COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE APPLICATION OF THE FUEL ADJUSTMENT CLAUSE OF KENTUCKY UTILITIES COMPANY FROM NOVEMBER 1, 1990 TO OCTOBER 31, 1992	)))))	CASE NO. 92-493

O R D E R

This case involves the review of the operation of the fuel adjustment clause ("FAC") of Kentucky Utilities Company ("KU") for the two-year period ending October 31, 1992. It poses the following issues: (1) Should the revenue which KU realized from the lease of railcars used to transport coal from the Coal Ridge Mine be used to offset KU's cost to buy out its coal supply contract with Coal Ridge Fuel, Inc.? (2) Are KU ratepayers, who incurred the depreciation expense for these railcars through KU's FAC charges, entitled to any gain realized from the sale of the cars? Finding in the affirmative on both issues, the Commission orders KU to reduce its fuel cost by $3,511,987 when calculating its next monthly fuel adjustment charge.

PROCEDURAL HISTORY

On December 4, 1992, the Commission, pursuant to Administrative Regulation 807 KAR 5:056, Section 1(12), initiated a review of the operation of KU's FAC for the two year period ending October 31, 1992. As part of its review, the Commission ordered KU to submit certain information concerning its FAC, its fuel usage and the operation of its fuel adjustment clause. The Commission held a public hearing in this matter on February 18, 1993.

On April 5, 1993, the Commission issued an interim order in this proceeding in which it established a new base fuel charge for KU. It ordered that this docket remain open pending completion of proceedings before the Federal Energy Regulatory Commission ("FERC") which involved KU's depreciation practices for 126 railcars used to transport coal from a Hoyt, Kentucky mine to KU's Ghent Generating Station.[1] The Commission subsequently ordered KU to file in this docket all documents which were filed in the FERC proceeding.[2]

Dissatisfied with the slow pace of the FERC proceedings,[3] the Commission on August 5, 1994, in Case No. 92-493-C[4] ordered KU, inter alia, to show cause why it should not be required to charge off and amortize, by means of a temporary decrease in rates, the revenues which it received from the rental and sale of the 126 railcars previously used to transport coal from the Hoyt, Kentucky mine to KU's Ghent

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1 Kentucky Utilities Co., FERC Docket No. FA91-65-000.

2 Order of May 3, 1993 at 6.

3 After discovery and the filing of written testimony, FERC held a hearing in FERC Docket No. FA91-65-000 on June 30, 1993. FERC Staff, KU, and KU's municipal customers jointly moved that the initial decision by an administrative law judge be waived and that the matter be submitted to FERC for decision. On July 14, 1993, the administrative law judge certified the hearing record to the FERC. See Letter from Robert M. Hewett to Don R. Mills of July 20, 1993. As of the date of this Order, the FERC has yet to issue a decision.

4 Case No. 92-493-C, An Examination By The Public Service Commission Of The Application Of The Fuel Adjustment Clause of Kentucky Utilities Company From November 1, 1993 to April 30, 1994, Order of August 5, 1994 at 5.

Generating Station. This action was taken as a part of the Commission's review of KU's fuel adjustment clause for the six-month period ending April 30, 1994.

Following discovery and the filing of written testimony, the Commission conducted a public hearing on January 24, 1995.[5] Testifying before the Commission were Robert M. Hewett, KU's Vice President of Regulation and Economic Planning; Michael D. Robinson, KU's Comptroller and Chief Accounting Officer; Richard J. DeCleene, Partner, Arthur Andersen & Co.; James N. Heller, Founder, Fieldston Company; and Russell L. Klepper, Founder and Partner, Rawson, Klepper & Company. After the filing of briefs, this case was submitted for decision on March 10, 1995.

STATEMENT OF THE CASE[6]

Coal Ridge Fuel Contract

On April 23, 1973, KU and River Processing Company, Inc. ("River Processing") entered into a coal supply contract for KU's Ghent Units No. 1 and 2. Three years later, the parties renegotiated this contract. Under the terms of the renegotiated contract, KU agreed to purchase 900,000 tons of coal annually from River Processing's Hoyt, Kentucky mine for a 15-year period for use at Ghent Unit No. 2. KU took delivery of the coal at the Hoyt, Kentucky coal mine and then shipped it by rail to the Cleancoal Terminal transfer facility on the Ohio River adjacent to Ghent Unit No. 2. Barges then transported the coal to Ghent Unit No. 2.

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5 The Attorney General of Kentucky and Kentucky Industrial Utility Customers, Inc. were granted leave to intervene in this proceeding.

6 For a chronology of the events in this case, see Appendix A.

After initiating legal action against River Processing in May 1983 for breach of the 1976 Contract, KU entered a new coal supply agreement with Coal Ridge Fuels, Inc. ("Coal Ridge Fuels") which had recently acquired River Processing. This agreement, which the parties executed on December 22, 1983, required KU to purchase coal from the Hoyt, Kentucky mine for an 8-year period. During the first year of the Agreement, KU agreed to purchase a minimum of 600,000 tons. During subsequent years, the minimum purchase requirement gradually increased to 900,000 tons annually, or 75,000 tons monthly. The Agreement provided that KU would take delivery of the coal at the Hoyt, Kentucky mine and that Coal Ridge Fuels would load the coal into railcars at the delivery point.

Alleging that KU had improperly adjusted downward the price and had misapplied the agreement's force majeure provisions, Coal Ridge Fuels in January 1987 brought suit against KU.[7] Facing a potential exposure of $40 million from an adverse judgment, KU entered negotiations with Coal Ridge Fuels. On April 1, 1988, they executed a Termination and Release Agreement (hereinafter "Buyout Agreement"). In return for Coal Ridge Fuels' agreement to dismiss its action and to terminate the 1983 Agreement, KU made a lump sum payment of $14.5 million to Coal Ridge Fuels and agreed to purchase 24,000 tons of coal per month for the following 12 months.

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7 Coal Ridge Fuels, Inc. and River Processing, Inc. v. Kentucky Utilities Co., No. 87-CI-0014 (Perry Cir. Ct. filed January 1987).

KU applied to the Commission[8] and to the FERC[9] for approval to amortize the cost of the Buyout Agreement over a 44-month period through its FAC. Under KU's proposal, Kentucky retail ratepayers would pay approximately $12.25 million of the costs through the FAC billings. In support of its application, KU argued that: (1) the $14.5 million payment was a prepayment for fuel and therefore a cost of fuel; (2) the Buyout Agreement reduced KU's average cost of fuel; and (3) the prepayment was a reasonable and prudent means of "obtaining the benefits of current spot market prices and substantial savings for the Company's customers."[10]

On October 7, 1988, the Commission approved KU's application. Addressing the appropriateness of recovering this cost through the FAC, the Commission found that:

> The $14.5 million represents a prepayment of fuel costs for the purpose of obtaining a current and future reduction in fuel expense; the buy-out results in an immediate benefit to KU's customers which will continue through the remaining life of the contract; and denial of the proposed recovery would tend to discourage utilities from attempting to negotiate for lower rates and prices in existing contracts.[11]

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8 Case No. 10214, Application of Kentucky Utilities Company For An Order Approving Certain Accounting Treatment of Amounts Paid For Coal Contract Release (Application filed April 6, 1988).

9 Kentucky Utilities Company, FERC Docket No. EL88-20-000 (Application filed May 2, 1988).

10 Case No. 10214, KU's Application at 4.

11 Case No. 10214, Order of October 7, 1988 at 3 - 4.

FERC subsequently approved KU's application, but used a different theory to support its action.[12]

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12 Although its regulation on FACs is virtually identical to Administrative Regulation 807 KAR 5:056, the FERC rejected KU's argument that the costs were a cost of fuel which could properly pass through KU's FAC. The FERC declared:

> Section 35.15 limits fuel cost recovery to the cost of fossil and nuclear fuel consumed in the utility's own plants and the identifiable cost of fossil and cost of fossil fuel associated with purchases. The cost of fossil fuel is further limited to include no items other than those listed in Account 151. The Account 151 limitation is simply an additional constraint beyond the threshold requirement that amounts reflect only the cost of fossil fuel consumed. To the extent amounts are booked to Account 151 which are not part of the cost of fossil and nuclear fuel consumed, those costs do not meet the requirements of section 35.14 and are not eligible for fuel clause recovery.
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> ***Buyout costs are payments to vendors in consideration for not purchasing fuel required by contract. As such, buyout costs are the very antithesis of the cost of fuel consumed.*** Accordingly, waiver of the fuel clause regulations is required whenever a utility seeks to recover buyout costs in the fuel clause regardless of the accounting treatment which may be permitted.

Kentucky Utilities Co., 45 FERC at 62,291 - 62,292 (Dec. 13, 1988) (emphasis added).

The FERC recognized that the Buyout Agreement could produce savings for KU's wholesale customers and that such transactions should be encouraged. It therefore granted a waiver for the FERC FAC Regulation to permit the pass through of the buyout costs for each month in which KU could demonstrate that savings achieved by the Buyout Agreement for that month exceed the buyout costs for that month. Id. at 62,292 - 62,293; Kentucky Utilities Co., 49 FERC ¶61,008 (Oct. 5, 1989).

As Administrative Regulation 807 KAR 5:056 does not permit waivers, it would have required the denial of KU's application had the Commission adopted the FERC's interpretation of the Buyout Agreement.

During the next 44 months, KU amortized the $14.5 million cost of the Buyout Agreement through its FAC. Beginning in October 1988 and continuing until May 1992, KU increased its monthly fuel costs by $329,545 to reflect the Buyout Agreement's cost. During the two-year period under review, KU added approximately $6,261,355 to its actual cost of fuel when determining the FAC charge for its Kentucky retail ratepayers.

Railcars

In 1973, while still negotiating its coal supply contract with River Processing, KU took steps to acquire railcars to transport coal from the Hoyt, Kentucky mine to its Ghent Station. In February 1973, KU retained the independent engineering firm of Sargent & Lundy to design the railcars. In July 1974, it tentatively awarded the contract to construct the railcars to Thrall Car Manufacturing Company. KU and Thrall Car Manufacturing Company executed an agreement in mid-1975. KU purchased and took delivery of 126 railcars in September 1976.[13] Between September 1976 and 1988, KU used the 126 railcars primarily to transport coal as part of a unit train[14] from the Hoyt, Kentucky mine to a transfer point on the Ohio River.

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13 For a detailed account of KU's purchase of the railcars, see RCG/Hagler, Bailly, Inc, Investigation of the Prudence of the Fuel Procurement Practices of Kentucky Utilities Company (Aug. 15, 1988) (filed in PSC Case No. 9631), at 5.3.

14 "A unit train is a group of coal cars used continually as a unit to transport coal from a mine to a transfer point or a generating station." FERC Docket No. FA91-65-001, Prepared Direct Testimony of Leland H. Soltz at 3.

The 126 railcars are high side steel gondola railcars.[15] Each has a struck capacity of 4,000 cubic feet, weighs 60,000 pounds, and is designed to carry a maximum payload of approximately 101.5 tons.[16] Because they are gondola cars, they can only be unloaded with rotary dumpers. No KU generating station has a rotary dumper.[17] Accordingly, their use is limited to the Cleancoal Terminal near the Ghent Generating Station and the Licking River Terminal near Wilder, Kentucky.[18]

At the time of the railcar purchase, KU recorded an addition of $4,197,569 to Account 101, Electric Plant in Service.[19] To determine the railcars' depreciation rate and the amount to accrue as depreciation expense, KU used a service life of 12 years and estimated each railcar's salvage value at 4 percent of purchase cost or $1,300. KU based

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15 There are two types of railcars - hopper cars and gondola cars. A hopper car is characterized by doors (hoppers) at the bottom of the railcar which can be opened to release the coal. These cars can generally be unloaded by bottom dumping over a trestle or pit, using a car shaker, or being rotary dumped. Gondola cars have no doors at the bottom and can only be dumped using a rotary dumper. See FERC Docket No. FA91-65-000, KU's Response to Trial Staff's Third Set of Data Requests, OCA-38.

16 Case No. 94-492-C, KU's Response to KIUC's Information Request of September 15, 1994, Item 12.

17 Case No. 94-492-C, KU's Response to the Commission's Order of October 4, 1994, Item 5(a).

18 Case No. 94-492-C, KU's Response to KIUC's Information Request of September 15, 1994, Item 12.

19 Case No. 94-492-C, KU's Response to the Commission's Order of August 5, 1994, Item 14.

its estimates upon an informal survey which its comptroller performed at the time of purchase.[20]

KU never undertook an independent study of the railcars' service life and salvage value. While it owned the railcars, KU on two separate occasions retained the auditing firm of Deloitte & Touche to conduct a depreciation study of its utility plant. In 1984, it commissioned a depreciation study for its utility plant as of December 31, 1983. It commissioned a similar study in 1988 for its utility plant as of December 31, 1987. On both occasions, however, KU instructed Deloitte & Touche <u>not</u> to include the 126 railcars in the depreciation study.[21]

Depreciation for these railcars as well as their maintenance expense was passed directly to KU's retail ratepayers through KU's FAC.[22] KU recorded depreciation expense

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20 Case No. 94-492-C, Testimony of Michael D. Robinson at 3. <u>See also</u> Case No. 94-492-C, KU's Response to the Commission's Order of October 4, 1994, Item 9. KU presented no evidence on the survey's methods or the raw data which the survey collected.

21 FERC Docket FA91-65-000, KU's Response to Trial Staff's First Set of Data Requests, OCA-1.

22 Commission Regulation 807 KAR 5:056, Section 1(6) provides:

> The cost of fossil fuel shall include no items other than the invoice price of fuel less any cash or other discounts. The invoice price of fuel includes the cost of the fuel itself **and necessary charges for transportation of the fuel from the point of acquisition to the unloading point**, as listed in Account 151 of FERC Uniform System of Accounts for Public Utilities and Licensees.

Account 151 of the FERC Uniform System of Accounts defines fuel as:

1. Invoice price of fuel less any cash or other discounts.

(continued...)

on the railcars by debiting Account 151, Fuel Stock, and crediting Account 108, Accumulated Provision for Depreciation of Electric Utility Plant. A similar accounting entry was made for maintenance expense. As it burned the related fuel, KU amortized the amounts from Account 151 to Account 501, Fuel. KU included the amounts in Account 501 as a component of fuel cost in computing the FAC charge to its customers. By December 1988, when the railcars were fully depreciated, KU had passed directly to its wholesale and retail ratepayers $4,074,450 in depreciation expenses associated with these cars.[23]

Following the execution of the Buyout Agreement in 1988, KU primarily used the 126 railcars to transport the limited amounts of coal which it purchased from the Hoyt, Kentucky

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22 (...continued)

2. Freight, switching, demurrage and other transportation charges, not including, however, any charges for unloading from the shipping medium.

3. Excise taxes, purchasing agents' commissions, insurance and other expenses directly assignable to cost of fuel.

4. **Operating, maintenance and depreciation expenses and ad valorem taxes on utility-owned transportation equipment used to transport fuel from the point of acquisition to the unloading point.**

5. Lease or rental costs of transportation equipment used to transport fuel from the point of acquisition to the unloading point.

17 C.F.R. Part 101 (emphasis added).

23 Case No. 92-493-C, KU's Response to the Commission's Order of October 4, 1994, Item 5(c). KU also passed through approximately $1,739,117 of maintenance costs associated with the 126 railcars. <u>See</u> Case No. 92-493-C, KU's Response to KIUC's Request of September 15, 1994, Item 8.

mine.[24] Near the end of the Buyout Agreement, it began considering other uses for the railcars. Determining that the railcars could only unload at a few locations and that continued ownership of the railcars limited its flexibility in fuel procurement, KU leased the railcars to TECO Enterprises for the period February 17, 1989 through March 31, 1989 and to Tradewater Railroad Company from April 10, 1989 through April 30, 1990.[25] KU realized net rental income of $626,587 from these transactions which was booked in Account 454, Rent from Electric Property.[26]

Beginning in March 1990, KU received several offers to purchase the 126 railcars.[27] Due to the volatility of the used railcar market, the offering price for railcars rapidly escalated.[28] When Helms Financial Company made its first offer on March 19, 1990, the proposed purchase price was $17,500 for each railcar. When KU accepted David J. Joseph Company's offer on August 31, 1990, the agreed purchase price was $24,200.

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[24] Case No. 92-493-C, KU's Response to the Commission's Order of October 4, 1994, Item 3(a). Between 1987 and 1990, KU also used the railcars to transport 380,545 tons of spot market coal from other mines to its Ghent Station Units. See Rebuttal Testimony of Robert M. Hewett at 15. Approximately 146,354 tons were hauled in 1990. It is unclear, however, whether the remaining amount was transported after the Buyout Agreement was executed.

[25] Case No. 94-492-C, Testimony of Michael D. Robinson at 4; FERC Docket FA91-65-001, KU's Response to Trial Staff's First Set of Data Requests, OCA-13.

[26] Case No. 92-493-C, KU's Response to the Commission's Order of October 4, 1994, Item 5(e); Case No. 92-493-C, KU's Response to the Commission's Order of August 5, 1994, Item 24(c). KU realized total rental income of $693,607 but incurred broker fees of $67,020.

[27] For a listing of all offers which KU received, see FERC Docket FA91-65-001, KU's Response to Trial Staff's First Set of Data Requests, OCA-15.

[28] Case No. 92-493-C, Testimony of James N. Heller at 5-7.

On December 20, 1990, KU sold the 126 railcars to David J. Joseph Company for $3,049,200.[29] Sale of the railcars represented a net gain of $2,885,400.[30] KU accounted for the sale by (1) crediting Account 101, Electric Plant in Service, with the $4,238,060 original cost of the railcars;[31] (2) debiting Account 108, Accumulated Depreciation, with $4,074,260 of depreciation previously recorded on the railcars; (3) crediting Account 108, Accumulated Depreciation, with the $163,800 estimated salvage value of the railcars; and (4) crediting Account 421.1, Gain on Disposition of Property, with $2,885,400 as a gain on the sale.[32]

DISCUSSION

Proceeds from the Rental of the Railcars

KU advances several arguments in support of its position that its ratepayers have no right to the lease proceeds. First, it contends that no economic relationship exists between the Buyout Agreement and the leasing arrangements and that changing coal and

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29 Case No. 94-492-C, KU's Response to KIUC's Information Request of September 15, 1994, Item 15.

30 Net Gain on Sale = Total Sales Price - Estimated Salvage Value = $3,049,200 - $163,800 = $2,885,400.

Estimated Salvage Value = 126 railcars x $1,300 per railcar = $163,800.

31 KU's original cost at the time of the railcars' purchase was $4,197,569. In 1980, KU replaced three railcars which were damaged in a derailment. The railroad involved in the derailment reimbursed KU $96,829 for the railcars. With the addition of the three replacement railcars, the original cost of the railcars was $4,238,060. See Case No. 94-492-C, KU's Response to KIUC's Information Request of September 15, 1994, Item 2; Case No. 94-492-C, KU's Response to the Commission's Order of October 4, 1994, Item 5(a).

32 FERC Docket No. FA91-65-000, Prepared Direct Testimony of Leland H. Soltz at 5 -6.

transportation market conditions alone were responsible for the rental. KU purchased and used the railcars to transport coal from the Hoyt, Kentucky mine, it argues, because it was the most economical and efficient means of transportation. In the late 1980s, KU's fuel procurement strategy changed to take advantage of short-term and spot market conditions. As the railcars were rotary dump cars and could not make deliveries to all KU generating stations, their usefulness to KU was limited and their rental made better economic sense. KU also notes that the railcars were not exclusively used to transport coal from the Hoyt, Kentucky mine, but transported coal from several mines. KU was never under any legal obligation to use the railcars to transport only coal from the Hoyt, Kentucky mine.

KU next argues that return of the rental revenues through the FAC is contrary to Administrative Regulation 807 KAR 5:056. It notes that this regulation permits only charges related to the cost of fuel or the transportation of fuel to pass through an electric utility's FAC. The rental revenues, KU argues, are neither fuel costs nor charges for the transportation of fuel. They are revenues produced through the lease of a capital asset. Such revenues have always been considered as part of a utility's revenues when determining the revenue requirement for base rates. Moreover, assuming arguendo that these revenues were related to fuel or fuel transportation charges, they were collected in a prior review period and are not now subject to Commission review.

The Commission finds no merit to KU's argument that the Buyout Agreement and the railcars' rental are unrelated. The absence of any legal obligation on KU's part to use the railcars for deliveries from the Hoyt, Kentucky mine is irrelevant. The record shows a long historical relationship between KU's use of the railcars and its purchases from the mine. KU originally purchased the railcars primarily to transport coal from the mine to

Ghent Unit No. 2 and used them almost exclusively for that purpose throughout the River Processing and Coal Ridge Fuels contracts.

The record clearly supports the proposition that a direct causal relationship existed between the Buyout Agreement and the railcars' rental. KU presented no evidence to suggest that it would have forsaken the use of its railcars had the 1983 Agreement continued in effect. Nothing in the record suggests that an economically feasible alternative was available. Had no Buyout Agreement been executed and the 1983 Agreement run its course, the railcars would not have been available for rental between February 1989 and April 1990, no rental would have occurred, and no rental proceeds would have been available.

As the rental proceeds are directly related to the Buyout Agreement, the Commission's Order of October 7, 1988 and Administrative Regulation 807 KAR 5:056 require the Commission to consider those proceeds as a "cost of fuel." In approving KU's application to amortize the $14.5 million payment to Coal Ridge Fuels through KU's FAC, the Commission liberally interpreted the term "cost of fuel."[33] While none of the $14.5 million payment went to the purchase of fuel, the Commission considered the amount "a prepayment of fuel costs for the purpose of obtaining a current and future reduction in fuel expense."[34] It found that the Buyout Agreement would produce lower fuel costs and thus lower fuel charges for KU's retail customers and that such transactions should be

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[33] See the text accompanying note 12.

[34] Case No. 10214, Order of October 7, 1988 at 3.

encouraged.[35] As only KU's customers would receive the benefit of the Buyout Agreement, the Commission reasoned that they alone should bear that Agreement's costs. At the time of the Commission's Order, neither the Commission nor any party to this proceeding was aware of other benefits which the Buyout Agreement might produce.

To the extent that the Buyout Agreement has resulted in direct and immediate financial benefits to KU, those benefits must be considered in determining the actual cost of the Buyout Agreement. To ignore those benefits, as KU urges, would permit KU to retain the benefits of the Buyout Agreement without bearing any of its costs and would place upon KU's ratepayers an unfair burden. To maintain the delicate balance which the Commission created in its October 7, 1988 Order, the rental proceeds should be considered as an offset to the Buyout Agreement's cost and the amount of these costs recovered through KU's FAC should be reduced to reflect this offset.

With the rental proceeds considered, KU's actual cost in entering the Buyout Agreement was $13,873,413. Through monthly amortization of the lump-sum payment to Coal Ridge Fuels, KU flowed through $14.5 million in additional fuel charges associated with that payment. Approximately $6,261,355 of those charges occurred during the two-year period under review. To the extent that these charges exceeded the actual cost of the Buyout Agreement, KU incorrectly calculated the fuel charge during the period under review and should temporarily reduce its rates to return the excessive charges to its ratepayers.

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35 Id. at 3-4.

Gains from the Sale of the Railcars

Courts have generally permitted regulatory commissions to weigh the surrounding circumstances to determine who is entitled to the gain from a sale of a utility asset. For example, in Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Comm'n, 485 F.2d 786, 805 (D.C. Cir. 1973), the U.S. Court of Appeals for the District of Columbia stated:

> Investors . . . are not automatically entitled to gains in the value of operating utility properties simply as an incident of the ownership conferred by their investments. And it goes without saying that consumers do not succeed to such gains simply because they are users of the service furnished by the utility. Neither capital investment nor service consumption contributes in any special way to value-growth in utility assets.

The Court concluded that two principles must be considered in making its determination:

> One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden of particular utility activity should also reap the benefit resulting therefrom.

Id. at 806. See also Maine Water Co. v. Pub. Utilities Comm'n, 482 A.2d 443 (Me. 1984); Kansas Power & Light Co. v. State Corp. Comm'n, 620 P.2d 329 (Kan. App. 1980); Casco Bay Lines v. Pub. Utilities Comm'n, 390 A.2d 483 (Me. 1978).

A key factor in determining the ratepayers' right to any gain is whether depreciation has been charged on the asset. Finding that the ratepayers' payment of depreciation expense established a right to the gain on the sale of an asset, the Idaho Supreme Court in Boise Water Corp. v. Idaho Pub. Util. Comm'n, 578 P.2d 1089, declared:

> In the world of utility law there are two methods of treating revenue. Some revenue benefits utility customers by

> decreasing the amount charged for rates. Other revenue benefits the shareholders of the utility. Which class of person receives the benefit of such revenue depends on who has borne the financial burdens and risks of that property. On property other than real property, the utility receives a depreciation allowance which effects its rate of return. The depreciation is an amortized amount allowed to the utility for the consumptive utilization of its property. Theoretically, at the end of the depreciation period the property is useless or consumed and the utility has been paid back its cost of acquiring that property for the benefit of its customers. Again, theoretically, the utility can then turn around with the money received as a depreciation allowance and buy a new piece of equipment to perform the function of that property which has been consumed or become useless. **One way of looking at a depreciation allowance on a utility's personal property is that the public buys that property from the utility as it is used up. In one sense, therefore, the public owns depreciable property and when a utility sells depreciable property, the ratepayers are entitled to have that sale price treated as if it were the sale of the ratepayers' property. The revenue ought to be included in the utility's revenue receipts which reduce the rate charges to customers.**

Id. at 1092 (emphasis added).

KU argues that the holding in City of Lexington v. Lexington Water Co., Ky., 458 S.W.2d 778 (1970) indisputably establishes its right to the gain. In Lexington Water Co., the Lexington Water Company (now Kentucky-American Water Company) applied for an increase in its rates for water service. In establishing new rates, the Commission considered the profit which the utility had made on a sale of land three years earlier. The utility then successfully appealed to Franklin Circuit Court. The Commission and the City of Lexington then appealed. Framing the issue as "whether the sale profit of 'nonrevenue producing real estate which had been retired from public service' belonged to the shareholder or inured to the benefit of the customers," the Kentucky Court of Appeals held that

> [p]rofit made from the sale of non-depreciable land no longer used in serving customers is not an ingredient to be considered in fixing rates. The customers had no interest in the profit realized on the sale--it belonged to the stockholder.

Id. at 780.

The facts of the present case are readily distinguishable from Lexington Water Co. Lexington Water Co. involved the sale of land. Land is not a depreciable asset. Nothing in the record of that case indicates that any ratepayer funds were expended on the land. In the present case, virtually the entire cost of the railcars was depreciated. Moreover, FAC charges to KU customers covered not only depreciation, but maintenance expense to keep the railcars in working condition.

KU correctly argues that it bore certain risks associated with the railcars. These included the risk that the railcars would not remain in service long enough for KU to recover the full value and that the coal contract for which KU expressly purchased them would be terminated. Because the FAC allowed for direct and immediate recovery of railcar expenses, however, KU's risk was significantly lessened. Moreover, KU was compensated for this risk through the rate of return component within its base rates.[36]

The record also shows that the Buyout Agreement directly benefitted KU's sale of the railcars. While KU could have sold the railcars in December 1991 at the expiration of

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[36] In Case No. 8624, Kentucky Utilities Co. (March 18, 1983), the Commission included the cost of the 126 railcars in KU's rate base for purpose of developing KU's base rates. See Case No. 92-493-C, KU's Response to the Commission's Order of August 5, 1994, Item 24(a).

its 1983 Agreement, the Buyout Agreement allowed KU to sell the railcars earlier and to take advantage of unusually high market prices for the railcars. Had KU waited another year, it would have faced falling market prices for its railcars and obtained a significantly lower sale price.[37]

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[37] KU Witness Heller testified:

> Q: If KU had sold the railcars in 1988, would KU have realized the same gain that the company realized when it sold the cars at the end of 1990?
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> A: No. KU came very close to hitting the peak in the market for that type of equipment. **Their gain would have been substantially less, maybe half, had those cars been sold a few years earlier or a few years later.** This market moves rather quickly depending on what the demand is for coal equipment, what cars are coming off of lease, what the needs are for this type of equipment in particular, and rather than selling those cars for $24,000, they more likely would have sold for about half of that. **Had they been sold a few years earlier or a few years later, the gain would have been far, far less.**
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> . . .
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> Q: Is it fair to conclude, in your opinion and based on your experience in this field, that the gain or the loss from the sale of railcars is determined by the timing of the disposition and the condition of the market rather than other factors, such as the operation and maintenance of the car?
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> A: I think the key determinants are [sic] the market is extraordinarily volatile in terms of the range at which it drives prices within. The car itself, the condition of the car, is important, but it is the nature of the market which seems to be the primary determinant in the railcar market for the specific equipment you've got, which, in this case, were gondolas without rotary couples. . . .
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> Q: Do I understand you to say that it's **the time of the disposition** that's an influence, as well?
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> A: **Yes,** and KU had offers for these cars at $17,000 four months before they sold them, and then the same offers came back almost $5,000 to $7,000 higher within a period of months, and I talked with the same people who looked at the cars and who ultimately made other buys. **One of the companies that was not a successful buyer of the KU cars did buy similar equipment two years later for about $11,000 to $12,000.** KU did well.

Case No. 93-493-C, Transcript at 191 - 194 (emphasis added).

Based upon the holdings in Boise Water Corp. and Democratic Central Committee, the Commission finds that KU's ratepayers are entitled to the gain on the sale of the railcars. They bore the burden of the railcars' depreciation and maintenance expenses. They also bore the costs of the Buyout Agreement which made possible such a large gain from the sale of the railcars. As the net proceeds of the railcars' sale represent a recovery of depreciation expense which was passed through the FAC as a cost of fuel, they represent a negative cost of fuel and should have been considered when KU calculated its FAC charges. As they were not, KU improperly calculated its FAC charges during the period under review.

SUMMARY

After review of the evidence of record and being otherwise sufficiently advised, the Commission HEREBY ORDERS that:

1. The records of Cases No. 9631[38] and No. 92-493-C are incorporated by reference into the record of this proceeding.

2. Upon filing its first monthly fuel adjustment after the entry of this Order, KU shall, in calculating its monthly fuel cost, reduce actual monthly fuel cost by $3,511,987 to reflect the net revenues earned from the rental and sale of the 126 railcars.

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[38] Case No. 9631, An Investigation Into the Fuel Procurement Practices of Kentucky Utilities Company. All parties to the present case were parties to Case No. 9631. Moreover, KU has previously moved for incorporation by reference of the record of this case into the current proceeding. See KU's Application for Reconsideration and Motion to Incorporate Prior Commission Orders By Reference (filed April 23, 1993) at n.4.

3. KU shall make the following accounting entries on its books: It shall debit Account No. 216, Unappropriated Retained Earnings, and credit Account No. 151, Fuel Stock, for $3,511,987. Upon filing its first monthly fuel adjustment after the entry of this Order, it shall charge this amount in total to Account No. 501, Fuel.

4. Ordering paragraphs 1, 2, 3, and 4 of the Commission's Order of April 5, 1993 are declared final.

5. This case is closed and shall be removed from the Commission's docket.

Done at Frankfort, Kentucky, this 2nd day of January, 1997.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Vice Chairman

B. J. Helton
Commissioner

ATTEST:

Executive Director

APPENDIX A

AN APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION OF KENTUCKY IN CASE NO. 92-493 DATED JANUARY 2, 1997

CHRONOLOGY

Date	Event
04/27/73	Kentucky Utilities Company enters into coal supply contract with River Processing Company, Inc. Shipments under contract would begin in September 1976.
07/05/74	Kentucky Utilities Company, through Sargent & Lundy (an independent engineering firm), gives notice of its intent to award Thrall Car Manufacturing Company the contract for furnishing 126 high side gondola railcars to transport coal from the Hoyt, Kentucky mine to Ghent Generating Station Unit No. 2.
07/75	Kentucky Utilities Company executes a contract with Thrall Car Manufacturing Company for the purchase of 126 high side gondola railcars.
05/20/76	Kentucky Utilities Company and River Processing Company, Inc. execute a renegotiated contract. Kentucky Utilities agrees to take 900,000 tons of coal annually at Ghent Station Unit No. 2. Contract term is 15 years.
09/76	Kentucky Utilities Company purchases 126 railcars at a cost of $4,197,569 from Thrall Car Manufacturing Company.
1980	Three railcars extensively damaged in derailment. KU reimbursed $96,829 for the railcars and purchased replacements. Total original cost of railcars is now $4,238,060.
12/22/83	Kentucky Utilities Company and Coal Ridge Fuels, Inc. execute a coal supply agreement. This Agreement supersedes the 1976 Agreement with River Processing Company. Contract term is 8 years.
1984	Kentucky Utilities Company commissions Deloitte & Touche to conduct a depreciation study for utility plant as of December 31, 1983. Kentucky Utilities Company expressly advises consultant <u>not</u> to include railcars in the study.
01/01/84	New coal supply agreement with Coal Ridge Fuels, Inc. takes effect

1988	Kentucky Utilities Company commissions Deloitte & Touche to conduct a depreciation study for utility plant as of December 31, 1987. Kentucky Utilities Company expressly advises consultant not to include railcars in the study.
04/01/88	Kentucky Utilities Company and Coal Ridge Fuels, Inc. execute Buyout Agreement. Kentucky Utilities Company will pay $14.5 million to Coal Ridge Fuels, Inc.
04/06/88	Kentucky Utilities Company applies for Kentucky Public Service Commission approval to amortize the cost of the Buyout Agreement over a 44-month period and recover the cost through its fuel adjustment clause.
05/02/88	Kentucky Utilities Company applies to Federal Energy Regulatory Commission for approval to amortize the cost of the Buyout Agreement through its fuel adjustment clause.
10/07/88	Kentucky Public Service Commission approves Kentucky Utilities Company's application to amortize the costs of the buyout agreement to its Kentucky jurisdictional retail ratepayers.
10/88	Kentucky Utilities Company begins amortizing the buyout costs through its fuel adjustment clause ($329,545 per month).
12/13/88	Federal Energy Regulatory Commission denies Kentucky Utilities Company's application.
02/89	Kentucky Utilities Company decides to lease the railcars.
02/17/89 - 03/31/89	Kentucky Utilities Company leases 60 railcars to TECO Transport & Trade Corporation. Total rental payment was $33,468. After payment of $3,347 broker fee, approximately $30,121 in net revenue is recognized.
03/31/89	Kentucky Utilities Company's purchases from Coal Ridge Fuels, Inc. under the Buyout Agreement end.
04/10/89 - 04/30/90	Kentucky Utilities Company leases 126 railcars to Tradewater Railroad Company. Total rental payment was $660,139. After payment of $63,673 for broker fees, net revenues of $596,466 were realized.

10/05/89	Federal Energy Regulatory Commission approves second Kentucky Utilities Company application for passthrough of buyout costs to its wholesale ratepayers.
03/19/90	Kentucky Utilities Company receives its first offer to purchase the 126 railcars. Helm Financial Corporation offers to purchase the railcars for $17,500 per railcar.
06/90 - 11/90	Kentucky Utilities Company uses the 126 railcars for coal deliveries.
08/27/90	Kentucky Utilities Company receives offer from David J. Joseph Company to purchase the 126 railcars for $24,200 per railcar.
08/31/90	Kentucky Utilities Company accepts David J. Joseph Company's offer.
12/20/90	Kentucky Utilities Company sells railcars to David J. Joseph Company for $3,049,200.
12/31/91	Termination Date for the December 23, 1983 coal purchase contract between Kentucky Utilities Company and Coal Ridge Fuels, Inc.
12/91	Kentucky Utilities Company acquires 150 coal cars to transport coal to the Brown Generating Station
05/92	Kentucky Utilities Company completes amortization of the buyout costs and ceases adding $329,545 to its monthly fuel costs.
11/12/92	Division of Audit, Office of Chief Accountant, Federal Energy Regulatory Commission issues report questioning Kentucky Utilities Company's accounting practices.