COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR AN ORDER APPROVING THE ESTABLISHMENT OF A REGULATORY ASSET FOR THE AMOUNT EXPENDED ON ITS SMITH 1 GENERATING UNIT	)))))	CASE NO. 2010-00449

O R D E R

On November 18, 2010, East Kentucky Power Cooperative, Inc. ("EKPC") tendered an application requesting Commission authorization to establish a regulatory asset in the amount of $163.4 million for expenditures made on its Smith 1 Generating Unit ("Smith 1"), a 278 MW coal-fired plant that was under construction in Clark County, Kentucky. EKPC's request is predicated on Commission acceptance and approval of the settlement agreement ("Settlement"), filed concurrently in Case No. 2010-00238.[1] That Settlement, among other things, provides for EKPC to cancel Smith 1 and voluntarily relinquish the Certificate of Public Convenience and Necessity ("CPCN") granted by the Commission for the construction of Smith 1 in Case No. 2005-00053.[2] EKPC based its asset request on the amount it had expended on Smith 1 as of

[1] Case No. 2010-00238, An Investigation of East Kentucky Power Cooperative Inc.'s Need for the Smith 1 Generating Facility, opened June 22, 2010.

[2] Case No. 2005-00053, Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity, and a Site Compatibility Certificate, for the Construction of a 278 MW (Nominal) Circulating Fluidized Bed Coal Fired Unit and Five 90 MW (Nominal) Combustion Turbines in Clark County, Kentucky (Ky. PSC Aug. 29, 2006).

September 30, 2010, plus its $10 million estimate of the costs of cancelling, or unwinding, various vendor contracts.

BACKGROUND

EKPC's request to establish a regulatory asset in this case arises from the issues raised and the proposed resolution thereto in Case No. 2010-00238, in which a final order is being issued today approving certain provisions of the unanimous Settlement filed in that case on November 18, 2010. The Commission opened that case on June 22, 2010, for the purpose of investigating whether EKPC continued to have a need for additional base load capacity and, if so, whether Smith 1 was still the lowest cost alternative available to meet that need.

Based on its 2010 load forecast, which was filed in Case No. 2010-00238 and which demonstrated a significant decline in its load growth, EKPC determined that it did not need additional base load capacity in the time frame within which Smith 1 was scheduled for completion. EKPC also determined that, under scenarios in which the completion of Smith 1 was delayed by either two or four years, constructing the unit would still not be the least cost alternative for meeting its future base load needs. As a result, EKPC and the parties to Case No. 2010-00238 entered into the Settlement which provides for EKPC to cancel Smith 1.

PROCEDURAL HISTORY

On December 16, 2010, the Commission issued a procedural schedule which provided for two rounds of discovery on EKPC and scheduled a formal hearing on February 8, 2011. Gallatin Steel Company ("Gallatin") and the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), sought and were granted intervenor status in this proceeding.[3] The AG issued one data request to which EKPC timely responded, while Gallatin issued no data requests. The Commission Staff issued two data requests to which EKPC filed timely responses.

An informal conference attended by the parties and Commission Staff was held at the Commission offices on January 25, 2011.[4] The formal hearing, which was a combined hearing for both this proceeding and Case No. 2010-00238, was held as scheduled on February 8, 2011. EKPC's responses to data requests made at the hearing were filed with the Commission on February 14, 2011. This completed the evidentiary record and this case now stands submitted for a decision.

DISCUSSION

In 2006, the Commission awarded EKPC a CPCN to construct Smith 1. In 2007, the Commission subsequently affirmed that decision upon finding a continued need for the unit.[5] Based on these Commission decisions, EKPC asserts that the amounts expended as construction costs on the unit were prudently incurred and, on that basis, EKPC claims that it should be permitted to create a regulatory asset for those costs and ultimately be permitted to recover those costs through the rates it charges to its 16 member distribution cooperatives ("Members").

In its application, EKPC noted that, on September 30, 2010, its Members' equity balance was $252.5 million. The loan covenants on its $450 million unsecured credit facility require that it maintain a minimum equity balance of $200 million and an equity-

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[3] Gallatin and the AG were among the parties to the Settlement in Case No. 2010-00238.

[4] This was a joint conference both for this case and Case No. 2010-00238.

[5] Case No. 2006-00564, An Investigation Into East Kentucky Power Cooperative, Inc.'s Continued Need for Certificated Generation (Ky. PSC May 11, 2007).

to-asset ratio of at least five percent at the end of each calendar quarter. If it had to write off its Smith 1 investment, EKPC would be in violation of those loan covenants, which would allow the lenders in its unsecured credit facility to declare it in default and demand immediate payment of the balance of the $450 million unsecured loan.

EKPC's request to establish a regulatory asset in this situation is guided by the standards contained in Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation" and SFAS No. 90, "Regulated Enterprises - Accounting for Abandonments and Disallowances of Plant Costs." Absent the creation of a regulatory asset, these standards would require that EKPC immediately write off its total investment in Smith 1, and doing so would trigger the default condition described above.

EKPC cites a prior case, Case No. 2008-00436,[6] in which the Commission summarized the categories of expenses that had previously been approved for inclusion in a regulatory asset. Those categories include:

> (1) an extraordinary nonrecurring expense which could not have reasonably been anticipated or included in the utility's planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry sponsored initiative; or (4) an extraordinary nonrecurring expense that over time will result in a saving that fully offsets the cost.

EKPC states that its instant request is within category (1) above because the extraordinary cost of writing off the investment in Smith 1 could not have reasonably been anticipated or included in its planning. It also claims that its request is within

[6] Case No. 2005-00436, The Application of East Kentucky Power Cooperative, Inc. for an Order Approving Accounting Practices to Establish a Regulatory Asset Related to Certain Replacement Power Costs Resulting from Generation Forced Outages (Ky. PSC Dec. 23, 2008).

category (4) above because its 20-year present value net requirements analysis shows that employing other power supply alternatives with full recovery of the Smith 1 costs is less costly than completing the construction of the unit.

EKPC states that it will seek to mitigate the amount of the regulatory asset by determining if components of the Smith 1 facility can be: (1) sold to another electric generator, either domestically or internationally; (2) used in its other circulating fluidized bed coal-fired units; (3) sold as scrap metal; or (4) some combination thereof. While it estimates that this process could take as long as 18 months, EKPC states that, to the fullest extent reasonably and practically possible, it will seek to mitigate the balance of the regulatory asset prior to seeking recovery of the cost of the asset.

On the issue of recovery of the regulatory asset for which it seeks Commission authorization, EKPC indicates that it will also request recovery of the cost of financing the asset. As the cost of Smith 1 represents a physical asset rather than expenses incurred in responding to an extraordinary event, such as a major storm-related outage, EKPC requires financing similar to what any other long-lived asset would require.

ANALYSIS

EKPC's request to establish a regulatory asset for the amounts expended on a generating facility which is being cancelled represents a matter of first impression for the Commission. However, the Commission's analysis of the accounting standards cited by EKPC, SFAS 71 and SFAS 90, brings us to the same conclusion as that of EKPC: absent the creation of a regulatory asset, EKPC will be obligated to write off its total Smith 1 investment in its books of account for calendar year 2010, placing it in technical default of the loan covenants for its unsecured credit facility. This would likely result in an impairment of EKPC's credit and its financial condition, and this would jeopardize its ability to continue providing electric service to its Members.

In its application, EKPC sought approval for a regulatory asset in the amount of \$163,448,904, based on construction account balances as of September 30, 2010 and EKPC's initial estimate of contract unwinding costs. During the course of discovery, a number of account balances were updated and the estimate of contract unwinding costs was refined,[7] such that the amount for which EKPC seeks a regulatory asset has been reduced to \$157,388,715.[8]

Having considered the evidence presented by EKPC, based on present circumstances and the Settlement offered in Case No. 2010-00238, the Commission finds that EKPC's expenditures for Smith 1 were prudently incurred. In addition, based on the significance of the decline in load growth reflected in EKPC's 2010 load forecast, the increased capital costs of Smith 1, and the impact of cancellation on EKPC's financial condition, the cost of cancellation must be considered an extraordinary nonrecurring cost which could not have reasonably been anticipated or included in EKPC's planning. Having accepted the Settlement reached in Case No. 2010-00238, which reflects EKPC's decision to cancel Smith 1, and based upon our review of EKPC's present value analysis of the costs of continuing with the construction of Smith 1, as well as the costs of pursuing other power supply alternatives, we find that it is less costly to cancel Smith 1 and recover the amount invested therein than it would be to complete construction of the unit. Therefore, the cost to cancel Smith 1 is similar to the

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[7] See EKPC's Response to Item 2 of Commission Staff's Supplemental Data Request, filed January 31, 2011.

[8] This reduced amount, as the original amount, does not reflect any mitigation.

types of expenses that the Commission has previously authorized for inclusion in a regulatory asset.

The Commission finds that EKPC's request for authority to establish a regulatory asset for the amounts it has expended on Smith 1, plus its updated estimate of contract unwinding costs, is reasonable and should be approved. This approval allows EKPC to establish a regulatory asset in the amount of $157,388,715, which reflects the most recent information provided to the Commission by EKPC in this proceeding.[9]

IT IS HEREBY ORDERED that:

1. EKPC is authorized to establish a regulatory asset in the amount of $157,388,715, which includes both amounts expended on Smith 1 and EKPC's estimate of the costs to unwind its Smith 1 vendor contracts.

2. EKPC shall, within 14 days of the date of this Order, file with the Commission the accounting entries made on its books of account to effectuate the creation of the Smith 1 regulatory asset.

3. EKPC shall file quarterly reports with the Commission summarizing the status of its mitigation efforts to reduce the balance of the regulatory asset through the sale of the Smith 1 physical assets, with the first report to be filed by July 1, 2011.

4. Any document filed in the future pursuant to ordering paragraphs 2 and 3 herein shall reference this case number and shall be retained in the utility's general correspondence file.

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[9] While the Settlement in Case No. 2010-00238 states that the parties agree that a ten-year amortization of the requested regulatory asset is reasonable, EKPC has not requested rate recovery in this case. Accordingly, recovery of the asset and the terms of that recovery are not part of this proceeding. We are now approving only the request to establish a regulatory asset, not the appropriate amortization period for that asset.

By the Commission

ENTERED

FEB 28 2011

KENTUCKY PUBLIC SERVICE COMMISSION

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