

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF THE UNION LIGHT, HEAT)	
AND POWER COMPANY FOR A CERTIFICATE OF)	
PUBLIC CONVENIENCE TO ACQUIRE CERTAIN)	
GENERATION RESOURCES AND RELATED)	CASE NO.
PROPERTY; FOR APPROVAL OF CERTAIN)	2003-00252
PURCHASE POWER AGREEMENTS; FOR)	
APPROVAL OF CERTAIN ACCOUNTING TREATMENT;)	
AND FOR APPROVAL OF DEVIATION FROM)	
REQUIREMENTS OF KRS 278.2207 AND 278.2213(6))	

O R D E R

On July 21, 2003, The Union Light, Heat and Power Company ("ULH&P") applied for a certificate of public convenience to acquire 1,105 megawatts ("Mw") of generating capacity from its parent company, The Cincinnati Gas and Electric Company ("CG&E"), and approval of: (1) certain purchase power agreements with CG&E; (2) certain accounting and rate-making treatments related to the proposed acquisition; and (3) requests to deviate from certain statutory requirements related to affiliate transactions.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), is the only intervenor in this proceeding. A public hearing was held on October 29 and 30, 2003. The Commission issued an Interim Order granting preliminary approval to ULH&P's proposal, subject to certain conditions, on December 5, 2003.

In addition to the Commission's approval of the proposed transaction, ULH&P is required to obtain various approvals from the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC") before consummating

the transaction. Subsequent to receipt of our preliminary approval of the transaction, ULH&P sought the requisite FERC and SEC approvals. It has received the necessary FERC approvals and anticipates a decision on its SEC application in the near future.

Informal conferences attended by representatives of ULH&P, the AG, and the Commission Staff were held on January 11 and March 24, 2005 to discuss the status of the FERC and SEC proceedings and modifications to the proposed transaction that had occurred since the issuance of our Interim Order in this proceeding. On March 21 and 29, 2005, respectively, ULH&P submitted a compliance filing and supplemental compliance filing which detailed the proposed modifications. On May 10, 2005, ULH&P submitted an application for deviation from various Commission rules related to affiliate transactions, and on May 20, 2005 it submitted attachments which had inadvertently been omitted from the application for deviation.

BACKGROUND

ULH&P's proposal entails it acquiring CG&E's 69 percent share of East Bend No. 2,¹ a 648 Mw base load, coal-fired generating unit located in Rabbit Hash, Kentucky; Miami Fort No. 6, a 168 Mw intermediate load, coal-fired generating unit located in North Bend, Ohio; and the Woodsdale Generating Station, a 490 Mw facility consisting of 6 peak load, gas or propane-fired generating units located in Trenton, Ohio.

With its March 21, 2005 compliance filing and May 10, 2005 application for deviation, ULH&P seeks final approval of its acquisition of the CG&E generating units. ULH&P states that the factors that caused the proposed transfer to be in the public

¹ The Dayton Power and Light Company owns the other 31 percent.

interest in 2003 are unchanged and that its acquisition of the CG&E generation assets continues to be in the public interest.

ULH&P also requests a waiver from the provisions contained in our Interim Order which require that it file final versions of the Back-up Power Supply Agreement with CG&E envisioned under the transfer and the amended or new coal and lime supply contracts for the East Bend and Miami Fort units in order to receive final Commission approval of the transfer. These waiver requests stem from ULH&P's decision to put its back-up power supply needs out for bid to address FERC's concerns about affiliate transactions and from changing conditions in the eastern United States coal industry that have contributed to delays in finalizing new coal supply agreements.

In addition, ULH&P requests approval for deviations from the affiliate transaction requirements of KRS 278.2207(1)(b) and 278.2213(6)² in order to: (1) engage in coal and lime supply transactions with CG&E until new coal and lime contracts are executed; (2) enter into an agreement for CG&E to operate, on ULH&P's behalf, the Miami Fort 6 unit and; (3) enter into an agreement for CG&E to provide gas and propane services to ULH&P at the Woodsdale Station. The deviation to engage in coal and lime supply transactions relates to the delays previously referenced concerning the execution of new coal contracts. The deviation for the Miami Fort 6 operation agreement stems from ULH&P's decision that CG&E should continue as the operator of the unit in order to retain the unit's existing Ohio environmental permits rather than ULH&P seeking to

² KRS 278.2207(1)(b) requires all services and products provided to a utility by an affiliate to be priced at the affiliate's fully distributed cost, but in no event greater than market. KRS 278.2213(6) requires all dealings between a utility and a non-regulated affiliate to be at arm's length. The Commission is authorized to grant deviations from these requirements if requisite findings are reached.

obtain new permits for the unit. The deviation for gas and propane services at the Woodsdale Station results from a decision to retain the benefits of CG&E's Gas Operations Department continuing to provide operation and maintenance services to certain natural gas and propane facilities at the Woodsdale Station.

A final matter to be addressed in this proceeding is the timing of ULH&P's next Integrated Resource Plan ("IRP"). In response to concerns raised by the AG in this case, ULH&P filed an IRP in 2004 which was docketed in Case No. 2004-00014.³ The final Order in that case stated:

While we are approving the IRP filed in this proceeding, we are not deciding when ULH&P's next IRP shall be filed. Due to the significance of the proposed CG&E to ULH&P generation asset transfer, we will defer a decision on the timing of ULH&P's next IRP until that matter is resolved in Case No. 2003-00252.

We note that the demand forecasts submitted by ULH&P in this case and in Case No. 2004-00014 reflect that, beyond the proposed acquisition of generating capacity from CG&E, no need for additional generating capacity is anticipated until 2011 – 2012. The Commission is also cognizant of ULH&P's previous interest in being able to efficiently coordinate its IRP filings with those of its affiliates operating in other jurisdictions. For these reasons, there does not appear to be an urgency in the filing of ULH&P's next IRP; however, we find that we should begin addressing the timing of such a filing.

³ Case No. 2004-00014, The Union Light, Heat and Power Company's Integrated Resource Plan, Order dated January 14, 2005.

DISCUSSION

As ULH&P and CG&E worked through numerous agreements and conditions related to the proposed transfer over the past 18 months, various aspects of the terms of the transaction have been modified. Although none of the modifications appear to be cause for concern or require the Commission to alter its preliminary decision to approve the transfer, there are a number of issues that must be addressed at this time.

Back-up Power Supply Agreement

Initially, ULH&P and CG&E proposed an agreement under which CG&E would provide the back-up power supply to meet ULH&P's needs. However, to mitigate concerns that FERC might have about less than-arms-length affiliate operating and pricing arrangements, ULH&P chose to bid out its back-up power supply needs. With ULH&P's rates frozen through 2006 and with it having the ability to take power from CG&E under the proposed Purchase, Sale and Operation Agreement, we find there is little expectation that the lack of a back-up power supply agreement on a short-term basis will negatively affect ULH&P ratepayers.

Since CG&E will continue to honor the terms it initially offered, all parties can be assured that the terms under which ULH&P ultimately receives back-up power supply services will be the same as or more favorable than the CG&E terms which received preliminary approval in our December 5, 2003 Interim Order. However, it is important for the Commission to remain apprised of this matter. Accordingly, ULH&P will be required to report to the Commission quarterly on the status of its selection of a source for back-up power supply services starting 3 months from the date of this Order. When

it is executed, ULH&P will also be required to file the final back-up power supply contract for Commission approval.

Coal and Lime Supply Agreements

Originally, it was intended that the existing CG&E contracts, which supply the East Bend and Miami Fort units, would be assigned to ULH&P. However, as coal market conditions have evolved, CG&E and ULH&P began looking into system-wide, or “global” contracts, which could achieve economies of scale, permit coal shipments to be diverted to different generating stations, and allow CG&E and ULH&P to engage in coal sales and purchase transactions with each other. Until such time as a decision can be made on such contract, ULH&P requests that it be granted a deviation that would permit it to engage in coal and lime supply and transportation transactions for its plants with CG&E at fully distributed cost. ULH&P states that CG&E will continue to supply ULH&P coal and lime from the same contracts that serve the plants today. ULH&P states that continuing to be supplied under CG&E’s current contracts allows it to take advantage of being part of a larger system and relieves it of the administrative burden of negotiating separate contracts during this interim decision period.

Given that ULH&P’s rates, including its fuel costs, are frozen through 2006, we find the delay in entering into a new contract and in filing same with the Commission prior to approval of the asset transfer poses little risk to customers. In addition, any risk is further minimized since the Commission will continue to have the final approval authority over the contracts that are ultimately executed by ULH&P. We also find that ULH&P has met its burden under KRS 278.2207(2) and KRS 278.2219 and that the requested deviation from KRS 278.2207(1)(b) and KRS 278.2213(6) for the coal and

lime transactions should be granted. However, as previously stated, we find that ULH&P should make quarterly filings on the status of the coal and lime supply agreements beginning 3 months from the date of this Order.

Deviation for CG&E's Operation of Miami Fort 6

ULH&P indicates that environmental permits are granted either to the owner or operator of a coal-fired generating unit in the state of Ohio. Having CG&E continue as the operator of Miami Fort 6, even though it will no longer own the unit, allows the existing environmental permits to remain in effect and avoids the risks attendant to the permitting process, which would be required if ULH&P were to be both owner and operator. In addition, ULH&P explains that Miami Fort 6 shares various plant and equipment with Miami Fort 5, including the exhaust stack containing the required continuous emission monitoring system ("CEMS"). It states that obtaining separate air permits for two generating units sharing a common stack might potentially trigger additional requirements as drastic as relocation of existing CEMS equipment, which would require additional expense and provide no additional value. It argues that even if it is not required to relocate the CEMS, additional administrative burdens and expenses would be incurred without additional benefits. ULH&P proposes to enter into an operation agreement with CG&E wherein ULH&P would reimburse CG&E the total costs incurred to operate Miami Fort 6 and requests that the Commission grant it the necessary deviations. Under the circumstances outlined by ULH&P, we find that the proposed at cost pricing is reasonable, that compliance with the arms-length transaction requirement would be impracticable, and that ULH&P should be granted the deviations requested and permitted to enter into the proposed operation agreement.

Deviation for CG&E to Provide Operation and Maintenance Services at Woodsdale

ULH&P proposes to enter into a Gas and Propane Services Agreement with CG&E wherein CG&E would agree to provide operation and maintenance services at Woodsdale to ULH&P at CG&E's fully distributed costs. ULH&P requests that the Commission grant it the necessary deviations that would allow it to enter into this agreement.

CG&E has the personnel and expertise to provide gas and propane operation and maintenance services, plus it has experience with the Woodsdale Station, having been the sole provider of these services since Woodsdale went into operation in the early 1990s. Furthermore, Woodsdale's southern Ohio location, in close proximity to CG&E's gas distribution facilities, makes it more economical and cost-effective for ULH&P to avail itself of such an arrangement rather than incur the additional travel expenses necessary to have its gas operations personnel perform these services. Given CG&E's experience and knowledge of the Woodsdale Station, we find that the pricing arrangement for this proposed transaction is reasonable and that it would be impracticable for ULH&P to comply with KRS 278.2213(6). Therefore, we find that the deviations requested should be approved and that ULH&P should be permitted to enter into the Gas and Propane Services Agreement.

The Timing of ULH&P's Next IRP

As previously stated, we find that the timing of ULH&P's next IRP is an issue that must be reviewed. However, given the reserve margin that ULH&P will have after the acquisition and its forecast of when it will need additional capacity, the Commission finds that a new IRP may not be required until the 2008–2010 time period. We also find

that input on this issue from both ULH&P and the AG should be considered before a final decision is reached. Therefore, we will require that ULH&P file, in a separate action, within 3 months of the date of this Order, a proposal along with supporting documentation, stating when it proposes to file its next IRP. In addition, the AG will be permitted to file written comments on the proposed IRP filing schedule within 30 days of the filing of ULH&P's proposal.

SEC Approval Issues

The Commission takes note that the Public Utilities Commission of Ohio recently filed a letter with the SEC which supports the statement of CG&E that the transfer will not have a material affect on retail market rates because it does not affect the regional market for electricity. We believe that ULH&P's assessment of the SEC's action on the transfer request is accurate and that the SEC will rule upon the request in the near future. However, since that decision is still pending, we will require that ULH&P include a status update on the SEC proceeding in its IRP compliance filing and require that it file the SEC decision document with the Commission within 10 days of the SEC's decision on the transfer.

Other Filing Requirements

In a transaction of this magnitude, there are several matters of a "housekeeping" nature which the Commission believes must be addressed within this docket. These matters concern: (1) the documents executed as part of closing on the asset transfer transaction; (2) the accounting entries made by ULH&P to reflect the transaction; and (3) the breakdown of how ULH&P finances its acquisition of the CG&E generation assets. To address the first of these matters we will require ULH&P to file one complete

set of the final executed transaction documents in the record of this case. To address the second and third items we will require ULH&P to file the accounting entries made to reflect the generation asset transfer in its books and records along with explanations for how the amounts included in the entries were determined. These entries should reflect the decisions contained in our December 5, 2003 Interim Order concerning the “below the line” treatment of Accumulated Deferred Income Tax Credits and deferred income tax balances related to the transferred generating assets. The explanations for the accounting entries should also identify specific components of ULH&P’s financing of the acquisition including, but not limited to, new debt issued, assumption of existing CG&E debt, and common equity issued.

SUMMARY

The Commission, having considered the evidence of record and being otherwise sufficiently advised, finds that:

1. The proposed transfer of 1,105 Mw of generation assets from CG&E to ULH&P is in the public interest and should be approved.
2. ULH&P’s request to deviate from the requirement in our December 5, 2003 Interim Order that it file final versions of its back-up power supply agreement and coal and lime supply contracts prior to obtaining final Commission approval of the transaction is reasonable and should be approved.
3. ULH&P’s request for deviations from the provisions of KRS 278.2207(1)(b) and KRS 278.2213(6) should be granted as discussed herein.

4. The date for filing ULH&P's next IRP should be established in a separate proceeding and ULH&P and the AG should follow the process specified in Ordering Paragraph 5 of this Order.

5. ULH&P should update the Commission on the status of the SEC's review of the proposed transaction in accordance with the process specified in Ordering Paragraph 5 of this Order.

IT IS THEREFORE ORDERED that:

1. The proposed acquisition of generating facilities by ULH&P, as described in its October 29, 2003 amended application, as further modified in its March 21, 2005 compliance filing and May 10, 2005 application for deviation, is approved.

2. ULH&P's request to deviate from the requirement in our December 5, 2003 Interim Order that it file final versions of its back-up power supply agreement and coal and lime supply contracts prior to obtaining final Commission approval of the transaction is granted.

3. ULH&P shall file quarterly reports to keep the Commission apprised on the status of its efforts to enter into and consummate the final agreements and contracts envisioned as part of its acquisition of the generating facilities in question. The first of these reports shall be filed 90 days from the date of this Order with subsequent reports due every 90 days thereafter.

4. ULH&P's request for deviations from KRS 278.2207(1)(b) and KRS 278.2213(6) is granted for the transactions proposed herein.

5. Within 90 days from the date of this Order, ULH&P shall file, in a separate proceeding, a proposed date for the filing of its next IRP along with any

explanation it believes is appropriate to support its proposal. The AG is invited, but not required, to file comments on ULH&P's proposal within 30 days from the date of its filing.

6. Within 90 days from the date of this Order, ULH&P shall file a status update on the SEC's review of the proposed asset transfer transaction. It shall file the SEC decisions on the proposed transfer with the Commission within 10 days after its issuance by the SEC.

7. Except as modified herein, all other findings and orders contained in our December 5, 2003 Interim Order are incorporated herein and shall remain in full force and effect.

Done at Frankfort, Kentucky, this 17th day of June, 2005.

By the Commission

ATTEST:



Executive Director