COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF KENTUCKY UTILITIES COMPANY FOR AN ORDER AUTHORIZING THE ISSUANCE OF SECURITIES AND ASSUMPTION OF OBLIGATIONS	))))	CASE NO. 2019-00242

ORDER

On July 15, 2019, Kentucky Utilities Company (KU) filed an application for authority to incur debt in the form of First Mortgage Bonds in a principal amount not to exceed $500 million; and authority to enter into interest rate hedging agreements in connection with the issuance of the First Mortgage Bonds. KU responded to one request for information on August 28, 2019. No requests for intervention were made in this matter, and no public comments were received. The case now stands submitted for a decision based on the evidentiary record.

BACKGROUND

First Mortgage Bond Debt

KU requested authorization from the Commission to incur additional long-term debt in the form of First Mortgage Bonds in a principal amount not to exceed $500 million for the purpose of refunding and replacing $500 million of existing Series B First Mortgage Bonds. KU expects the issuance of the First Mortgage Bonds to be sold at various times through 2019 and into 2020 in one or more underwritten public offerings, negotiated sales, or private placement transactions utilizing the proper documentation. The price, maturity date(s), interest rate(s), redemption provisions and other applicable terms, including whether the bonds have a fixed or variable interest rate, would be determined by negotiations among KU and the underwriters, agents, or other purchasers of the First Mortgage Bonds.

KU would issue the First Mortgage Bonds under its Mortgage Indenture. KU's Mortgage Indenture and amendments thereto (Mortgage Indenture) authorize it to issue from time to time, First Mortgage Bonds of one or more series, with each series having such date, maturity date(s), interest rate(s), and other terms as may be established by a supplemental indenture executed by KU. All First Mortgage Bonds issued under the Indenture would be secured equally and ratably by a first mortgage lien, subject to permitted encumbrances and exclusions, on substantially all of KU's permanently fixed properties in Kentucky.

KU noted that interest rates and associated issuance costs are dictated by market conditions, which are fluid. However, as of August 13, 2019, KU stated that the indicated rate on a 10-year, fixed-rate First Mortgage Bond was 2.507 percent and that the indicated rate on a 30-year, fixed-rate First Mortgage Bond was 3.268 percent.[1] KU further stated that as of August 13, 2019, a five-year variable-rate First Mortgage Bond would have an initial interest rate of 2.918 percent, consisting of the current three-month LIBOR rate of 2.168 percent plus a risk premium of 75 basis points.[2] Further, based on experience with past issuances, KU estimated the amount of compensation to be paid to underwriters and agents for their services would not exceed 1 percent, or approximately $500,000.[3]

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[1] KU's Responses to Commission Staff's First Request for Information (Response to Staff's First Request), Item 11.

[2] *Id.*

[3] Application, paragraph 8.

KU indicated that the requested financing is needed to refund and replace the existing $500 million of Series B First Mortgage Bonds.[4] Specifically, as of May 31, 2019, KU stated that the Series B First Mortgage Bonds had an outstanding principal of $500 million with a maturity date of November 1, 2020.[5]

KU stated that the issuance of the First Mortgage Bonds would not affect its equity position or credit rating because "[t]he issuance of First Mortgage Bonds, for which approval is sought, is a replacement of maturing First Mortgage Bonds and therefore would have no impact on KY's equity position."[6] However, KU asserted that an order denying its request would significantly reduce its liquidity, given its current short-term obligations and restrictions on the amount of short-term debt it can incur. KU stated that this reduction in liquidity, in turn, would require it to request equity contributions from its parent company, thereby substituting higher-cost equity for debt, which would drive up customer rates.[7] KU also argued that a denial and the resulting reduction in its liquidity would "almost certainly result in the credit rating downgrade, thereby increasing costs to customers."[8]

<u>Interest Rate Hedging Agreements</u>

KU requested authority from the Commission to enter into interest rate hedging agreements "[i]n connection with the issuance of the First Mortgage Bonds."[9] KU

[4] *Id.* page 1.

[5] *Id.* Exhibit 2 at page 2.

[6] Response to Staff's Requests, Item 9 and 12.

[7] Response to Staff's Requests, Item 14.

[8] *Id.*

[9] Application at paragraph 10.

explained that by requesting authority to enter into such agreements "in connection with the issuance" of the bonds, that it was indicating that any such hedging agreements would be directly associated with the bonds for which authorization is being sought.[10] KU stated that it is not seeking authority to enter into any such agreements that are speculative in nature or related to any other transaction.[11] Further, KU indicated that it is seeking authority to enter into interest rate hedging agreements up to the entire amount of the bonds issued.[12]

KU stated that it was requesting authority to enter into three types of interest rate hedging agreements—forward starting fixed payer interest rate swaps, treasury locks, and floating ratepayer interest rate swaps.[13] KU asserted that: (1) forward starting fixed payer interest rate swaps would allow it to hedge against increases in interest rates, including the credit spread, from the time it enters into the agreement to the time the bonds are issued; (2) treasury locks would permit KU to hedge against increases in treasury rates from the time it enters into the agreement to the time the bonds are issued, but would not provide a hedge against changes in the credit spread; and (3) floating ratepayer interest rate swaps, which would be an agreement by KU to swap a fixed interest rate for a variable interest rate, would reduce volatility of the value of the fixed-rate bond as the change in the value of the swap should virtually offset a change in the value of the bond.[14]

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[10] Response to Staff's, Item 3.

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

To mitigate counterparty risks associated with interest rate hedging agreements, KU indicated that it would only enter into a hedging agreement with PPL Corp. (PPL) or a bank. Importantly, if it entered into a hedging agreement with PPL, PPL would enter into the hedging agreement with a bank and would enter into a mirror agreement with KU. PPL would not charge KU any fee for this service. Further, regardless of whether KU entered into a hedging agreement through PPL or directly with a bank, KU indicated that the bank would be rated at or above A3 as defined by Moody's Investor Services or A- as defined by Standard and Poor's at the time the transaction is booked, which KU contended would guard against counterparty risk.[15]

KU estimated that the cost to lock in ten-year rates for twelve months would be approximately four basis points. Similarly, KU estimated that the cost to fix the interest rate of a variable rate bond for three years would be approximately 84 basis points. However, KU noted that those estimates in the cost of the hedging agreements were based on market conditions at the time it made its application and that costs could change based on changes in the market.[16]

Moreover, KU indicated that the overall benefits and costs of its use of interest rate hedging agreements would not be known until those agreements reach maturity.[17] KU is requesting to establish regulatory assets or liabilities to account for the losses or gains arising from the interest rate hedging agreements and to amortize those losses or gains

[15] Response to Staff's Request, Item 3; *see also* Response to Staff's Request, Item 8 (indicating key risks associated with hedging agreements identified by KU and how KU claimed it would guard against them).

[16] Application at paragraph 11.

[17] Response to Staff's Request, Item 6 (discussing the costs and benefits of proposed hedging agreements).

over the remaining life of the First Mortgage Bonds.[18] KU stated that "[t]he hedging could result in higher costs or lower costs depending upon the movement of interest rates."[19] However, KU noted that its cost of debt has remained among the lowest in its utility peer group for over a decade, which it argued demonstrates its prudent use of hedging agreements previously authorized by the Commission.[20]

DISCUSSION

Having considered the evidence of the record and being otherwise sufficiently advised, the Commission finds that the issuance of the First Mortgage Bonds in a principal amount not to exceed $500 million; and the use of interest rate hedging agreements and corresponding regulatory assets and liabilities as set out in KU's application, are for lawful objects within the corporate purposes of KU's utility operations, are necessary and appropriate for and consistent with the proper performance of KU's service to the public and will not impair KU's ability to perform that service, are reasonably necessary and appropriate for such purposes, and should therefore be approved. However, the Commission notes that its approval herein is based upon statements made by KU in its application and its responses to Commission Staff's First Request for Information. Thus, the Commission notes that its approval is conditioned on KU acting in a manner consistent with representations made in this matter, including those discussed below.

Most importantly, KU indicated that if it entered into any interest rate hedging agreement with an affiliate that the affiliate would be PPL, and that PPL would enter into

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[18] Application at paragraph 10.

[19] Response to Staff's Request, Item 6(b).

[20] Response to Staff's Request, Item 7.

a hedging agreement with a bank and then enter into a "mirror transaction" with KU. If there was no mirror transaction between PPL and the bank, then a perverse incentive would arise, because losses to KU would be recovered through a regulatory asset with the corresponding gain going to PPL, whereas losses to PPL would result in a benefit to KU that would be passed along to ratepayers through a corresponding regulatory liability. Along the same lines, KU indicated that PPL would not charge KU a fee to act as an intermediary in entering into a transaction with a bank and a mirror transaction with KU. Thus, the Commission notes any interest rate hedging agreement with PPL must be based on a specific mirror transaction with a bank, and that KU may not agree to pay a fee charged by PPL for acting as an intermediary between the bank and KU.

The Commission also notes that KU stated that its company policy requires that the counterparty to any interest rate hedging agreement be rated at or above A3 as defined by Moody's Investor Services or A- as defined by Standard and Poor's at the time transaction is booked. The Commission understands this statement to mean that KU would not enter into an interest rate hedging agreement with a bank directly or through PPL unless the bank met those standards. Thus, the Commission notes that KU's authority to enter into interest rate hedging agreements granted herein is subject to that condition regarding the credit rating of the counterparty regardless of any subsequent change in company policy.

IT IS THEREFORE ORDERED that:

1. KU is authorized to issue long-term debt in the form of First Mortgage Bonds in a principal amount not to exceed $500 million, from the date this Order is entered through December 31, 2020.

2. KU is authorized to enter into the interest rate hedging agreements for which approval was sought herein in connection with its issuance of the First Mortgage Bonds.

3. KU is authorized to establish regulatory assets or liabilities to account for the losses and gains arising from its use of the interest rate hedging agreements approved herein and to amortize the losses and gains over the remaining life of the First Mortgage Bonds as described in the application.

4. The proceeds from the transactions authorized herein shall be used only for the lawful purposes set out in the application.

5. KU shall, within 30 days from the date of issuance, file with the Commission a statement setting forth the date or dates of issuance of the debt authorized herein, the date of maturity, the price paid, the proceeds of such issuances, the interest rate, costs or gains from the use of hedging agreements, and all fees and expenses, including underwriting discounts or commissions or other compensation, involved in the issuance and distribution. KU shall also file documentation showing the quotes that it relied upon to determine the lowest interest rate.

6. KU shall agree only to such terms and prices that are consistent with the parameters set out in its application.

7. Any documents filed pursuant to ordering paragraph 5 of this Order shall reference the number of this case and shall be retained in the post-case correspondence file.

8. Nothing contained herein shall be construed as a finding of value for any purpose or as a warranty on the part of the Commonwealth of Kentucky or any agency thereof as to the debt authorized herein.

9. This case is closed and removed from the Commission's docket.

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By the Commission

ENTERED

SEP 11 2019

KENTUCKY PUBLIC
SERVICE COMMISSION

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