option will be immediately exercised upon the inception of the lease. LG&E and KU will deposit with the defeasance bank a sum representing the basic rent payments and an option price under the lease terms, which is approximately 95 percent of the transaction price. The defeasance bank will then be responsible for making the scheduled lease payments to the lending bank. LG&E and KU will have no further payment obligations under the lease. In the event of an early termination of the lease,³ all contingent liabilities are to be assumed by LG&E Energy Corp.⁴

LG&E and KU expect to receive an up-front payment between 3.5 percent and 5.0 percent of the transaction price, or approximately \$4 million to \$7 million. In consideration for the assumption of the contingent liabilities under the lease, LG&E and

² Based on the respective tax laws, LG&E and KU indicated that a Swedish or Finnish investor would fund the transaction price with 5 percent equity and 95 percent borrowed funds. For a German or Swiss investor, the funding mix would be 20 percent equity and 80 percent borrowed funds.

³ Early termination could be due to a lessee's event of default, a lessee general termination, default by the lending or defeasance banks, or a change in tax law.

⁴ The amount of exposure assumed by LG&E Energy decreases over the life of the lease.

KU will pay LG&E Energy Corp. a total fee equal to 0.21 percent of the present value of the assumed obligations at the time of the lease inception. This amount is estimated to be approximately \$300,000. In order to execute the lease and engage in the proposed transaction, LG&E and KU will incur expenses of no more than 1.5 percent of the transaction price. Based on a transaction price of \$125 million, the maximum amount of associated expenses would be \$1,875,000.

Because the proposed transaction involves only the tax law-related intangible asset, LG&E and KU stressed that the sale and leaseback will in no way impact their ownership and utilization of the CTs. LG&E and KU will be responsible for the financing of the CTs and the maintenance and operating expenses. Under United States tax law, LG&E and KU will maintain tax ownership of the CTs, will continue to depreciate the CTs on their respective books, and will retain full operational and residual control of the CTs.

LG&E and KU are seeking a written determination from the Revenue Cabinet concerning the Kentucky sales and use tax treatment of the transaction. LG&E and KU indicated at the informal conference that an unfavorable determination from the Revenue Cabinet would probably terminate any further consideration by LG&E and KU of the transaction, as an unfavorable ruling would make the proposed transaction uneconomical.

LG&E and KU stated in their amended application that they were not requesting a determination by the Commission as to the rate-making treatment of the net benefit expected from the proposed transaction. During the informal conference, LG&E and KU provided the accounting entry they proposed to make to record the receipt of this net

benefit. The entry would debit cash and credit Account No. 421 Miscellaneous Nonoperating Income. On October 28, 1999, KIUC filed an objection to the proposed accounting entry, contending that recording the net benefit as below the line income might not preserve the Commission's authority over the gain for rate-making purposes. KIUC proposed that the net benefit be credited to Account No. 254 Other Regulatory Liabilities, and that it be amortized over the life of the CTs as a reduction to depreciation expense.

On October 29, 1999, LG&E and KU replied to KIUC's concerns, contending that KIUC misunderstood the companies' position. LG&E and KU argue that the proposed accounting treatment will not impair the Commission's authority over the net benefit for base rate-making purposes. LG&E and KU further argued that if and when the companies seek recovery of the cost of the CTs through customer rates, the Commission could determine whether customers should share in some ratable portion of the net benefit. Finally, LG&E and KU stated that the creation of a regulatory liability prejudices the rate-making treatment, and that KIUC's alternative request to amortize the net benefit over the life of the CTs as a reduction to depreciation expense was a determination of the rate-making treatment.

The Commission has reviewed the Uniform System of Accounts and finds that the proper accounting treatment for the net benefit from the proposed transaction is not clearly defined. As the net benefit is associated with utility plant in service, it does not appear to be appropriate to record the net benefit as Nonoperating Income. However, the use of Other Regulatory Liabilities does not appear proper, as these items result

from rate actions of regulatory agencies.⁵ LG&E and KU have specifically stated they are not seeking a final rate-making determination for the net benefit at this time. Therefore, given the circumstances of the proposed transaction and the need for an expedited decision, the Commission finds that the net benefits realized from the proposed transaction should be recorded as a credit to Account No. 253 Other Deferred Credits.⁶ The disposition of this deferred credit will be determined in an appropriate future rate-making proceeding.

The proposed transaction is the first of its kind to be presented to the Commission. Based on the description of the proposed transaction, there does appear to be some benefit to LG&E and KU, even after the costs to achieve the transaction have been considered. As the transaction involves an intangible asset resulting from foreign tax incentives, it appears that the physical CT assets will continue to be available for the use of LG&E and KU to meet the electricity needs of their customers. Since LG&E Energy Corp. is assuming all contingency liabilities under the transaction, LG&E and KU will not incur any additional exposure under the proposed transaction.

⁵ 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. 18 CFR Part 1, Section 101, Definition 30.

⁶ Account No. 253 Other Deferred Credits. This account shall include advance billings and receipts and other deferred credit items, not provided for elsewhere, including amounts which cannot be entirely cleared or disposed of until additional information has been received. 18 CFR Part 1, Section 101, Balance Sheet Accounts.

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that LG&E and KU should be authorized to proceed with the proposed transaction.

IT IS THEREFORE ORDERED that:

1. LG&E and KU are authorized to execute a lease of two 164 megawatt CTs at KU s E. W. Brown Generating Station in Mercer County, Kentucky, pursuant to a sale and leaseback transaction as described in the amended joint application.

2. LG&E and KU shall agree only to such terms, conditions, and prices that are consistent with said parameters as set out in their amended joint application.

3. LG&E and KU shall file with the Commission copies of the Revenue Cabinet determination concerning Kentucky sales and use taxes within 10 days of its receipt. If the Revenue Cabinet determination causes LG&E and KU to abandon the proposed transaction, notice of that decision should be included with the filing.

4. LG&E and KU shall, within 30 days of the completion of the sale and leaseback transaction, file two copies of all transaction documentation with the Commission. In addition, LG&E and KU shall include an executive summary of the terms and conditions of the finalized transaction.

5. LG&E and KU shall, in the first monthly financial report filed with the Commission after the booking of the benefits from the sale and leaseback transaction, include notes to their respective financial statements explaining the determination of the benefits recognized from the transaction. This shall include the disclosure of the final transaction price, the gross up-front benefit amount received by LG&E and KU, the amount of the contingency fee payment to LG&E Energy Corp., the total expenses to

achieve the transaction, and an explanation of how the benefits were allocated between LG&E and KU.

6. LG&E and KU shall credit their respective portions of the net benefits realized from the transaction to Account No. 253 Other Deferred Credits.

Done at Frankfort, Kentucky, this 2nd day of November, 1999.

By the Commission

ATTEST:

Executive Director