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PSC Issues Management Audit of East Kentucky Power

Independent review says utility needs major changes to remain viable

FRANKFORT, Ky. (April 22, 2010) – East Kentucky Power Cooperative, Inc. (EKPC) should make substantial improvements in its governance and financial condition, according to an independent review released today by the Kentucky Public Service Commission (PSC).

The changes will likely have to begin with and be driven by the member-customers of the electric generation and transmission cooperative that own and purchase power from EKPC and that are ultimately responsible for how EKPC is operated, the review said. The review, known as a focused management and operations audit, was conducted by The Liberty Consulting Group.

Chairman David Armstrong said the PSC appreciates the work done by Liberty.

"This report raises serious questions which the PSC intends to explore," he said. "We look forward to working with EKPC and its member cooperatives as they work to address the audit's findings and recommendations."

The PSC ordered the audit after EKPC's financial condition had declined for several years as demonstrated by deteriorating financial ratios and a prior default on credit agreements. In ordering the audit, the PSC noted that EKPC was perilously close to a second credit default.

EKPC's 16 member distribution cooperatives have over 500,000 customers in 87 counties in eastern and central Kentucky. EKPC generates electricity at four plants and operates 2,755 miles of high-voltage transmission lines.

EKPC's "distribution cooperatives, in their role as stewards for their customer-owners, should take the initiative now to change direction" because the EKPC board seems unwilling to do so on its own, Liberty said in its report, which was ordered by the PSC in December 2008. Liberty last audited EKPC in 2001.

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Topics covered by the audit included EKPC's governance, including the structure and functioning of its board of directors; the utility's strategic planning; the interaction of EKPC's management with its board; and the utility's operations, including financial systems, business strategies and operating policies and procedures.

Liberty conducted interviews with the EKPC board and with top managers at both EKPC and its member cooperatives. The auditors also examined a number of documents, including financial records, operating policies, strategic plans, board records and earlier reviews conducted by outside parties on behalf of EKPC.

Liberty noted that its conclusions are consistent with those of the earlier reviews. The Liberty report's findings include:

- EKPC is threatened by a "real, continuing and hazardous conflict" created by an overriding priority on keeping rates low at the expense of the utility's financial condition. This has led to low equity ratios, under-spending of capital funds budgeted for needed improvements and rates which nevertheless are higher than those of neighboring investor-owned utilities. Liberty's conclusion applies only to EKPC and not to cooperative governance in general.
- Responses to financial difficulties have been ineffective, although the situation has improved as the result of two recent rate increases.
- EKPC has been too reliant on building, owning and operating electric generating facilities and has not sufficiently explored other options, including purchasing power from neighboring utilities. This has increased financial risk.
- Although EKPC's strategic planning has focused on cutting costs rather than the company's long-term direction, the cost-cutting initiatives have not been effective.
- EKPC has not acted on the recommendations emerging from its earlier reviews and has not maintained a current strategic plan.
- The cooperative's governance standards have not kept pace with current expectations and the board does not meet minimum standards for acceptable governance.
- EKPC's board is not sufficiently engaged in the utility's strategic planning and operations, does not provide an acceptable level of oversight and has not been effective in setting an overall direction for the utility beyond a focus on keeping rates as low as possible. This has negatively affected EKPC's financial strength.

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Liberty's audit includes 29 recommendations for actions by EKPC.

Liberty recommended that:

- The EKPC board "immediately reconcile the conflict of interest" created by the emphasis on low rates by adopting plans and policies that favor the financial health of strategic plans and rate strategies that favor the financial health of the utility.
- EKPC develop and implement strategic plans to address issues including power supply, financial strength, rates and competitiveness. Attaining strategic goals should be the top priority for the EKPC board and management.
- Financial management be improved in areas including capital and operating expenditures, financing and the impact of financial decisions on rates.
- EKPC evaluate its generation and transmission assets to determine the most economically effective ways of meeting future needs.
- The EKPC board adopt modern governance standards, along with a mechanism for compliance with those standards.
- The board emphasize strategic planning and the financial health of EKPC and move away from its focus on low rates "at the expense of all else."
- EKPC board take a more active role in oversight of the cooperative's management. This should include internal audit and risk management programs.

If EKPC is to effectively address the issues it faces, change will have to come from the base of the organization – the distribution cooperatives and their members, Liberty said. The objective should be an EKPC with a "newly developed view of its future according to management and governance consistent with the needs of such an enterprise," Liberty concluded.

With the completion of the audit report, the next step is for Liberty and EKPC to develop a set of action plans to address Liberty's findings and recommendations. The action plans should be completed in early June.

Concurrent with the preparation of the action plan, PSC staff will meet in the coming weeks with board members and managers of EKPC's 16 member cooperatives to discuss the audit report and answer questions. The member cooperatives were not involved in the management audit.

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The Liberty audit was paid for by EKPC. State law allows the PSC to hire an independent auditor at company expense. State law also allows EKPC to assist in the selection of the auditor.

The final audit report is available on the PSC website, psc.ky.gov.

The PSC is an independent agency attached for administrative purposes to the Energy and Environment Cabinet. It regulates more than 1,500 gas, water, sewer, electric and telecommunication utilities operating in Kentucky and has approximately 100 employees.

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TIME LINE FOLLOWS

EAST KENTUCKY POWER COOPERATIVE TIME LINE

Oct. 2001	Liberty issues management audit report identifying six material risks confronting EKPC, including: major outage of a generating unit; increase in environmental regulation; low equity ratios; changes in federal lending policies for coops; deregulation; and culture change necessary to compete in marketplace.
July 2004	Outage at Unit 1 at Spurlock power plant in Mason County forces EKPC to spend $38 million for repairs and to purchase outside power.
April 2005	Unit 3 at Spurlock becomes operational.
Sept. 2005	PSC approves Unit 4 at Spurlock in order to meet additional need created due to Warren Rural Electric Cooperative Corp. (RECC) joining EKPC system in 2008. The coal-fired unit is expected to cost $473 million.
Jan. 2006	US Environmental Protection Agency files suit against EKPC, alleging violations at its Dale power plant in Clark County. EKPC eventually sets aside $32 million to address the environmental liability.
April 2006	PSC approves a $159 million emission-control scrubber at Spurlock.
Aug. 2006	PSC approves new $533 million coal-fired unit and five additional gas-fired units (total cost of $259 million) at Smith power plant in Clark County. EKPC said units are needed to meet anticipated increase in power needs.
	PSC approves a second $142 million emission-control scrubber at Spurlock.
Oct. 2006	PSC initiates investigation into EKPC's financial condition.
Late 2006	Consultant Richard Byrne completes report for EKPC in which he recommends the utility develop alternative strategies for meeting its future electric power needs.
Nov. 2006	EKPC CEO retires; replaced by interim CEO.
Dec. 2006	Warren RECC cancels plans to join EKPC, opting to remain in the Tennessee Valley Authority system.
	PSC opens investigation into EKPC's continued need for new electric generating capacity.
Jan. 2007	EKPC files for $43 million rate increase and asks that it take effect immediately due to financial situation.
April 2007	Consulting unit of National Rural Electric Cooperative Association completes report which finds major weaknesses in EKPC's governance, organization and management, especially in the areas of strategic planning, finance and power supply.
	PSC grants interim rate increase of $19 million finding that failure to do so would result in EKPC suffering a material impairment of its credit.

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EAST KENTUCKY POWER COOPERATIVE TIME LINE

May 2007	EKPC drops plans for three of five gas-fired generators at Smith plant. PSC allows construction of remaining new facilities, ending investigation.
June 2007	PSC, citing ongoing rate case, closes financial investigation.
Dec. 2007	PSC grants permanent $19 million rate increase.
Feb. 2008	Federal Rural Utilities Service imposes a moratorium on lending for coal fired baseload generating units, forcing EKPC into private capital markets.
March 2008	Crowe Chizek, EKPC's outside auditor, warns EKPC board of a serious deficiency in its practices to manage risk of fraud.
Oct. 2008	EKPC asks to account separately for the cost of unplanned outages that forced power purchases earlier in the year.
	EKPC requests $68 million rate increase.
Nov. 2008	EKPC requests approval for $324 million in pollution-control projects.
Dec. 2008	PSC grants requests for accounting treatment of outage costs and orders management audit.
	EKPC's long-term debt reaches $2.4 billion.
March 2009	PSC approves settlement giving EKPC a $59.5 million rate increase.
April 2009	Unit 4 at Spurlock plant goes into operation.
May 2009	PSC approves additional pollution-control projects.
June 2009	Liberty Consulting Group begins audit.
	Interim CEO retires; replaced by new CEO.
Nov. 2009	Liberty delivers first draft of audit.
Dec. 2009	EKPC applies for PSC approval to take on $921 million in new debt to complete Smith 1 unit.
Jan. 2010	After receiving four extensions, EKPC delivers audit response to PSC.
April 2010	Liberty delivers second draft of audit.
	EKPC files motion to withdraw $921 million financing application.
	Audit report made public.