

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF CUMBERLAND )  
VALLEY ELECTRIC, INC. FOR AN ) CASE NO. 2005-00187  
ADJUSTMENT OF RATES )

O R D E R

On July 22, 2005, Cumberland Valley Electric, Inc. ("Cumberland Valley") applied for a \$1,394,876 increase in retail electric service rates. The requested increase is 4.92 percent over normalized test-year operating revenues. Cumberland Valley states that the proposed increase was required in order to maintain its financial integrity, cover operating costs, and maintain the minimum margins required by its mortgage agreement.

BACKGROUND

Cumberland Valley is a consumer-owned rural electric cooperative corporation, organized under KRS Chapter 279, engaged in the distribution and sale of electric energy to approximately 23,000 member-consumers in the Kentucky counties of Bell, Harlan, Knox, Laurel, Leslie, Letcher, McCreary, and Whitley. Cumberland Valley has no electric generating facilities and purchases its total power requirements from East Kentucky Power Cooperative, Inc. ("East Kentucky").

The Commission granted a motion to intervene filed by the Attorney General, by and through his Office for Rate Intervention ("AG"). Public hearings were conducted on

April 11, 2006 and April 14, 2006.<sup>1</sup> All information requested during the hearings has been submitted. Both parties filed post-hearing briefs on May 10, 2006. Simultaneous with the filing of his brief, the AG filed a motion requesting the Commission to order a complete financial, operational, and management audit or review of Cumberland Valley. Cumberland Valley filed a response to the AG's motion on May 17, 2006, and the AG filed his reply thereto on May 22, 2006. Cumberland Valley's rate application and the AG's motion stand submitted to the Commission for decision.

#### AG'S MOTION FOR MANAGEMENT AUDIT

In his motion for management audit, the AG states that the evidence compiled in this record reveals that Cumberland Valley has engaged in several questionable business practices and conflicts of interest that cast doubt upon the reliability of Cumberland Valley's test-year accounting figures. In addition, the AG states that he has further "documentary evidence and statements which support the allegations of imprudent spending."<sup>2</sup> However, he chose, without explaining his reasons, not to present this additional evidence to the Commission in this proceeding. He requests that the Commission grant his motion prior to rendering its decision on the rates. In the

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<sup>1</sup> During the public hearing on April 11, 2006, Cumberland Valley stated that while it attempted to publish notice of the hearing as required by 807 KAR 5:011, Section 8(5), and KRS 424.300, the notice was printed with an incorrect hearing date. To correct the error, Cumberland Valley republished notice of the hearing in all the newspapers in its service territory. Due to the weekly printing of 6 of the newspapers, its notice did not meet the minimum notice period of 7 days prior to the hearing. Consequently, the April 11, 2006 hearing was held as scheduled and reconvened on April 14, 2006 to allow for any public comment.

<sup>2</sup> Attorney General's Sur-Reply to Petitioner's Reply to Attorney General's Motion for Complete Financial, Operational and Management Audit or Review at 1.

alternative, he requests that the Commission take note of his position on Cumberland Valley's proposed rate adjustments.

In its response to the AG's motion, Cumberland Valley states that the management of Cumberland Valley has caused no harm to its members and that the AG "has not produced the first shred of evidence which would indicate that any of the business practices complained of by the AG have financially adversely affected CVE's members."<sup>3</sup> While maintaining this position, Cumberland Valley states that it does not object to a review by the Commission.<sup>4</sup>

Having reviewed the AG's motion and sur-reply and Cumberland Valley's reply, the Commission finds that the AG was provided ample opportunity during the discovery phase of this proceeding and during the hearing to provide information to support his allegations that the management practices of Cumberland Valley have affected its test-year revenues and expenses. We further find that while the AG has raised concerns relating to Cumberland Valley's business practices, he has failed to provide adequate evidence to support his arguments that these practices have affected the accuracy of Cumberland Valley's test-year financial information. Therefore, the Commission finds that Cumberland Valley is entitled to receive a decision on its rate application at this time.

The Commission recognizes that Cumberland Valley has an excellent record of providing some of the lowest cooperative electricity rates in this state and that it has not

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<sup>3</sup> Cumberland Valley's Reply to the AG's Motion for a Complete Financial, Operational and Management Audit or Review at 2.

<sup>4</sup> Id. at 7.

requested a rate increase since 1980. However, while we do not find that the AG has provided sufficient evidence that any business or operating procedure has adversely affected the rates being established herein, we do find that he has raised some legitimate questions regarding some of Cumberland Valley's business and operating policies and note Cumberland Valley's statement that it has no objection to a review by the Commission. Therefore, pursuant to the authority provided in KRS 278.255(2), the Commission finds that a focused management audit is appropriate and should be performed. The focused management audit will review the duties and responsibilities of Cumberland Valley's management, the efficacy of its business and operating policies and procedures, and the role of the Board of Directors and its relationship to Cumberland Valley. The audit will further review whether there are adequate systems in place to sufficiently track and maintain Cumberland Valley's financial integrity and accountability.

Pursuant to KRS 278.255(3), the costs of conducting the audit shall be borne by the utility and included in the cost of service of the utility for rate-making purposes. The Commission finds, therefore, that Cumberland Valley should be allowed to defer the costs of the audit until the filing of its next rate application.

CUMBERLAND VALLEY'S RATE APPLICATION  
TEST PERIOD

Cumberland Valley proposed and the Commission accepted the 12-month period ending December 31, 2004 as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test year, the Commission considered appropriate known and measurable changes.

## VALUATION

### Rate Base

Cumberland Valley determined a net investment rate base of \$39,758,954<sup>5</sup> based on the adjusted test-year-end value of plant in service and construction work in progress ("CWIP"), the test-year-end balances for materials and supplies and prepayments, and excluding the adjusted accumulated depreciation and the test-year-end level of customer advances for construction. The AG did not state a position on Cumberland Valley's rate base determination.

The Commission determined that Cumberland Valley's rate base should reflect the test-year-end value of plant in service and CWIP. The Commission used the 13-month average balances for materials and supplies and prepayments. The Commission excluded the adjusted accumulated depreciation and the test-year-end level of customer advances for construction. Finally, the Commission calculated working capital allowance as one-eighth of the operating expenses exclusive of purchased power, depreciation, taxes, and other deductions. The operating expenses used in the working capital calculation reflect the adjustments to operating expenses discussed in this Order.

Based on these adjustments, Cumberland Valley's net investment rate base for rate-making purposes is as follows:

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<sup>5</sup> Response to Commission Staff's Second Data Request dated September 2, 2005, Item 12, p. 2.

Utility Plant in Service	\$61,817,626
CWIP	<u>62,085</u>
Total Utility Plant	\$61,879,711
ADD:	
Materials and Supplies	\$ 314,197
Prepayments	90,485
Working Capital	<u>592,797</u>
Subtotal	\$ 997,479
DEDUCT:	
Accumulated Depreciation	\$22,793,339
Customer Advances for Construction	<u>785,533</u>
Subtotal	\$23,578,872
 NET INVESTMENT RATE BASE	 <u>\$39,298,318</u>

### Capital Structure

The Commission finds that Cumberland Valley's capital structure at test-year-end for rate-making purposes was \$41,750,900. This capital structure consisted of \$14,490,998 in equity and \$27,259,902 in long-term debt. The Commission excluded generation and transmission capital credits ("GTCCs") in the amount of \$9,024,188.

### REVENUES AND EXPENSES

Cumberland Valley proposes several adjustments to revenues and expenses to reflect current and expected operating conditions. The Commission finds that three of the adjustments proposed by Cumberland Valley and not opposed by the AG are reasonable and will be accepted without change:

- the normalization of revenues, which includes the fuel adjustment clause ("FAC") adjustment, a reduction in revenues of \$266,585;
- the normalization of depreciation expense, an increase in expense of \$288,207;<sup>6</sup> and

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<sup>6</sup> The Commission is accepting the results of the depreciation study submitted as Exhibit O of Cumberland Valley's application filed on July 22, 2005.

- the adjustment to remove donations made during the test year, a reduction in expense of \$9,736.

The Commission makes the following modifications to the remaining proposed adjustments:

#### Customer Growth Adjustment

Cumberland Valley proposes a customer growth adjustment for Rate Schedule I based on a 12-month average number of customers and energy sales, which results in increased margins of \$25,511. In response to a Staff data request, Cumberland Valley calculated an adjustment for all customer classes based on 13-month average for the period December 2003 through December 2004.<sup>7</sup> This 13-month customer adjustment results in an increase in total margins of \$150,555 including increased margins of \$120,109 for Rate Schedule IV-A.<sup>8</sup> The AG supports this adjustment, which is consistent with the type of year-end customer adjustment typically accepted by the Commission.

Cumberland Valley states that it is not appropriate to use a 13-month average for Rate Schedule IV-A since a reclassification of customers from Schedule II to Schedule IV-A in the last month of the test year increased the number of customers in the class from 63 in November to 73 in December 2004. Cumberland Valley claims that this distorts the typical customer growth patterns such adjustments are intended to capture.<sup>9</sup>

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<sup>7</sup> Response to the Commission Staff's Second Data Request dated September 2, 2005, Item 5(a).

<sup>8</sup> Initially, Cumberland Valley calculated respective amounts of \$205,553 and \$172,715 for these margins, but corrected these amounts later in this proceeding.

<sup>9</sup> Transcript of Evidence, April 11, 2006, at 62 - 63.

The reclassified customers' demands and energy use, which are significantly lower than those of the average Schedule IV-A customer, were billed under Schedule IV-A only in December 2004. Cumberland Valley believes that the results of an adjustment for the test-year-end number of customers based on only 1 month of information would be inaccurate. It provided 2005 load and sales data for Rate Schedule IV-A and, in its brief, applied the 2005 data to the test year-end number of customers to derive more representative demand and energy usage levels. The resulting increase in margins for Schedule IV-A is \$97,655, while the overall increase in margins is \$128,101.

The Commission finds that a 13-month end of test year customer growth adjustment is appropriate for all rate classes except Schedule IV-A. We agree with Cumberland Valley that Rate Schedule IV-A revenues would be distorted if calculated solely on the basis of the test-year-end number of customers. Although it goes well beyond the test year, we find that recognizing the demand and energy levels for Rate Schedule IV-A based on load data for calendar year 2005 is reasonable in this specific instance. We also find that those levels, applied to the test-year-end number of customers, should be used to calculate the test-year-end customer growth adjustment. Therefore, we will accept the customer growth adjustment, as modified by Cumberland Valley, which results in an overall increase in margins of \$128,101.

#### Interest Expense

Cumberland Valley proposes an increase of \$140,234 to normalize the test-year interest expense. On May 10, 2006, Cumberland Valley updated its current variable

interest rates that would result in an additional increase of \$372,229 to the current level of interest expense of \$512,463.<sup>10</sup>

Since the filing of the application, Cumberland Valley has experienced a significant increase in its variable long-term debt interest rates. The Commission has generally recognized any change, whether an increase or decrease, in long-term debt rates as of the hearing date to most accurately reflect the financial condition of the cooperative when determining the revenue requirement. The Commission finds that it is reasonable to recognize the change in the variable interest rates as of the date of the hearing. The treatment afforded to Cumberland Valley is consistent with previous Commission decisions.<sup>11</sup>

Therefore, the Commission has recalculated the test-year interest expense using the test-year-end debt balances at the variable interest rates in effect as of the hearing date and has increased the interest expense to \$512,577.

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<sup>10</sup> Cumberland Valley Brief at 3-4, Exhibit B. Cumberland Valley recalculated its interest expense using updated debt balances instead of the debt balances at test-year-end.

<sup>11</sup> See Case No. 2001-00092, Adjustment of Gas Rates of The Union Light, Heat and Power Company, final Order dated January 31, 2002.

## Labor and Labor-Related Costs

Cumberland Valley proposes adjustments to increase test-year operating expenses by \$244,591 for labor and labor-related costs.<sup>12</sup> The adjustments consist of increases to wages and salaries, payroll taxes, and employee benefits.

Wages and Salaries. Cumberland Valley proposes an adjustment of \$204,983 to normalize total wages and salaries, of which \$70,668 was capitalized<sup>13</sup> and \$134,315 was expensed. Cumberland Valley's calculations for full-time employees were based on 2,080 hours. Its calculations for its part-time employees were based on the number of hours actually worked during the test year. Test-year normalized overtime hours were calculated utilizing an overtime factor for employees that come under the labor agreement.<sup>14</sup>

The AG proposes to remove the Christmas bonuses paid to Cumberland Valley's employees for rate-making purposes. The AG notes that Cumberland Valley's rate expert did not contest the AG's proposal to exclude this expense of \$5,895.<sup>15</sup>

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<sup>12</sup> The revised increase for wages and salaries is \$204,983; the increase for payroll taxes is \$15,170; the decrease for employee benefits is \$56,262; and the increase for post-retirement benefits is \$80,700. See Application Exhibits F, Schedules 6 through 9 and the Response to the AG's Second Data Request dated October 12, 2005, Item 11.

<sup>13</sup> The capitalized portion reflects actual capitalized costs and payroll costs allocated to "payroll other." The payroll other includes amounts assigned to clearing accounts and accounts receivable. Unless otherwise noted, references in this Order to "capitalized" reflect this combination of actual capitalized costs and other costs.

<sup>14</sup> Application Exhibit F, Schedule 6.

<sup>15</sup> Post Hearing Brief of the AG at 3 and AG Schedule 11.

The AG also recommends that the normalized overtime expenses be based on a normalized level of overtime hours, consisting of the average overtime hours during 2002, 2003, and 2004. He calculates an average test-year hourly overtime rate by dividing the actual test-year total overtime hours by the actual test-year total overtime wages. He then applies an average overtime payroll increase based on the overall increase in the total payroll during the test year to determine the average hourly overtime rate used in his recommendation. The AG states that the actual overtime hours are abnormally high and therefore recommended a normalized level of overtime expenses based on his methodology. After applying the test-year capitalization rate, the AG reduced Cumberland Valley's proposed expense adjustment by \$64,572.<sup>16</sup>

The Commission agrees with the AG that the Christmas bonuses should not have been included in the wage and salary normalization and has recalculated the proposed adjustment excluding the bonuses. The Commission does not agree with the AG's proposal to normalize overtime expenses based on an average of 3 years and does not find the AG's methodology of applying an average to an average of an average to be reasonable.

The Commission recalculated the proposed adjustment excluding the bonuses. The Commission has generally normalized overtime expense utilizing the actual test-year hours of overtime at 1.5 times the test-year-end wage rates and finds this approach to be reasonable in this proceeding. Therefore, the Commission has recalculated the normalized overtime expense accordingly. After applying the test-year

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<sup>16</sup> Post Hearing Brief of the AG at 3-4 and AG Schedule 3.

capitalization rate of 34.5 percent, the Commission finds that an adjustment to increase test-year operating expenses by \$102,261 is reasonable.

Payroll Taxes. Cumberland Valley proposes to increase its payroll taxes by \$14,259, based on the proposed normalization of wages and salaries and reflecting the Federal Insurance Contribution Act ("FICA") base wage limit of \$90,000 at the test-year end. Of this amount, \$5,230 was capitalized and \$9,940 was expensed.<sup>17</sup>

The AG proposes removing the payroll tax expense associated with the Christmas bonuses and his recommended overtime expense adjustment. Based on the AG's proposed reduction in salary expense of \$70,467, the AG proposes that Cumberland Valley's proposed expense adjustment be reduced by \$5,222.<sup>18</sup>

As with the wage and salary normalization, the Commission agrees with the AG that the impact of the Christmas bonuses should be removed. The Commission has recalculated this adjustment, based on the level of normalized wages and salaries found reasonable and the current FICA base wage limit of \$94,200. This results in an increase in test-year payroll taxes of \$11,612. After applying the test-year capitalization rate of 34.5 percent, the increase to test-year payroll tax expense is \$7,606.

The Commission finds that the recalculated annual accrual should be recognized as an adjustment to Cumberland Valley's operating expenses. After applying the test-year capitalization rate of 34.5 percent, the Commission will include an adjustment to increase operating expenses by \$7,606.

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<sup>17</sup> Application Exhibit F, Schedule 7. Payroll taxes include FICA, Medicare, and Federal and State Unemployment.

<sup>18</sup> Post Hearing Brief of the AG at 4-5 and AG Schedule 4.

Employee Benefits and Postretirement Benefits. Cumberland Valley proposes to increase its expense for employee benefits and post-retirement benefits by \$16,013. Included in this adjustment is a net decrease in the expenses for employee benefits<sup>19</sup> of \$56,262; of this amount, \$19,396 is capitalized and \$36,866 is expensed. The expense for post-retirement benefits is increased by \$80,700; of this amount, \$27,821 is capitalized and \$52,879 is expensed.

The Commission recalculated these components of the adjustment to reflect the level of normalized wages and salaries found reasonable. The Commission finds the employee benefits expense should be reduced by \$36,699 and the post-retirement benefits expense should be increased by \$52,879. Therefore, the total employee benefits and post-retirement benefits expense should be increased \$16,180.

#### Rate Case Expense

Cumberland Valley estimated its rate case expense at \$60,000. It proposes to recover this expense through a 3-year amortization. This estimate did not include in-house labor. Throughout this proceeding, Cumberland Valley has been providing updates of the actual expenses incurred in presenting this rate case. As of April 11, 2006, Cumberland Valley had expended \$32,197 to prepare and process this rate case. The Commission finds that a 3-year amortization of these expenses is reasonable and will allow an increase in operating expense of \$10,732 to reflect the first year of the amortization for rate-making purposes.

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<sup>19</sup> Employee benefits include 401K contributions; retirement and security contributions; medical, dental, and life insurance; workers' compensation; and long-term disability insurance.

### Professional Services Expenses

Cumberland Valley proposes to remove \$79,066 in professional services expenses for non-recurring items. The AG proposes to reduce Cumberland Valley's professional services expenses by an additional \$1,460. The proposed adjustment is composed of the expense associated with a territorial dispute and Kentucky Association of Electric Cooperatives' ("KAEC") annual meeting expenses paid to Cumberland Valley's attorney.<sup>20</sup> The AG argues that the expense associated with the territorial dispute is a non-recurring item and should be excluded for rate-making purposes. The AG notes that Cumberland Valley agreed that the expense associated with the territorial dispute should be excluded for rate-making purposes. The AG states that the expense for Cumberland Valley's attorney to attend the KAEC annual meeting should also be excluded for rate-making purposes. He states that this is consistent with the Commission's treatment of these items in previous cases.<sup>21</sup>

The Commission agrees with Cumberland Valley's initial adjustment and the AG's adjustments, which results in a reduction to Cumberland Valley's operating expenses of \$80,526.

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<sup>20</sup> Post Hearing Brief of the AG at 7, AG Schedule 7.

<sup>21</sup> Post Hearing Brief of the AG at 7.

## Directors' Fees and Expenses

During the test year Cumberland Valley paid its seven directors fees and expenses totaling \$214,082. Cumberland Valley proposes an adjustment to reduce this expense by \$160,065 to exclude certain expenses for rate-making purposes.<sup>22</sup>

The AG proposes to reduce these expenses an additional \$11,467, which reflects the exclusion of per diem fees and meeting fees and expenses for directors attending the annual meeting of the National Rural Electric Cooperative Association ("NRECA").<sup>23</sup> One of Cumberland Valley's directors served as its representative to the NRECA meetings. In previous cooperative rate cases, the Commission found it excessive to include annual meeting expenses for directors who were not the designated delegate or alternate. No evidence has been presented in this case to persuade the Commission to treat Cumberland Valley differently. The Commission finds, therefore, that the expenses for directors, other than the delegate, for attending the NRECA annual meeting should be excluded.

The Commission agrees with the exclusions identified by Cumberland Valley and the AG with one exception. The AG proposes to remove the fees and expenses associated with one director attending the NRECA Legislative Conference. While this expense appears on Cumberland Valley's adjustment detail, it was not included in the total allowable for rate-making purposes proposed by Cumberland Valley. The

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<sup>22</sup> Application Exhibit F, Schedule 13. The \$160,065 adjustment was comprised of health insurance premiums; per diems paid to retired directors, directors' Christmas party, and expenses associated with a director's attendance at legislative conference.

<sup>23</sup> Post Hearing Brief of the AG at 8

exclusion of these items, including the legislative conference, is consistent with the Commission's decisions in previous electric distribution cooperative rate proceedings.

In addition, the Commission has identified further adjustments that should be made to the directors' fees and expenses. In its proposed adjustment, Cumberland Valley misstated an expense and overlooked another expense associated with two of its directors attending director-training conferences.<sup>24</sup> The Commission finds that it is important for the cooperative directors to receive training to be effective and responsible stewards of the cooperative and such training expenses should be included for rate-making purposes. This results in an increase of \$402.

Based on these findings, the Commission reduced Cumberland Valley's operating expenses by \$168,638.<sup>25</sup>

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<sup>24</sup> Application, Exhibit F, Schedule 13 and the Response to Commission Staff's Third Data Request dated September 30, 2005, Items 13 and 14.

<sup>25</sup> This total reflects Cumberland Valley's original reduction, the AG's additional reduction less the legislative conference expenses, and the Commission's two identified adjustments.

## Property Taxes

Cumberland Valley proposes an increase of \$15,226 to normalize property taxes for the test year. The AG proposes to increase Cumberland Valley's property taxes by an additional \$8,893.<sup>26</sup> The AG noted that Cumberland Valley agrees that the adjustment should be made for rate-making purposes.

The Commission agrees with Cumberland Valley's initial proposal and the AG's additional adjustment and finds that the property taxes should be increased by an additional \$24,119.

## Advertising Expenses

In his brief, the AG recommends that \$68,940 in expenses associated with the *Kentucky Living* magazine should be excluded for rate-making purposes. He also recommends the exclusion of \$10,949 in advertising classified by Cumberland Valley as conservation advertising. For both items, the AG argues that the expenses reflect institutional and promotional advertising that must be excluded for rate-making purposes consistent with 807 KAR 5:016, Section 4(1).

*Kentucky Living Magazine.* Cumberland Valley reported for the test year a total expense of \$96,840 for the *Kentucky Living* magazine. Cumberland Valley recorded \$31,570 of this expense in Account No. 909, Informational and Instructional Advertising Expense, and \$65,270 in Account No. 930.11, General Advertising Expense. The AG proposes that the entire amount recorded in Account No. 909 and all but \$27,900 of the amount recorded in Account No. 930.11 should be excluded for rate-making purposes,

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<sup>26</sup> In its response to the AG's Initial Request for Information, dated September 2, 2006, Cumberland Valley states that it did not properly consider state property taxes associated with Item 26 resulting in the additional increase in property taxes.

a reduction in expense of \$68,940. The AG argues that the expense recorded in Account No. 909 is clearly considered to be institutional advertising by Cumberland Valley, and that his review of the magazine shows that very little of the content of *Kentucky Living* has anything to do specifically with Cumberland Valley or electric energy in general.<sup>27</sup> The AG bases his inclusion of \$27,900 of the magazine's expense on Cumberland Valley's representations that it avoided certain required publication costs by using inserts in *Kentucky Living*.<sup>28</sup>

During the processing of this case, Cumberland Valley has provided differing opinions of the purpose and benefits received from the *Kentucky Living* magazine. Cumberland Valley's management has stressed that the magazine provides its members with valuable information about Cumberland Valley operations as well as broader electric industry concerns such as local economic development, energy policy, efficient energy use, and safety awareness. Cumberland Valley's management has also stated that *Kentucky Living* enables its members to have a better understanding of the unique nature of the cooperative business model and member responsibilities related to that model.<sup>29</sup> However, Cumberland Valley's consultant provides somewhat conflicting responses concerning the *Kentucky Living* magazine. He provides a response indicating that the *Kentucky Living* magazine does reflect institutional advertisement, but notes that while the corporate image of Cumberland Valley is

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<sup>27</sup> Post Hearing Brief of the AG at 5-6.

<sup>28</sup> Id. at 7.

<sup>29</sup> Response to the AG's Second Data Request dated October 12, 2005, Item 15.

enhanced by the magazine, it also provides information on safety issues, outage reporting, and information specific to Cumberland Valley.<sup>30</sup>

Institutional and promotional advertising are addressed in 807 KAR 5:016, Section 4, which states:

Advertising Disallowed. (1) Advertising expenditures for political, promotional, and institutional advertising by electric or gas utilities shall not be considered as producing a material benefit to the ratepayers and, as such, those expenditures are expressly disallowed for rate-making purposes.

(a) "Political advertising" means any advertising for the purpose of influencing public opinion with respect to legislative, administrative, or electoral matters, or with respect to any controversial issue of public importance.

(b) "Promotional advertising" means any advertising for the purpose of encouraging any person to select or use the service or additional service of an energy utility, or the selection or installation of any appliance or equipment designed to use such utility's service.

(c) "Institutional advertising" means advertising which has as its sole objective the enhancement or preservation of the corporate image of the utility and to present it in a favorable light to the general public, investors, and potential employees.

In this case, it appears that the AG bases his recommendations on his review of a single issue of *Kentucky Living* magazine and only one portion of Cumberland Valley's consultant's responses regarding *Kentucky Living*. The AG apparently dismisses the remainder of the information provided by Cumberland Valley's consultant and all of the information provided by Cumberland Valley's management that addresses the nature,

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<sup>30</sup> Response to the Staff's Third Data Request dated October 14, 2005, Items 7 and 8.

purpose, and benefits Cumberland Valley's ratepayers derive from the magazine.<sup>31</sup> The AG offers no other evidence to support his proposed adjustment.

The Commission is not persuaded by the AG's arguments. While Cumberland Valley's consultant acknowledges that Cumberland Valley derives some enhancement to its corporate image, he also states, along with Cumberland Valley's management, that its customers receive material benefits. The AG does not explain why the Commission should disregard the benefits the customers receive from the magazine or why it is appropriate to base its decision on a review of a single issue of the magazine given that *Kentucky Living* magazine is issued monthly.

Nevertheless, the Commission reviewed the magazine issue the AG examined and, while we agree that only 4 of the 61 pages included in the magazine contain instructional material, we are not persuaded that this requires the *Kentucky Living* expense to be disallowed as institutional. As the AG states, "[t]he remaining fifty-seven (57) pages of this KLM issue consist of advertisements and general stories dealing with matters that have nothing to do with CVE, in specific, or electric energy in general."<sup>32</sup> If the majority of the material in the magazine has nothing to do with Cumberland Valley specifically, it should not be concluded that the magazine is enhancing or preserving the cooperative's corporate image or showing the cooperative in a favorable light to its member consumers.

Therefore, the Commission finds that the AG's recommendation to exclude \$68,940 is not reasonable or supported by the evidence of record and is denied.

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<sup>31</sup> Response to the AG's Second Data Request dated October 12, 2005, Item 15.

<sup>32</sup> Post Hearing Brief of the AG at 6.

Conservation Advertising. During the test year, Cumberland Valley recorded in Account No. 909 a portion of the expense for *Kentucky Living* magazine and \$10,949 in expenses classified as conservation advertising. In his brief, the AG argues that his review of the details of this conservation advertising “clearly indicate that these advertising expenses are of an institutional and/or promotional nature.”<sup>33</sup> The AG states that none of these expenses should be considered for rate-making purposes and recommends excluding the entire \$10,949 from expenses.

The Rural Utilities Service Uniform System of Accounts describes Account No. 909, Informational and Instructional Advertising Expenses, as:

This account shall include the cost of labor, employee pensions and benefits, social security and other payroll taxes, injuries and damages, materials used, and expenses incurred in activities which primarily convey information as to what the utility urges or suggests customers should do in utilizing electric service to protect health and safety, to encourage environmental protection, to utilize their electric equipment safely and economically, or to conserve electric energy.<sup>34</sup>

The Commission has reviewed the expense detail and Cumberland Valley’s explanations concerning the \$10,949 recorded in Account No. 909. Of this total, \$5,384 in expenses was described as advertising electric thermal storage (“ETS”) systems and a “Button Up” home energy audit program. The Commission has previously found in another electric distribution cooperative rate case that ETS advertising produces a benefit to the cooperative’s system through an improved load factor and to program

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<sup>33</sup> Id.

<sup>34</sup> 7 CFR Ch. XVII, § 1767.29, at 836-837.

participants through reduced electric bills.<sup>35</sup> The AG offers no evidence in this proceeding to change the Commission's opinion of ETS advertising. The Button Up home energy audits help customers identify actions they can take to improve the energy efficiency of their homes. Advertising to encourage energy conservation produces a material benefit to ratepayers and is consistent with the provisions of 807 KAR 5:016, Section 3(1). Therefore, the Commission finds these expenses have been properly classified as conservation advertising and will include the expenses for rate-making purposes.

Concerning the remaining \$5,565 in expenses recorded in Account No. 909 and challenged by the AG, the Commission has reviewed Cumberland Valley's explanation of the nature and purpose of these expenses. Based upon this review, the Commission agrees with the AG that these particular expenses are primarily promotional in nature. As noted previously in this Order, expenses for promotional advertising are expressly disallowed for inclusion in rate-making by 807 KAR 5:016, Section 4(1)(b). Therefore, the Commission finds that test-year expenses should be reduced by \$5,565.

#### Meter Maintenance Expenses

The AG proposes to reduce test-year meter maintenance expense recorded in Account No. 597, Meter Maintenance, by \$14,880. The AG argues that the test-year level of expense was unusually high when compared to previous calendar year levels and the level of expense reflecting the 12-month period ending September 30, 2005. The AG also notes that the test-year level of expense does not reflect the full impact of

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<sup>35</sup> Case No. 1998-00455, Application of Grayson Rural Electric Cooperative Corporation for an Adjustment of Rates, final Order dated July 8, 1999, at 9-10.

Cumberland Valley retrofitting new meter technology on its system. The AG proposes to normalize the meter maintenance expense using an average of the calendar years 2001 through 2004 and the 12 months ending September 30, 2005.<sup>36</sup> The difference between this average and the test-year actual expense is \$14,880.

The Commission has reviewed the information provided by the AG and agrees that the test-year level of expense recorded in Account No. 597 appears to be high. We also agree that cost savings resulting from the retrofitting of new meter technology should be reflected in the determination of Cumberland Valley's revenue requirements to the extent reasonable and consistent with established rate-making principles. However, the Commission notes several problems with the approach utilized by the AG to normalize this expense. The historic test year for this proceeding is the 12 months ending December 31, 2004. The AG uses expense information in his adjustment that is 9 months beyond the end of the test year. The Commission finds that this information is too far beyond the end of the test year to be considered. In previous historic test-year rate cases, the Commission has, with the exception of updated interest rates, generally considered no more than 6 months beyond the end of the test year when recognizing post-test-year changes in revenues or expenses.<sup>37</sup> The averaging approach utilized by the AG double-counts the impact of the last 3 months of calendar year 2004, which were also included in the 12-month expense level as of September 30, 2005. The AG's calculation divided the total of the expense by 5 years, or 60 months, when the time

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<sup>36</sup> Post Hearing Brief of the AG at 9 and AG Schedule 9.

<sup>37</sup> See, e.g., Case No. 2004-00067, Application of Delta Natural Gas Company, Inc. for an Adjustment of Rates, final Order dated November 10, 2004, at 41.

period reflected by the total expense was only 57 months. Finally, the AG has never explained why a 5-year average is reasonable for this type of adjustment.

In this case, the Commission believes that a more reasonable method to reflect the changes resulting from the retrofitting of the new meter technology would be to determine the ongoing level of this expense using the 12-month level of expense for the period ending June 30, 2005. The total expense for Account No. 597 for the 12-month period ending June 30, 2005 is \$42,147. Therefore, the Commission finds that the test-year expense in Account No. 597 should be reduced from \$62,430 to \$42,147, a reduction of \$20,283.

#### Miscellaneous Expenses

The AG proposes to reduce operating expenses by \$11,180 to remove certain miscellaneous expenses not normally included for rate-making purposes.<sup>38</sup> Cumberland Valley states that these items are legitimate expenses for rate-making purposes.<sup>39</sup>

The Commission agrees with the reductions proposed by the AG. Based on this finding, the Commission has reduced miscellaneous expenses by \$11,180.

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<sup>38</sup> These expenses include annual meeting prizes, flower and coffee fund, picture frames, and candy. See Post Hearing Brief of the AG at 9 and 10, and AG Schedule 10; Response to the AG's First Data Request dated September 2, 2005, Items 33, 34, and 37(b); Response to the AG's Second Data Request dated October 12, 2005, Item 2; and Response to the Commission Staff's Second Data Request dated September 2, 2005, Item 31.

<sup>39</sup> See Response to the Commission Staff's Third Data Request dated October 14, 2005, Item 16.

PSC Assessment

Cumberland Valley does not propose an adjustment to its PSC Assessment to reflect the effects of its normalization of revenues and purchased power expense or the impact of its proposed revenue increase. Likewise, the AG does not propose an adjustment to the PSC Assessment to reflect the impact of its proposed adjustments or proposed revenue reduction.

The Commission has calculated an adjustment to the PSC Assessment that reflects the normalization of revenue and purchased power found reasonable in this Order and applied the current PSC Assessment rate. This calculation results in an increase in the PSC Assessment of \$1,128.

Pro Forma Adjustments Summary

The effect of the pro forma adjustments on Cumberland Valley's net income is as follows:

	<u>Actual Test Period</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Period</u>
Operating Revenues	\$29,379,691	\$ 1,197	\$29,380,888
Operating Expenses	<u>28,548,143</u>	<u>91,704</u>	<u>28,639,847</u>
Net Operating Income	831,548	(90,507)	741,041
Interest on Long-Term Debt	874,856	512,577	1,387,433
Other Income and (Deductions) – Net	<u>95,757</u>	<u>(996)</u>	<u>94,761</u>
NET INCOME	<u>\$ 52,449</u>	<u>\$ (604,080)</u>	<u>\$ (551,631)</u>

REVENUE REQUIREMENTS

The actual rate of return earned on Cumberland Valley's net investment rate base established for the test year was 2.33 percent. Cumberland Valley requests rates that would result in a Times Interest Earned Ratio ("TIER") excluding GTCCs of 2.00X

and a rate of return of 5.14 percent on its proposed rate base of \$39,461,201.<sup>40</sup> Cumberland Valley proposes an increase in revenues of \$1,394,876 to achieve the 2.00X TIER excluding GTCCs.

The AG proposes that Cumberland Valley's revenues should be reduced by \$310,715. The AG's proposal was not determined using the TIER approach. Rather, the AG started with Cumberland Valley's proposed increase of \$1,394,876 and reflected the effects of 11 adjustments on the proposed increase, which results in the AG's proposed reduction of \$310,715.<sup>41</sup>

Cumberland Valley's actual TIER excluding GTCCs for the test period was 1.06X. For the calendar years 2002 and 2003, it was 1.30X and 1.27X, respectively. After taking into consideration pro forma adjustments, Cumberland Valley would achieve a 0.60X TIER excluding GTCCs without an increase in revenues. Cumberland Valley's equity to total capitalization ratio is 34.7 percent based on the approved capital structure.

Cumberland Valley proposes that a 2.00X TIER be used to determine its revenue requirement and the AG offers no position on the use of the 2.00X. The Commission finds that the use of a 2.00X TIER is reasonable for Cumberland Valley. In order to achieve the 2.00X TIER, Cumberland Valley would need to increase its annual revenues by \$1,939,059, which includes an additional \$3,244 to reflect the associated increase needed for Cumberland Valley's PSC Assessment. This increase exceeds the

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<sup>40</sup> Application Exhibit K, p. 2 of 2.

<sup>41</sup> Post Hearing Brief of the AG and AG Schedule 11.

amount requested by Cumberland Valley and results primarily from the increase in interest rates experienced by Cumberland Valley since the filing of this rate case.

Based upon the pro forma adjustments found reasonable, the Commission has determined that an increase in Cumberland Valley's revenues of \$1,394,876 would result in a TIER of 1.61X. Given the circumstances in this case, the Commission finds it reasonable to grant Cumberland Valley's originally requested revenue increase of \$1,394,876. This additional revenue should produce net income of \$846,334, which should allow Cumberland Valley to meet its mortgage requirements and service its mortgage debts.

Having concluded, however, that it is reasonable to use a 2.00X TIER to determine Cumberland Valley's revenue requirements, we find that Cumberland Valley should be allowed to request the additional \$544,183 in revenue necessary to achieve a 2.00X TIER by filing a motion for rehearing in this proceeding pursuant to KRS 278.400. If, in conjunction with the additional revenue, Cumberland Valley wishes to modify the rate design approved herein, it must include in its motion for rehearing its new proposal along with all supporting documentation.

### PRICING AND TARIFF ISSUES

#### Cost of Service

Cumberland Valley filed a fully allocated cost-of-service study ("COSS") for the purpose of determining the cost to serve and revenue requirements for all rate classes. The COSS indicates that Schedule I – Residential and Schedule VI – Security Lights produce revenues insufficient to meet their revenue requirements while the commercial and industrial rate classes produce revenues in excess of their revenue requirements.

In allocating its proposed revenue increase, Cumberland Valley proposes increases for only Rate Schedules I and VI.

The AG supports the results of Cumberland Valley's COSS for all classes except for the ETS class. He states that the COSS underestimated the cost to serve the ETS class by failing to include non-coincident peaks for the class. The AG states that Cumberland Valley also failed to allocate a portion of its customer-related costs to the ETS class. The AG claims that a marketing rate, such as the ETS rate, is not appropriate at a time when Cumberland Valley's wholesale power supplier, East Kentucky, is deficient on generating capacity. Correcting the problems he perceives with the COSS, the AG states that the ETS energy rate should be set at 87 percent of the Schedule I energy rate, rather than at 60 percent as proposed by Cumberland Valley. However, recognizing the principle of gradualism, the AG recommends that the ETS energy rate be set at 70 percent of the Schedule I energy rate. The AG recommends that the additional revenues generated from the higher ETS rate be used to offset the rates for Cumberland Valley's Schedule I residential customers.

Cumberland Valley notes that setting the ETS energy rate at 60 percent of the Schedule I energy rate is consistent with the Commission's original approval of the ETS program and that the program is still viable and consistent with the Energy Policy Act of 2005. In its brief, Cumberland Valley states that although the ETS rate proposed in its application is based on marginal cost recovery, as had previously been approved by the Commission, it is agreeable to the fully allocated cost recovery approach advocated by the AG and to setting the rate at 70 percent of the residential energy rate.

The Commission recognizes that the ETS rate was implemented as a marketing rate intended to encourage off-peak sales and that the ETS rates for East Kentucky's distribution cooperatives, including Cumberland Valley, have never been based on the recovery of fully allocated costs. We also recognize that all of East Kentucky's cooperatives that offer an ETS rate are based upon recovery of marginal costs at 60 percent of the cooperative's residential rate. We agree with Cumberland Valley that the ETS program is still viable and that it is consistent with the Energy Policy Act of 2005. We find that Cumberland Valley's originally proposed ETS rate (equal to 60 percent of the residential energy rate) will recover Cumberland Valley's marginal costs. This reflects the fact that the ETS rate applies to off-peak energy sales during periods which generally match East Kentucky's off-peak rate periods.

Therefore, we conclude, under the circumstances described herein, that an ETS rate equal to 60 percent of the Schedule I energy rate, as originally proposed by Cumberland Valley, is reasonable and should be approved. We also conclude that Cumberland Valley's COSS is acceptable for use as a guide in allocating the revenue increase awarded herein.

#### Revenue Allocation and Rate Design

Cumberland Valley proposes a revenue increase of \$1,394,876 or 4.92 percent, with increases of 7.15 percent for the residential class, 9.40 percent for the security lighting class, and zero percent for all other classes. Using the COSS as a guide, the requested increase will be allocated as proposed by Cumberland Valley.

As previously stated, residential and security lighting are the only rate classes receiving increases. Cumberland Valley proposes no increases to the customer charge

for the residential class. Assigning the full increase to the energy charge component of the rates for the residential class minimizes the impact of the increase for lower usage customers, which is acceptable to the Commission.

#### OTHER ISSUES

##### Cumberland Valley's Policy Statement No. 51

In response to the AG's argument that Cumberland Valley failed to appropriately charge the Whitley County School System for the construction of electricity lines, Cumberland Valley provided a policy statement approved by its Board of Directors in 1983. This policy statement, Policy Statement No. 51, provides that Cumberland Valley will relocate or construct lines to schools and churches in its service territory at no cost. The AG argues that while KRS 278.170(2) allows a utility to grant free or reduced rates to a charity or eleemosynary institution, the statute does not contemplate doing so for public schools. The Commission has reviewed its records and finds that Cumberland Valley's policy has not been approved and that it is not contained in its filed tariff. Therefore, the Commission finds that Cumberland Valley is prohibited from carrying out the provisions of its Policy Statement No. 51.

#### SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A are the fair, just, and reasonable rates for Cumberland Valley to charge for service rendered on and after February 4, 2006.
2. The rate of return and TIER granted herein will provide for Cumberland Valley's financial obligations, but it would also be reasonable for Cumberland Valley to

use a 2.00X TIER and Cumberland Valley should be allowed to request the additional revenues necessary to achieve a 2.00X TIER.

3. The depreciation rates proposed by Cumberland Valley are reasonable and should be approved.

4. A focused management audit should be performed to review the duties and responsibilities of Cumberland Valley's management, the efficacy of its business and operating policies and procedures, the role of the Board of Directors and its relationship to Cumberland Valley, and whether there are adequate financial systems in place to sufficiently track and maintain Cumberland Valley's integrity and accountability.

5. Cumberland Valley should be prohibited from carrying out the provisions of its Policy Statement No. 51.

6. Cumberland Valley should be permitted to defer its costs associated with the focused management audit and those costs should be eligible for recovery in rates in its next general rate case. Further, Cumberland Valley should establish a separate deferred asset account to record these costs.

IT IS THEREFORE ORDERED that:

1. The rates proposed by Cumberland Valley and set forth in Appendix A are approved for services rendered by Cumberland Valley on and after February 4, 2006.

2. Within 10 days from the date of this Order, Cumberland Valley shall file revised tariffs showing the date of issue, the effective date, and that the tariffs are issued by authority of this Order.

3. If Cumberland Valley elects to request the additional revenues discussed herein, it shall follow the procedure described within this Order.

4. The depreciation rates proposed by Cumberland Valley are approved. Cumberland Valley shall begin using these rates as of the date of this Order.

5. Cumberland Valley shall cease the relocation and construction of electricity lines for schools and churches in its service territory at no cost.

6. A focused management audit of Cumberland Valley's operations, consistent with the scope of described herein, shall be undertaken. Cumberland Valley shall defer the costs of the focused management audit for recovery in its next general rate case, as described within this Order.

Done at Frankfort, Kentucky, this 2nd day of May, 2006.

By the Commission

ATTEST:

A large, stylized handwritten signature in black ink, consisting of several overlapping loops and curves, positioned over the printed text 'Executive Director'.

Executive Director

## APPENDIX A

### APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2005-00187 DATED May 2, 2006.

The following rates and charges are prescribed for the customers in the area served by Cumberland Valley Electric, Inc. All other rates and charges not specifically mentioned in this Order shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

#### SCHEDULE I HOME, FARM, SCHOOLS AND CHURCHES

Energy Charge	\$ .06278
Marketing Rate	\$ .03767

#### SCHEDULE VI SECURITY LIGHTS

Rate per Month:

Mercury Vapor Lamps	
175 Watt	\$ 6.50
400 Watt	\$ 8.87
Sodium Lamps	
100 Watt Open Bottom	\$ 6.50
100 Watt Colonial Post	\$ 7.42
100 Watt Directional Flood	\$ 8.03
400 Watt Directional Flood	\$ 12.47
400 Watt Cobra Head	\$ 12.47