COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE 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 IN MASON COUNTY, KENTUCKY	)	CASE NO. 2004-00423

O R D E R

On October 28, 2004, East Kentucky Power Cooperative, Inc. ("East Kentucky Power") filed an application for a Certificate of Public Convenience and Necessity ("CPCN") under KRS 278.020(1), and a Site Compatibility Certificate under KRS 278.216, to construct a 278 megawatt ("MW") circulating fluidized bed ("CFB") coal-fired base load generating unit at its Spurlock Generating Station ("Spurlock") in Maysville, Kentucky. The proposed generating unit, referred to as "Spurlock 4," has an estimated capital cost of approximately $473 million including transmission facilities.

The Attorney General's Office and Gallatin Steel, the largest retail customer of electricity supplied by East Kentucky Power, requested and were granted intervention. EnviroPower, LLC ("EnviroPower"), a developer of a merchant power plant in Knott County, Kentucky, filed two requests to intervene. Those requests to intervene were

denied by Commission Orders dated February 3, 2005 and April 18, 2005.[1] The Commission established a procedural schedule that provided an opportunity for discovery, intervenor testimony, and a public hearing, which was held on June 13, 2005.

In addition to investigating East Kentucky Power's need for additional generating capacity and the reasonableness of its proposed Spurlock 4 project, the Commission has also investigated East Kentucky Power's solicitation and evaluation of power supply bids. Specific issues relating to East Kentucky Power's bid solicitation and evaluation process were raised by EnviroPower in this case and in Case No. 2005-00053.[2] Since East Kentucky Power conducted only one bid solicitation and evaluation process which was used to select the generation projects proposed in both cases, all bidding and evaluation issues were designated to be investigated in this case.[3]

BACKGROUND

East Kentucky Power is a generating and transmission cooperative which is organized under KRS Chapter 279 and currently provides service to 16 electric distribution cooperatives in Kentucky. On May 27, 2004, East Kentucky Power executed a Special Membership Agreement with Warren Rural Electric Cooperative Corporation ("Warren RECC"). Warren RECC, which has historically purchased its

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[1] The denial of intervention to EnviroPower was affirmed by the Franklin Circuit Court. See EnviroPower v. Public Service Commission, et al., Civil Action No. 05-CI-00553 (Franklin Cir. Ct. July 27, 2005).

[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.

[3] Case No. 2005-00053, Order dated April 18, 2005.

power supply from the Tennessee Valley Authority ("TVA"), is not subject to the Commission's regulatory jurisdiction. Thus, the Commission has no authority to review the reasonableness of the decision by Warren RECC to become a member of East Kentucky Power.

Under the terms of the membership agreement, East Kentucky Power is obligated to provide electric service to Warren RECC commencing April 1, 2008, upon the termination of Warren RECC's current supply contract with TVA. Warren RECC will become East Kentucky Power's 17th distribution cooperative. To ensure that there are no adverse impacts to East Kentucky Power's existing cooperatives, the agreement with Warren RECC requires it to pay the incremental costs of the generation and transmission needed to serve its load.

NEED FOR ADDITIONAL GENERATION

East Kentucky Power had previously filed in April 2003 an Integrated Resource Plan ("IRP") containing 20-year forecasts of electric loads and capacity needs.[4] That IRP projected a need for additional base load generation of approximately 270 MW by 2011 and additional peaking generation of approximately 500 MW in the 2004 through 2009 time period. East Kentucky Power then applied for, and was granted in January 2004, a CPCN to construct two combustion turbines ("CTs") totaling 160 MW of peaking capacity at its Smith Generating Station ("Smith") in Clark County, Kentucky.[5] Known

[4] Case No. 2003-00051, The 2003 Integrated Resource Plan of East Kentucky Power Cooperative, Inc.

[5] Case No. 2003-00297, Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity, and a Site Compatibility Certificate, for the Construction of Two 80 MW Combustion Turbine Generating Units in Clark County, Kentucky, Order dated January 5, 2004.

as the Smith CT Nos. 6 and 7, these units will provide approximately 150 MW of summer peaking capacity, and they reduced East Kentucky Power's five-year forecasted need for peaking capacity to approximately 350 MW.

In order to serve the incremental load of Warren RECC in 2008 and maintain a target 12 percent reserve margin, East Kentucky Power determined that it needed 270 MW of additional base load generation and 200 MW of peaking generation.[6] When the additional generation needed to serve Warren RECC is combined with that identified in East Kentucky Power's IRP as needed to serve existing customers, the total generation needed is 550 MW of base load and 550 MW of peaking. Based on East Kentucky Power's load forecast for its existing customers and its analysis of the load for Warren RECC, the Commission finds that those load projections are reasonable and they demonstrate a need for 550 MW of base load and 550 MW of peaking generation. In particular, East Kentucky Power's forecast demonstrates that 270 MWs of base load generation are needed to serve Warren RECC beginning in April 2008.

PROPOSED GENERATING PROJECT

On April 2, 2004, East Kentucky Power issued a Request for Proposals ("RFP") seeking power supply bids based on its projected need for additional base load and peaking generating capacity.[7] East Kentucky Power's RFP invited power suppliers to submit bids of up to 550 MW of base load generation, with a minimum bid of 100 MW, and up to 550 MW of peaking generation, also with a minimum bid of 100 MW. The

[6] Application Exhibit 3.

[7] See Exhibit 1 to Supplemental Testimony of David G. Eames, filed February 14, 2005.

deadline for submitting a bid was May 7, 2004, and any bidder was required to guarantee its price for at least 60 days, but preferably 90 days.[8] East Kentucky Power received 39 bids in response to its RFP, including its own self-construct bid.

East Kentucky Power hired Enervision, Inc. ("Enervision"), an energy services consultant with offices in Tucker, Georgia, to review and rank the bids based on their economic value. To ensure the comparability of the bids, all of the detailed analyses of the bids were done on a present value basis of the projected costs over 32 years. Of the 39 bids received, only 14 were analyzed in detail. The others were eliminated after a preliminary review because they were not in compliance with the RFP or were priced too high.

Enervision, working independently of East Kentucky Power, conducted a detailed economic analysis of the remaining bids in its offices, while East Kentucky Power simultaneously conducted its own analysis in its offices. Upon completion of both analyses, East Kentucky Power sent its results to Enervision for comparison. The results of both were very similar, and they both had concluded that the best and lowest-cost bid was East Kentucky Power's self-construct bid for Spurlock 4 in 2008 and an identical base load unit in 2009, plus 550 MWs of peaking capacity in the form of simple cycle CTs to be installed at Smith. On a present value basis, utilizing a 3 percent discount rate, the Spurlock 4 unit has a total present value revenue requirement of $1.447 billion, while the EnviroPower bid for a similar quantity of power has a present

[8] Id. at 7.

value revenue requirement of $1.632 billion.[9] The same calculations with a 6 percent discount rate show Spurlock 4 to be $0.909 billion, while EnviroPower is $1.016 billion.[10]

After selecting its self-construct bid, East Kentucky Power elected to file two separate CPCN applications with the Commission: the instant application, which is limited to Spurlock 4; and a subsequent application, docketed as Case No. 2005-00053, which includes an identical CFB unit at Smith, known as "Smith 1," and the 550 MWs of CTs. The instant application was supported by the prepared testimonies of seven witnesses and summaries of the economic analyses of the power supply bids.

BIDDING PROCEDURES AND EVALUATION PROCESS

In its first request to intervene, filed on January 14, 2005, EnviroPower raised what then appeared to be serious questions regarding East Kentucky Power's RFP and its evaluation of the power supply bids. EnviroPower filed an affidavit of Randall Bird, an officer of EnviroPower, which stated that EnviroPower was an unsuccessful bidder in East Kentucky Power's power supply solicitation. He alleged that even though EnviroPower submitted the lowest-cost power supply bid, East Kentucky Power selected its own self-construct bid because the procedures it utilized for receiving and evaluating the bids were not transparent and may have been less than objective to achieve a preordained outcome.

On February 3, 2005, the Commission denied EnviroPower's request to intervene, but added its name to the service list so it could monitor the case and submit

[9] East Kentucky Power Response to Commission Staff Second Data Request, Item No. 1 at 3, filed January 10, 2005.

[10] Id.

additional information and comments.[11] In a separate Order issued that same day, the Commission opened an investigation of East Kentucky Power's bidding procedures and evaluation process. That Order recognized the serious nature of EnviroPower's allegations, but noted that its affidavit "set forth bare allegations and very few facts."[12] The Commission directed East Kentucky Power to file: (1) additional documents relating to its RFP and bid evaluation process, including the filing of each bid received and the spreadsheets that summarize its evaluation and ranking of each bid; and (2) supplemental testimony on its bidding procedures and evaluation process, including testimony from Enervision regarding its role in evaluating the bids. Since most of the bids had been received by East Kentucky Power under requests for confidentiality, the bids and spreadsheets were filed with the Commission on a confidential basis

The specific issues raised by EnviroPower in its affidavit and subsequently filed comments included the following: (1) the RFP fails to disclose that East Kentucky Power's self-construct option was designed to win the award, not merely be used as a benchmark; (2) the RFP was unusually structured to allow East Kentucky Power to submit a self-construct bid and to evaluate all other bids; (3) the absence of a simultaneous public opening of all bids; (4) the lack of objective methodology to review the bids; (5) a request by East Kentucky Power for EnviroPower to increase its bid price; (6) the possibility that the bid evaluation improperly favored adding generation at the Spurlock and Smith sites to resolve a pending lawsuit filed on behalf of the

[11] EnviroPower did submit additional documents, filed comments in the form of testimony, and attended the public hearing but declined the opportunity to present comments at the hearing.

[12] February 3, 2005 Order at 1.

Environmental Protection Agency ("EPA") alleging Clean Air Act violations; (7) the Spurlock 4 costs are only estimates, while EnviroPower's construction costs are firm; (8) the failure to properly value EnviroPower's price and performance guarantees; (9) the omission of an inflation factor from the evaluation of the cost of the capital discount rate; and (10) the failure to recognize EnviroPower's lower cost of financing.

Based on a review of the record, including the contents of the power supply bids and each of the specific issues raised by EnviroPower, the Commission finds that East Kentucky Power, in conjunction with Enervision, properly evaluated EnviroPower's bid. Based on a review of all the economic analyses filed by East Kentucky Power, the Commission is able to independently confirm that East Kentucky Power's self-construct Spurlock 4 bid is the best and lowest cost. EnviroPower did not participate in developing East Kentucky Power's RFP or in evaluating any of the bids received. Consequently, EnviroPower has no first-hand knowledge of these issues. In addition, EnviroPower has not seen the cost components of East Kentucky Power's bid which were utilized to calculate its net present value for evaluation purposes. EnviroPower's role during the evaluation process was limited to providing clarifying information when asked to do so by East Kentucky Power and Enervision for use in their evaluation of the bids. Each of the major issues raised by EnviroPower will now be discussed briefly.

EnviroPower claims that East Kentucky Power did not clearly state that its self-construct option was more than a benchmark. However, East Kentucky Power's RFP clearly states on page 1 that East Kentucky Power "tentatively plans to file an application with the … Commission … for a [CPCN] and site compatibility," and that the RFP is being issued "in conjunction with EKPC's application to the PSC in order to

evaluate alternatives to EKPC's self-build options."[13] These disclosures negate any claim that East Kentucky Power's self-construct option was intended to be only a benchmark for evaluating other bids.

The RFP process was neither unusual nor irregular. There are no Kentucky statutes or regulations that require East Kentucky Power to utilize a competitive bidding process for adding new generating capacity. East Kentucky Power is not a public agency and it is not engaged in the awarding of a public contract. Although the Commission is a public agency, it is not awarding a contract, is not a party to any contract, and is not awarding the expenditure of any public funds. Rather, the Commission is being asked to award a CPCN, which is a statutory license needed by a regulated utility to construct facilities based on a showing of need. Thus, none of the requirements for bidding public contracts are applicable here.

East Kentucky Power utilized competitive bids to comply with a financing requirement of its lender, the Rural Utilities Service ("RUS"), and to demonstrate that it had selected the best and lowest-cost bid. East Kentucky Power previously utilized identical bidding procedures, i.e., soliciting bids and then evaluating them along with its own self-construct bid, in Case Nos. 2003-00297 and 2001-00053.[14] East Kentucky

[13] East Kentucky Power RFP No. 2004-01-Power Supply Resources, Exhibit 1 to the Supplemental Testimony of David G. Eames, filed February 14, 2005.

[14] Case No. 2001-00053, Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity, and a Certificate of Environmental Compatibility, for the Construction of a 250 MW Coal-Fired Generating Unit (With a Circulating Fluid Bed Boiler) at the Hugh L. Spurlock Power Station and Related Transmission Facilities, Located in Mason County, Kentucky, To Be Constructed Only in the Event That the Kentucky Pioneer Energy Power Purchase Agreement Is Terminated.

Power also established a "wall" to ensure that no cost information was shared between its Power Production Business Unit, which prepared its self-construct proposals, and its Finance and Planning Unit, which was involved in evaluating the power supply bids.[15] In addition, Enervision had no contact with the East Kentucky Power personnel who worked on its self-construct bid.[16] Considering that the bids were actually evaluated by Enervision, acting independently of East Kentucky Power, and that the Commission has been able to verify the accuracy of that evaluation, the structure of the RFP was not improper or inherently unfair.

The absence of any Kentucky statutes or regulations applicable to the RFP means that there is no obligation for East Kentucky Power to conduct a simultaneous public opening of all bids. In fact, considering that most of the bidders, including EnviroPower,[17] expressly requested that their entire bids be held confidential, a public bid opening would serve no useful purpose.[18] There is nothing unusual about conducting a private opening of power supply bids.[19]

Contrary to EnviroPower's claims, an objective methodology to evaluate the bids did exist and was used by Enervision to analyze the economics of the bids. Bid

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[15] Transcript of Evidence at 54, 105-107.

[16] Testimony of Lynne S. Travis ("Travis Testimony"), filed on February 14, 2005, at 3-4.

[17] EnviroPower's Petition for Confidentiality, filed on March 30, 2005.

[18] Transcript of Evidence at 48-49.

[19] Travis Testimony at 3.

evaluation criteria were developed by Enervision, with input from East Kentucky Power, after the RFP was issued.[20]

With regard to a bidder's pricing proposal, the RFP requested that bids include a guaranteed price for at least 60 days, but preferably 90 days. EnviroPower's bid complied with this request. However, East Kentucky Power was unable to complete its review of all the bids within that time frame. After the guaranteed pricing period had expired, East Kentucky Power called EnviroPower to inquire whether it needed to increase its bid price to reflect the then recent price increases in commodities such as cement and steel.[21] East Kentucky Power also inquired if EnviroPower was willing to supply half of its base load capacity, i.e., approximately 275 MW rather than 550 MW, and if doing so would affect the pricing.[22] Although EnviroPower agreed to hold its base load power bid firm, it did subsequently increase its peaking power bid by almost 18 percent.[23] Under these circumstances, there is nothing unusual about East Kentucky Power's inquiry to EnviroPower regarding an increase in its bid price.

With regard to the pending EPA lawsuit, there is substantial evidence to demonstrate that adding new generation at specific locations on the East Kentucky Power system has not been an issue in either the litigation itself or the discussions to

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[20] Transcript of Evidence at 46-47.

[21] Id. at 70-72.

[22] Supplemental Testimony of David G. Eames ("Eames Supplemental Testimony"), filed February 14, 2005, at 7-8.

[23] Id. at 5-6.

resolve that litigation.[24] Thus, the Commission is able to conclusively eliminate the possibility alleged by EnviroPower that East Kentucky Power manipulated the bidding process to improve its position in the EPA litigation.

East Kentucky Power's self-construct bid utilized estimated construction costs that were developed by its consulting engineer, Stanley Consultants. East Kentucky Power most recently used Stanley Consultants in conjunction with the construction of the 268 MW CFB Gilbert unit, which entered commercial operation in April 2005 at Spurlock. The Gilbert unit is virtually identical to the proposed Spurlock 4, except for a slight increase in output. Considering the similarity of the units and the proximity in time of Gilbert's completion, there is no valid reason to question the accuracy of the estimated cost for Spurlock 4.

EnviroPower's bid included a number of price and performance guarantees. For example, it proposed to guarantee the cost of purchased power that might be needed if it was unable to complete its project by the April 1, 2008 due date. In evaluating the bids, East Kentucky Power assumed that any bidder that committed to supply power as of April 1, 2008 would be able to live up to its commitment. Consequently, no additional economic value was added to EnviroPower's bid for this guarantee.[25] The Commission finds East Kentucky Power's evaluation of this guarantee to be reasonable. The guarantee appears to be little more than an acknowledgement of the damages that EnviroPower would be legally responsible for under contract law for missing the contract delivery date.

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[24] Supplemental Testimony of Robert E. Hughes, Jr., filed April 5, 2005, at 1-2.

[25] Eames Supplemental Testimony at 8.

EnviroPower also proposed an 88 percent availability for its base load power, while East Kentucky Power evaluated all bids on an 80 percent availability basis. EnviroPower's higher availability factor was not valued higher by East Kentucky Power because East Kentucky Power would not be able to economically dispatch the EnviroPower capacity. Rather, East Kentucky Power would have to purchase all the capacity available from EnviroPower on a round-the-clock basis, even though the full amount of the base load capacity was not otherwise needed during off-peak hours. Again, there is no reasonable basis to fault East Kentucky Power's evaluation of this factor.

The economic valuations of the power supply bids were performed by utilizing two different discount rates: 3 percent and 6 percent. The 3 percent rate was selected to approximate the future rate of inflation, while the 6 percent rate was selected to approximate East Kentucky Power's cost of capital. Since East Kentucky Power finances its capital projects by utilizing 100 percent long-term debt issued by RUS, 6 percent is a reasonable proxy for its cost of capital.

Contrary to EnviroPower's allegation, East Kentucky Power did not inappropriately omit an inflation factor from its 6 percent discount rate. East Kentucky Power's cost of debt will not be subject to inflation. It will be fixed and will not escalate over the 32 years that the bids were analyzed.[26]

[26] Second Supplemental Testimony of David G. Eames, filed April 5, 2005, at 3-4.

While EnviroPower claims that its financing costs are lower than those of East Kentucky Power, EnviroPower's analysis does not support its claim.[27] Unlike East Kentucky Power, which is able to utilize 100 percent debt financing, EnviroPower's bid was based on a mix of debt and equity financing. The interest rate that it has secured on its debt is higher than the interest rate that East Kentucky Power anticipates securing.[28] In addition, EnviroPower's analysis fails to recognize and reflect its equity cost.

In claiming to have a lower financing cost, EnviroPower simply ignores the equity component of its capital structure, thereby treating its equity as if it were cost free. Clearly, in today's economic climate, no rational investor would supply long-term equity financing unless there is an opportunity to earn a return that exceeds the return to debt investors.[29] In any event, the issues of whether EnviroPower's financing costs are lower than East Kentucky Power's, or whether EnviroPower's construction costs are less, are not relevant due to EnviroPower's bid pricing. Rather than proposing a bid price based on revenue requirements, i.e., actual annual costs plus a return, as did East Kentucky Power, EnviroPower's bid price consisted of demand and energy charges that escalated over time. Thus, even assuming that EnviroPower has a lower financing cost and a lower project construction cost, its total bid price exceeds East Kentucky Power's bid

[27] Rotondi Comments, at 51-53, filed March 30, 2005 (redacted version).

[28] Id. at 51 (confidential version).

[29] Transcript of Evidence at 77-78.

price.[30] This excess, commonly known as profit, is what EnviroPower needs to compensate its equity investors.[31]

In summary, the Commission finds that East Kentucky Power properly evaluated EnviroPower's bid and properly determined that it was not the best and lowest cost. Evaluating long-term power supply bids and construction options is not purely a science. It involves some degree of art, in the form of discretion and common sense. In 1999, East Kentucky Power chose to purchase power under a long-term contract rather than self-construct generation. Unfortunately, after a delay of over 2 years, that seller was unable to finance its project and East Kentucky Power had to proceed expeditiously to self-construct the Gilbert 1 unit. East Kentucky Power waited an additional 3 years before finally terminating that purchase power agreement.[32] Thus, there is no basis to claim that East Kentucky Power is biased against purchasing power. Rather, what this shows is that there are many intangible factors that must be considered in addition to a quantitative evaluation of the numbers.

Here, for example, EnviroPower is not a publicly traded company and its bid included no financial statements, even though the RFP specifically requested them.[33] EnviroPower has never owned, controlled, or operated any generating facilities, although certain members of its management have some experience in building

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[30] Eames Supplemental Testimony at 9-10.

[31] Transcript of Evidence at 79-80.

[32] Case No. 2003-00030, An Investigation of East Kentucky Power Cooperative, Inc.'s Need for the Gilbert Unit and the Kentucky Pioneer Energy, LLC Purchase Power Agreement, Order dated October 18, 2004.

[33] Transcript of Evidence at 66-67.

generation with prior employers. EnviroPower's business appears to be limited to developing two merchant generating projects.[34] Despite these shortcomings, East Kentucky Power chose not to eliminate EnviroPower's bid, but to continue evaluating it to determine if it was the lowest-cost option.[35] Under these circumstances, East Kentucky Power and Enervision should be commended for their evaluation process, which was truly designed and carried out to determine the best and lowest-cost bid. Here, the Spurlock 4 bid is clearly the best and lowest cost, even if the adjustments suggested by EnviroPower are made to its bid.[36]

In support of its request for a site compatibility certificate, East Kentucky Power filed an environmental assessment report that covers both the Spurlock 4 and Gilbert 1 units. The environmental assessment was prepared by East Kentucky Power and submitted to the RUS to demonstrate compliance with the National Environmental Policy Act ("NEPA"). The RUS conducted an independent evaluation of the environmental assessment and issued a Finding Of No Significant Impact, dated March 4, 2002. The RUS concluded that the units will have no significant impact to the air quality, ground or surface water, the 100-year floodplain, prime farmland, transportation, or ambient noise levels, and no effect to wetlands.

East Kentucky Power has thus documented its compliance with NEPA. Pursuant to the Commission's authority under KRS 278.216(2), that documentation will be

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[34] Id. at 68-70.

[35] Id.

[36] Second Supplemental Testimony of David G. Eames, filed March 30, 2005, at 10 (confidential version).

accepted in lieu of the site assessment report referenced in that statute. Based on the environmental assessment and the RUS finding, the Commission concludes that Spurlock 4 will have no adverse impact to the area surrounding the site and that a site compatibility certificate should be issued.

IT IS THEREFORE ORDERED that:

1. East Kentucky Power is granted a CPCN to construct a 278 MW CFB generating unit, known as Spurlock 4, at its Spurlock Station in Maysville, Kentucky.

2. East Kentucky Power is granted a site compatibility certificate for the construction of a 278 MW CFB generating unit, known as Spurlock 4, at its Spurlock Station in Maysville, Kentucky.

Done at Frankfort, Kentucky, this 13th day of September, 2005.

By the Commission

ATTEST:

Executive Director