

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF BLUE GRASS RURAL ELECTRIC)
COOPERATIVE CORPORATION AND FOX CREEK)
RURAL ELECTRIC COOPERATIVE CORPORATION FOR) CASE NO. 97-424
AN ORDER APPROVING CONSOLIDATION OF THE)
TWO (2) NAMED RURAL ELECTRIC COOPERATIVES)

O R D E R

On October 16, 1997, Blue Grass Rural Electric Cooperative Corporation ("Blue Grass") and Fox Creek Rural Electric Cooperative Corporation ("Fox Creek") filed a joint application pursuant to KRS 278.020(4) and (5) for approval of their proposed consolidation into a new utility to be named Blue Grass Energy Cooperative Corporation ("Blue Grass Energy"). Blue Grass and Fox Creek are nonprofit electric cooperatives, organized under KRS Chapter 279 and engaged in the retail distribution of electric power to member-consumers in central Kentucky. Blue Grass serves approximately 20,000 customers in six counties and Fox Creek serves approximately 10,000 customers in eight counties.

A public hearing in this matter was held at the Commission's offices on December 5, 1997.

BACKGROUND

The consideration to consolidate developed as a result of early actions by Blue Grass and Fox Creek to share services. The success of those activities lead to more

detailed discussions on the advantages of a possible consolidation. Initial analyses¹ indicated that significant savings could be achieved through consolidation. In September 1996, the Fox Creek board of directors authorized a preliminary consolidation study, which was performed by Mark Harper Consulting of Columbus, Indiana ("Harper Consulting"). After reviewing the results of the preliminary consolidation study, the Fox Creek and Blue Grass boards of directors jointly authorized a detailed consolidation study, which was also performed by Harper Consulting.

The detailed Harper Consulting Consolidation Study ("Consolidation Study"), completed in February 1997, examined the financial impacts and economic benefits of consolidating Blue Grass and Fox Creek. The Consolidation Study did not attempt to determine an optimal staffing level for the consolidated cooperatives; instead it was designed to ensure that no employee would be laid off or terminated as a result of a consolidation.² An economic model prescribed by the RUS was used to develop a base case financial forecast for use in determining the economic benefits of the proposed consolidation. The Consolidation Study includes nine scenarios relating to the economic benefits of the consolidation, with the primary distinction being whether there were normal or early staff retirements. The various scenarios projected savings ranging from \$10 million to \$11 million over the nine years from 1997 through 2005, with the most promising scenario estimating savings for the nine years at \$11.25 million.³

¹ Initial analyses were performed by the National Rural Cooperative Finance Corporation and the Rural Utilities Service ("RUS").

² Prefiled Testimony of Mark A. Harper, at 10 of 10.

³ Id. at 8 and 9 of 10.

The boards of directors of Blue Grass and Fox Creek approved a consolidation on April 14, 1997, and the members of both cooperatives voted to approve the consolidation on September 23, 1997.⁴ The effective date of the consolidation is to be January 1, 1998.⁵

DISCUSSION

Based upon a review of the record, the Commission finds that the proposed consolidation should provide significant long-term benefits to the member-consumers of Blue Grass and Fox Creek. The Commission is convinced that the financial impact and the economies of scale achievable through consolidation will allow Blue Grass and Fox Creek to best serve their member-consumers in the future. The evidence conclusively demonstrates that the consolidated organization, Blue Grass Energy, will have the financial and technical abilities to provide reasonable service to its member-owners. Blue Grass Energy should be able to provide electric service at a total cost that is lower than otherwise achievable without a consolidation.

KRS 278.020(4) requires that the Commission determine if the acquiring entity has the financial, technical, and managerial abilities to provide reasonable service. In this consolidation, the Commission has been unable to determine the managerial aspect because the By-laws of Blue Grass Energy have not been submitted for review. The review of this document is essential to the Commission's determination concerning the managerial abilities of Blue Grass Energy. Therefore, the Commission will condition its approval of the consolidation subject to the filing and review of the approved By-laws for

⁴ Approximately 93 percent of the voting members in each cooperative voted in favor of the consolidation. See Application at 3 of 6.

⁵ Application, Exhibit A, at 1.

Blue Grass Energy. Within five days of finalization, Blue Grass Energy should provide the Commission with copies of the approved By-laws.

All the directors from Blue Grass and Fox Creek have been elected at-large, rather than representing specific districts within the respective cooperative.⁶ Blue Grass and Fox Creek have indicated their resolve that the post-transitional Blue Grass Energy board of directors should not consist of more than 11 members, and plan to address this issue during a four-year transition period. The Commission notes that the majority of cooperatives under our jurisdiction have fewer than 10 members. Blue Grass and Fox Creek have decided that the initial board of directors for Blue Grass Energy will have 14 members, with 11 votes. The seven board members for Blue Grass will have seven votes, while the seven board members from Fox Creek will have four votes. Prior to each board meeting, the former Fox Creek directors will perform a random drawing to determine the individuals voting at that meeting.⁷ The method of allocating votes for the new Blue Grass Energy board, specifically as regards Fox Creek directors, appears cumbersome.

It appears to the Commission that more reasonable alternatives during the transition period would have been to either: 1) proportionally allocate the four Fox Creek votes equally among the seven serving directors; or 2) develop a methodology which would encourage three of the Fox Creek directors to voluntarily leave the board prior to the

⁶ Response to the Commission's November 11, 1997 Order, Item 10.

⁷ Response to the Commission's November 11, 1997 Order, Item 7. Blue Grass and Fox Creek could not identify any other cooperatives which had taken this approach to a consolidated board. In addition, all former Fox Creek board members would receive full director compensation, whether the director was a voting member or not. See the response to the Commission's November 27, 1997 Order, Item 5.

expiration of their term. While it is the responsibility of Blue Grass and Fox Creek to determine the composition and voting rights of the consolidated board, the methodology must be reasonable. The Commission is concerned with a consistency in the voting and the manner it would affect the public interest over various issues. The composition and voting rights of Blue Grass Energy's board during the transition will be a part of the approved By-laws and the Commission's concerns should be addressed when the By-laws are finalized.

The Commission views this consolidation effort as a "work in progress." The record demonstrates that all issues have not been finalized. Among the issues yet to be resolved is the movement to rate parity for all members of Blue Grass Energy. The Commission finds that it has an obligation to monitor the progress of this consolidation and the decisions made by Blue Grass Energy on the numerous outstanding issues which will impact the cost and delivery of electric service.

Blue Grass and Fox Creek have committed themselves to develop a plan where rate parity among the cooperative members will be achieved within the next five years. However, neither cooperative has undergone a general rate case since 1980, some 17 years ago. For Blue Grass Energy to properly achieve rate parity among all its members, it would appear reasonable for the consolidated cooperative to file a general rate case as part of the process. This would allow base rates to reflect conditions more current than those in 1980, as well as possibly capturing some of the initial benefits of the consolidation for member-consumers. The Commission believes Blue Grass Energy should give serious consideration to undergoing a general rate case as part of its discussions and analysis in developing a plan to achieve rate parity.

The Commission also recognizes that, in the near term, Blue Grass Energy may be in a position to adopt technological innovations that are feasible and cost effective. Such measures also warrant serious consideration if cost effective.

To facilitate the Commission's monitoring of this consolidation and the outstanding issues enumerated in this Order, Blue Grass and Fox Creek should file periodic reports describing their progress on these issues and in achieving the benefits of the consolidation. The first such progress report should be submitted one year after the consolidation has been consummated. The need for and the timing of subsequent progress reports will be determined after review and analysis of the first report. In addition, if Blue Grass Energy has not initiated a general rate case by the due date of the first progress report, it should also include with the progress report a description of the actions it proposes to take to return to member-consumers any consolidation savings which have resulted in increased earnings for Blue Grass Energy.

The Commission believes that Blue Grass and Fox Creek should be commended for their actions in seriously considering a consolidation and then pursuing it once the benefits became apparent. In summary, except for the reservations noted in this Order, we find this consolidation to be in accordance with the law, for a proper purpose, and consistent with the public interest. We encourage Blue Grass and Fox Creek to complete the consolidation in the most practical, efficient, and cost-effective manner. In addition, as we noted in our final Order in Case No. 97-156,⁸ the Commission urges all electric cooperatives to seriously consider consolidations and other forms of strategic alliances to

⁸ Case No. 97-156, The Application of Green River Electric Corporation and Henderson Union Electric Corporation for Approval of Consolidation.

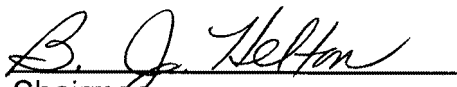
maintain the economies of scale necessary to continue to provide high quality service at reasonable costs to your member-consumers.

IT IS THEREFORE ORDERED that:

1. The consolidation of Blue Grass and Fox Creek into a new electric distribution cooperative to be know as Blue Grass Energy is approved, subject to Blue Grass Energy's filing and the Commission's review of the approved By-laws.
2. Within five days after consummation of the consolidation, Blue Grass Energy shall file a written notice with the Commission setting forth the date of consolidation.
3. Within five days of the date of the approval of the By-laws, Blue Grass Energy shall file seven copies of said By-laws with the Commission.
4. Twelve months after the consolidation Blue Grass Energy shall file a report detailing the status of all unresolved issues, including those issues identified in this Order, and the progress of consolidation.

Done at Frankfort, Kentucky, this 12th day of December, 1997.

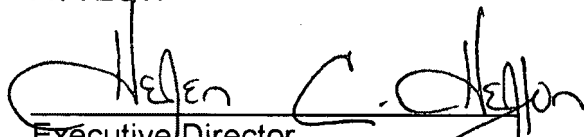
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ATTEST:


Executive Director