COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTH KENTUCKY RURAL ELECTRIC COOPERATIVE CORPORATION FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2011-00096

ORDER

On April 23, 2012, South Kentucky Rural Electric Cooperative Corporation ("South Kentucky") filed a petition, pursuant to KRS 278.400, requesting a rehearing of the Commission's March 30, 2012 Order ("Rate Order") approving an increase in electric rates of $3,715,879 annually. The Rate Order was issued in response to South Kentucky's application, accepted on July 28, 2011, requesting approval to increase its electric rates by $8,900,000 annually. In its pending request for rehearing, South Kentucky raises the following four issues that were adjudicated in the Rate Order:

1. The rejection of its new depreciation study and the disallowance of $1,189,025 of its proposed increase in annual depreciation expense;

2. The use of 15 years, rather than South Kentucky's proposed five years, to recover in rates the loss on the early retirement of mechanical meters;

3. The disallowance of a post-test-year adjustment to increase depreciation expense by $359,166 annually to reflect South Kentucky's projected post-test-year investment through September 30, 2012 in an Automated Metering Infrastructure ("AMI") project; and

4. The disallowance of South Kentucky's adjustment to increase the depreciation expense by $642,736 annually for the portion of the capital invested in the

AMI project that is to be funded by a grant from the United States Department of Energy ("DOE").

The Commission has fully considered each of the issues raised in South Kentucky's petition for rehearing and our findings on each issue are discussed below.

Depreciation Study

South Kentucky's rate application included a new depreciation study based on using the Simulated Plant Records ("SPR") method to develop a survivor curve analysis. When applying the SPR method, South Kentucky used a computer model that calculated simulated plant balances for each plant account group using different survivor curves. The computer model then determined the survivor curves that resulted in simulated balances that best matched the recorded book-plant balances of each group. The best-fitting curve was then used to determine each account group's average service life. The average service lives were used to determine each account group's depreciation rate.

South Kentucky chose to use the SPR method because it did not have the vintage accounting data necessary to determine the actual cost of plant retired each year. Although South Kentucky apparently maintains plant statistical data by vintage,[1] it does not maintain its plant accounting records using vintage information. Instead, South Kentucky maintains "continuous property records." Using these records, South Kentucky applied the "average cost approach" to determine the cost of retired property. As discussed in the Rate Order, South Kentucky unequivocally stated that its use of the average cost approach for its depreciation study resulted in the assignment of survivor

[1] Hearing Video Transcript beginning at 12:28:30.

curves that do not reflect actual plant mortality (i.e., the service lives of utility assets). Using survivor curves that do not reflect actual plant mortality produces service lives that are either too short or too long compared to the actual service lives of the assets. By using incorrect service lives, the resulting depreciation rates are either overstated or understated. Based on this evidence, the Commission rejected South Kentucky's depreciation study.[2]

In its request for rehearing, South Kentucky does not challenge the basis on which the Commission rejected the new depreciation study. South Kentucky presents no argument and points to no evidence in the record to demonstrate that the survivor curves used in its depreciation study accurately reflect the remaining useful lives of its plant in service. Rather, South Kentucky argues that the same "methods" used in its depreciation study to assign survivor curves were used in depreciation studies approved by the Commission in seven previous rate cases involving rural electric cooperatives. On two occasions in its petition for rehearing, South Kentucky states that in those prior cases the Commission approved the exact same "depreciation study" as submitted in this case.[3] South Kentucky now requests once again that the Commission approve the "methods" and "study" which it presented in support of its proposed depreciation rates.

---

[2] Commission's Final Order, dated March 30, 2012, at 20-21.

[3] Request for Rehearing at 2-3.

First, we note that six[4] of the seven rate cases referenced by South Kentucky were resolved by the Commission having accepted unanimous settlement agreements entered into by the utility and the Attorney General's Office. Each of those six settlement agreements contains similar provisions stating that the settlement "is submitted for purposes of this case only and is not deemed binding upon the parties hereto in any other proceeding, nor is it to be offered or relied upon in any other proceeding involving [the settling utility] or any other utility." In addition, the Commission's Orders approving those settlement agreements clearly stated that our approval of the settlements is based solely on their reasonableness in "toto" and does not constitute approval of any specific ratemaking adjustment or theory. While the Order approving the rate settlement for Big Sandy Rural Electric Cooperative Corporation in Case No. 2008-00401 does find that the proposed depreciation rates contained in the settlement are reasonable, that Order also finds that no ratemaking adjustment or theory is being approved. Thus, the approval of the settlement agreements in those rate cases does not establish any precedence, and South Kentucky's reliance on those cases is misplaced.

The Commission has also reviewed the record of the one prior rate case referenced by South Kentucky that was not resolved by a settlement agreement, Case No 2005-00187, which was filed by Cumberland Valley Electric, Inc. ("Cumberland

[4] Case No. 2007-00022, Fleming-Mason Energy Cooperative (Ky. PSC Dec. 20, 2007); Case No. 2008-00011, Bluegrass Energy Cooperative Corporation (Ky. PSC Aug. 28, 2008); Case No. 2008-00254, Grayson Rural Electric Cooperative Corporation (Ky. PSC June 3, 2009); Case No. 2008-00401, Big Sandy Rural Electric Cooperative Corporation (Ky. PSC June 3, 2009); Case No. 2009-00016, Licking Valley Rural Electric Cooperative Corporation (Ky. PSC Dec. 11, 2009); and Case No. 2009-00314, Clark Energy Cooperative, Inc. (Ky. PSC Apr. 16, 2010).

Valley").[5] The Commission's Order in that case did accept without discussion Cumberland Valley's depreciation study, but the record in that case is devoid of any evidence suggesting that Cumberland Valley's use of the average cost approach resulted in the assignment of survivor curves that did not match the actual mortality of its plant in service. In the present case, however, South Kentucky's evidence showed that the use of the average cost approach does result in the assignment of survivor curves that do not match the actual mortality of its plant in service.

Second, while other electric cooperatives have proposed new depreciation rates based on the SPR method, each of those cooperatives has filed its own unique depreciation study which utilizes its own specific plant balances. In prior cases, the Commission has approved depreciation rates that resulted from a utility-specific "study" that was based on the SPR method. However, there was no evidence in those prior cases that the utility was using inappropriate service lives for calculating depreciation rates. The "average cost approach," as utilized here by South Kentucky, overstated the cost of retirement units and understated the cost of survivor units, resulting in steeper survivor curves than would be assigned to plant accounts if vintage accounting data had been used. The evidence in the record of this case shows that South Kentucky has made no adjustment to its depreciation study to correct for survivor curves that do not accurately reflect the service lives of its utility plant. Therefore, the Commission denies rehearing on this issue.

[5] Case No. 2005-00187, Adjustment of Rates of Cumberland Valley Electric, Inc. (Ky. PSC June 2, 2006).

The Commission will take this opportunity to advise South Kentucky that if it decides to submit another depreciation study, consideration should be given to using its vintage plant statistical information when performing the survivor curve analysis. Using this information, survivor curves would be matched to actual plant retirement dispersions stated as units of property. This may result in the assignment of survivor curves that reflect actual plant mortality.

<u>Amortization Period for Loss on the Retirement of Mechanical Meters</u>

As a result of South Kentucky's AMI project, it will realize a loss on the retirement of its old mechanical meters. It determined the total amount of the loss to be $3,723,715 and requested special accounting treatment so that the loss could be amortized and recovered from ratepayers by being included in rates. South Kentucky proposed to amortize the loss over a five-year period for ratemaking purposes. This proposal to include one-fifth of the loss in rates would result in South Kentucky's rates being increased by $744,743 annually. The Rate Order approved the special accounting treatment but denied the proposed five-year amortization. Instead, a 15-year amortization period was approved to match the depreciable life of the AMI project.

South Kentucky requests the Commission reconsider its decision to use a 15-year amortization period and approve the five-year period as originally proposed. South Kentucky does not challenge or dispute the findings in the Rate Order regarding the accounting requirements prescribed by the Rural Utilities Service ("RUS") Uniform System of Accounts ("USoA") or our statement that "the utility's choice of a depreciation method should have no effect on the period of time over which the loss is recognized and paid for by ratepayers."[6] Rather, South Kentucky supports its request for rehearing by citing a Commission Order approving Shelby Energy Cooperative, Inc.'s ("Shelby Energy") request, in Case No. 2012-00102,[7] to use a five-year amortization period for its loss on the retirement of mechanical meters due to an AMI project. South Kentucky simply requests the Commission to use the same five-year amortization period as approved in the Shelby Energy case.

Based on a review of the five-year amortization approved in the Shelby Energy case, as well as a similar amortization approved in a case filed by Taylor County Rural Electric Cooperative Corporation ("Taylor County"),[8] the Commission finds that in neither case did the utility request, nor did we approve, an increase in rates to recover the amortization. Both Shelby Energy and Taylor County are continuing to charge their existing rates that were not increased to recover the amortization of their losses. Thus, the use of a five-year amortization period has no impact on the rates that are charged by either of those utilities and paid for by their respective customers. In each of those cases, the orders approving the amortizations explicitly stated that the five-year periods were approved for accounting purposes only, and that any decision regarding rate

[6] Rate Order at 25.

[7] Case No. 2012-00102, Request of Shelby Energy Cooperative for Approval to Establish a Regulatory Asset in the Amount of $443,562.75 and Amortize the Amount over a Period of Five (5) Years (Ky. PSC April 16, 2012).

[8] Case No. 2008-00376, Filing of Taylor County Rural Electric Cooperative Corporation Requesting Approval of Deferred Plan for Retiring Meters (Ky. PSC Dec. 9, 2008).

recovery of the losses being amortized would be deferred until each utility filed its next rate proceeding.[9]

In this case, South Kentucky has not requested an amortization period to be used for accounting purposes only. Rather, it has requested an amortization period over which the loss should be recovered in rates. The Rate Order discussed the proper accounting for the removal of depreciable assets as prescribed by the RUS USoA. Specifically, the Rate Order stated that under RUS USoA accounting, gains and losses flow through the accumulated depreciation account so that when remaining life depreciation is used, the gains and losses are recognized over the life of the assets remaining in service. When depreciation rates are determined using the whole life method, gains and losses will not be charged against revenue unless an accounting treatment alternative to that prescribed by the RUS USoA is allowed.

In this instance, South Kentucky requested, and the Commission approved, depreciation rates using the whole life method. South Kentucky proposed an alternative accounting treatment so the loss on the early retirement of its mechanical meters would be charged against income. It proposed to record the loss as a regulatory asset to be amortized over five years for both accounting and rate recovery. Citing the magnitude of the loss relative to the meter account balance, the Commission allowed the recording of the regulatory asset. However, in approving this accounting treatment, we found that the use of whole life depreciation should not impact the period of time over which the loss should be charged against income. We further found that, had remaining life

[9] Case No. 2008-00376, Order dated December 9, 2008, at 3; Case No. 2012-00102, Order dated April 16, 2012, at 4.

depreciation been used to calculate depreciation rates, South Kentucky's loss on the mechanical meters would have been recognized for accounting and for rate purposes over the 15-year life of the new AMI project. Accordingly, we required that the loss be amortized for both purposes over 15 years.

Requiring South Kentucky to recover its loss on retired meters over 15 years is clearly not inconsistent with our prior decisions for Shelby Energy and Taylor County. The Commission denies South Kentucky's request for rehearing on the use of a 15-year amortization period for the loss on mechanical meters.

Cut-Off Date for the AMI Project

In its request for rehearing, South Kentucky again requests recovery of depreciation on the total projected cost of its AMI project, slated for completion by September 2012. South Kentucky asserts that the projected cost of the AMI project was known and measurable and should be allowed.

The test year chosen by South Kentucky was the 12 months ending September 30, 2010. The anticipated completion date of its AMI project is September 2012, two years beyond the test-year-end. South Kentucky proposed to go two years beyond the end of the test year to recover rates at the level of depreciation expense that is projected to exist based on the projected total cost of the AMI project. This request was denied in the Rate Order on the basis that it violated the Commission's long recognized application of the "matching principal," which requires all revenues, expenses, rate base components, plant additions, and capital items to be updated to the same period. The Commission has long recognized the matching principle when establishing rates for rural electric cooperatives, especially with regard to expense adjustments arising from post-test-year capital investments such as at issue here. In previous cases, the Commission has consistently disallowed adjustments to test-year interest expense on long-term borrowings that were secured subsequent to the end of a test year.[10]

As the Commission found in the Rate Order, while South Kentucky proposed adjustments to update its depreciation expense on meters and investment in meters to the levels projected to exist as of September 30, 2012, it did not similarly propose adjustments to update all other expenses and investments, or its revenues and rate base components, to reflect the levels projected to exist as of September 30, 2012. We also found that disallowing the proposed adjustment to update for the projected level of depreciation actually resulted in greater revenues to South Kentucky than would have been granted if the requested September 30, 2012 update had been accepted due to significantly offsetting changes in revenues and operating and maintenance ("O&M") expenses.[11]

In neither its rate application nor its request for rehearing did South Kentucky propose changes to the O&M expenses associated with the deployment of its AMI project. In the Rate Order, Table 1 at 8, the net allowable change to revenues and O&M expenses, based on the test-year-end cut-off, was a $154,807 decrease to operating expenses. However, under South Kentucky's proposal to allow depreciation on the AMI project through September 30, 2012, a net adjustment to net revenues and O&M expenses of $713,919 ($868,726 less $154,807) would have been required to

[10] Case No. 10275, Green River Electric Corporation Notice of Increase in Rates for Retail Electric Service (Ky. PSC Dec. 27, 1988).

[11] Final Order, page 8, Table 1.

accurately reflect the operating expenses related to the AMI project. This would have decreased operating expenses by $713,919, and would have had to have been recognized if the cut-off for the AMI project was extended to September 30, 2012 as South Kentucky requested. For these reasons, the Commission denies rehearing on this issue.

Depreciation on the Portion of the AMI Project Funded by a DOE Grant

South Kentucky's final issue on rehearing is the Commission's disallowance of depreciation on the portion of the AMI project funded with a DOE grant. The total cost of the AMI Project is estimated to be $19,636,215. South Kentucky has been awarded a DOE grant in the amount of $9,538,234 to fund 49 percent of the project. In the Rate Order, the Commission disallowed depreciation on the portion of the AMI project to be funded by the grant. The Rate Order rejected South Kentucky's reliance on the Kentucky Supreme Court's decision in *Public Service Commission of Kentucky v. Dewitt Water District, 720 S.W.2d 725 (KY. 1986)*, ("Dewitt decision") for the proposition that the cost of plant acquired through a grant is recoverable in the rates of an electric cooperative utility. South Kentucky seeks rehearing to allow rate recovery of depreciation expense on the full cost of the AMI project, including the portion to be funded by the DOE grant.

The Rate Order included an extensive discussion of South Kentucky's obligation to comply with the RUS USoA and the requirements thereunder which state that "[t]he electric plant accounts shall not include the cost or other value of electric plant contributed to the company."[12] South Kentucky's proposal on this issue is contrary to

[12] Rate Order at 9, citing 7 CFR 1767.16(b)(4).

the required accounting rules, and its request for rehearing fails to address this aspect of the issue. Rather, South Kentucky merely restates the argument it previously presented as to why it should be treated the same as a water district for purposes of coming within the provisions of the Dewitt decision. But as the Commission stated in the Rate Order at 11, the Dewitt decision relies on accounting rules for sewer utilities and, more specifically, the controlling provision of KRS 74.480(2)(c), which requires the rates for certain water utilities "[t]o provide an adequate fund for renewals, replacements, and reserves." South Kentucky is not a water utility, it is not covered by the provision of KRS 74.480(2)(c) or any other provision of KRS Chapter 74, and as an electric cooperative that borrows funds from RUS to finance construction projects, it must comply with the RUS USoA. South Kentucky's petition for rehearing does not address any of these points even though they are discussed in the Rate Order.

As an RUS borrower, South Kentucky is required to comply with RUS Bulletin 183-1, entitled "Depreciation Rates and Procedures." That bulletin provides, in pertinent part, as follows:

> II. Depreciation Defined: Depreciation is defined in the REA Uniform System of Accounts as "the loss in service value of depreciable plant not restored by current maintenance resulting from causes against which no insurance is carried, such as wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand, and requirements of public authorities."
>
> III. Objectives of Depreciation Accounting:
>
> A. The objective of depreciation accounting is to charge to expense the capital investment in certain fixed assets, less salvage at time of retirement, over their useful lives. Thus it may be said that the cost of capital investments in plant is

> recovered by means of proper depreciation accounting. The useful life of such assets is dependent upon such factors as use, misuse, maintenance and obsolescence. The charge to expense is accomplished by establishing depreciation rates as a percentage. This percentage is applied to the asset cost to yield a monthly or annual amount of depreciation expense.
>
> B. Depreciation accounting provides for the systematic, periodic writedown or allocation of the cost of a limited-life asset or asset group. The established rate of depreciation should recognize useful life and recovery values. Depreciation is not intended to provide funds for replacement, nor is it to be legitimately considered as a means to make a desirable showing on the revenue and expense statement.

South Kentucky agrees with this definition of depreciation as being the recovery of investment, and it adopted this definition in the study it filed in support of its application in this case. This RUS Bulletin further reinforces the findings in the Rate Order. As noted in the Rate Order, the RUS USoA provides that "[t]he electric plant accounts shall not include the cost or other value of electric plant contributed to the company. "[Contributions such as grant funds] shall be credited to accounts charged with the cost of such construction . . . [and] shall be shown as a reduction to gross plant constructed."[13] Thus, grant funds are not accounted for as investment in plant, grant funds are not recoverable through depreciation, and "[d]epreciation is not intended to provide funds for replacements."[14]

The Rate Order also demonstrated that the level of depreciation expense included in South Kentucky's revenue requirements is sufficient for South Kentucky to

---

[13] Rate Order at 9, 7 CFR 1767.16(b)(4).

[14] RUS Bulletin 183-1 at 1-2.

pay annual debt principal retirements on all of its long-term debts outstanding as of the end of the test year and to fund the level of plant improvements historically paid from its internal funds. Therefore, there is no need for South Kentucky to recover the cost of the DOE grant as a component of depreciation to provide funds for "renewals and replacements."

Furthermore, to depreciate the entire cost of the AMI project, South Kentucky must deviate from the accounting requirements of the RUS USoA when recording the DOE grant. As discussed in more detail in the Rate Order, the DOE grant is a Contribution in Aid of Construction which is required by the RUS USoA to be credited to the plant accounts that are charged [debited] with the cost of construction. South Kentucky instead requests to credit account 208, Donated Capital, for the amount of the DOE grant. This accounting treatment would increase the depreciable basis in the AMI project by the amount of the grant.

In a previous section of this Order, we reaffirmed an accounting treatment alternative to that prescribed by the RUS USoA when reporting the loss on mechanical meters; however, in conjunction with that alternative treatment, we required that the loss be amortized over a 15-year period. This action insured that the alternative treatment would have the same effect on South Kentucky's revenue requirements, and its ratepayers, as if the prescribed accounting treatment been applied. With respect to the DOE grant, there are no conditions that can be placed on South Kentucky's requested accounting treatment to ensure that there will be no adverse effects on its ratepayers. If South Kentucky is allowed to report the grant in account 208, the depreciable basis in the AMI Project will be greater than South Kentucky's investment in that project. This would result in excessive depreciation which would have to be collected by increasing rates above their current levels. South Kentucky has not presented sufficient evidence to support increasing its current rates to recover from ratepayers depreciation on the portion of the AMI project in which South Kentucky has no investment. Therefore, we reaffirm our previous decision that the DOE grant should be accounted for in accordance with the USoA as a credit to the asset account to which the cost of the AMI project is charged, and South Kentucky's rehearing request on this issue is denied.

IT IS THEREFORE ORDERED that South Kentucky's petition for rehearing of the March 30, 2012 Order is denied.

By the Commission

ENTERED

MAY 11 2012

KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

Allen Anderson
Manager
South Kentucky R.E.C.C.
925-929 N. Main Street
P. O. Box 910
Somerset, KY 42502-0910

Stephen Johnson
Vice President of Finance
South Kentucky R.E.C.C.
925-929 N. Main Street
P. O. Box 910
Somerset, KY 42502-0910

Honorable Darrell L Saunders, P.S.C.
Attorney at Law
700 Master Street
P.O. Box 1324
Corbin, KENTUCKY 40702