

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC)	
RATES OF EAST KENTUCKY POWER)	CASE NO. 2006-00472
COOPERATIVE, INC.)	

INTERIM ORDER

This matter is before the Commission on the application of East Kentucky Power Cooperative, Inc. ("EKPC") for an increase in base rates during the suspension period of EKPC's pending application for a general adjustment of electric rates. For the reasons set forth herein, the Commission will grant EKPC interim rate relief on the terms and conditions set forth herein.

PROCEDURAL BACKGROUND

EKPC submitted for filing its application for an adjustment of electric rates with the Commission on January 29, 2007. Deficiencies were noted and, upon the resolution of those deficiencies, the application was deemed filed as of February 6, 2007. Kentucky Industrial Utility Customers, Inc. ("KIUC") and the Attorney General, by and through his Office of Rate Intervention ("AG"), were granted status as intervenors on February 19, 2007. The Cumberland Chapter of the Sierra Club ("Sierra Club") was granted intervention from the bench on March 6, 2007.¹ On February 20, 2007, the Commission issued its second data request relating principally to EKPC's request that it

¹ An Order granting intervention to the Sierra Club was issued on March 21, 2007.

be granted interim rate relief in the amount of \$43.3 million during the suspension period. Also on that date, the AG issued his initial set of data requests to EKPC. EKPC filed its responses to both data requests on February 27, 2007.

A hearing scheduled for March 6, 2007 was continued when EKPC failed to provide timely public notice of the hearing. In place of the hearing, however, representatives of EKPC, KIUC, the AG, and the Sierra Club engaged in settlement discussions and arrived at a settlement in principle.² In an Order entered on March 16, 2007, the Commission noted that despite the terms of any settlement the parties might be able to reach, EKPC ultimately had the burden to demonstrate that the statutory criteria set forth in KRS 278.190(2) were satisfied as a prerequisite to any interim rate relief award.

On March 22, 2007, a hearing was held in the Commission's offices in Frankfort for the purpose of providing testimony on EKPC's request for interim rate relief. Upon the conclusion of the hearing, EKPC agreed to file additional information with the Commission no later than March 27, 2007. Parties were also invited to file briefs on or before March 27, 2007. The Sierra Club, EKPC, and the AG availed themselves of the opportunity to do so.

DISCUSSION

As a general matter, prudently managed utilities will not willingly place themselves in a position where interim rate relief during the suspension period is necessary to avoid a material impairment of the utility's credit or operations. This is especially true of rural electric cooperative corporations. KRS 279.095 provides that a

² Sierra Club subsequently refused to sign the settlement agreement.

cooperative “shall be operated on a nonprofit basis for the mutual benefit of its members and patrons.” While low rates are desirable, this must be balanced against the necessity that a cooperative remain financially and operationally viable. With the shadow of Big Rivers Electric Corporation’s bankruptcy only recently receding in the memory of Kentucky utility jurisprudence, all directors and officers of jurisdictional utilities should take note that the extraordinary relief authorized under KRS 278.190(2) is just that – extraordinary. In other words, only where the financial or operational condition of a utility has deteriorated to a perilous extent has the General Assembly authorized the Commission to utilize the procedures of KRS 278.190(2), which states in relevant part:

[I]f the commission, at any time, during the suspension period, finds that the company's credit or operations will be materially impaired or damaged by the failure to permit the rates to become effective during the period, the commission may, after any hearing or hearings, permit all or a portion of the rates to become effective under terms and conditions as the commission may, by order, prescribe.

In measuring the record against the statutory criteria, we will examine each element of the statute in turn – first EKPC’s potential credit impairment and then EKPC’s potential operational impairment.

Credit Impairment

EKPC has a two-tiered debt structure. Approximately \$1.7 billion of EKPC’s existing debt is subject to a 2004 Restated and Consolidated Mortgage and Security Agreement (the “Mortgage Agreement”) with the Rural Utilities Service (“RUS”).³ The total allowable debt under the Mortgage Agreement is \$3 billion. Additionally, EKPC

³ EKPC Notes to Consolidated Financial Statements December 31, 2006 and 2005, Note 5-Long-Term Debt.

has a 2005 \$650 million Unsecured Credit Agreement (the "Credit Facility") with a consortium of lenders led by the National Rural Utilities Cooperative Finance Corporation ("CFC"). At this time, EKPC has drawn all but approximately \$195 million of the unsecured credit line.⁴ Both agreements have cross-default provisions.

In its response to data requests relating to an alleged credit impairment, EKPC asserted that without interim rate relief, it would fail to achieve the required debt service coverage ratio ("DSC") for 2007 and, because of poor financial results in previous years, EKPC would be in a position wherein it is subject to a declaration of default under its Mortgage Agreement with RUS.⁵ EKPC also asserted that while it hoped to achieve a net margin of \$6 million in 2007, \$34 million of its earnings were comprised of the Allowance for Funds Used During Construction ("AFUDC"), which is non-cash earning.⁶ Finally, EKPC asserted in its data request responses that the President's proposed federal budget for 2008 included a provision eliminating RUS funding of loans for generation projects.⁷ In testimony submitted by EKPC's President and Chief Executive Officer, Bob Marshall, EKPC further asserted that the cost of potential penalties and fines to be levied against EKPC by the United States Environmental Protection Agency were a source of potential credit impairment.⁸ Mr. Marshall also asserted that an

⁴ See Transcript of Evidence ("T.E."), March 22, 2007, at 108.

⁵ See EKPC Response to Commission Second Data Request, filed Feb. 27, 2007, Response 6(a).

⁶ See id.

⁷ See id.

⁸ See Testimony of Bob Marshall, filed Feb. 6, 2007, at 3.

increased capital construction budget exposed EKPC to greater interest expense and that this too contributed to its credit impairment.⁹ At the March 22, 2007 hearing, EKPC additionally asserted that any default under the Mortgage Agreement would also trigger a cross-default provision in its Credit Facility. David Eames, EKPC's Vice President of Finance, testified that if sums due and owing under the Mortgage Agreement and Credit Facility were required to be repaid due to a default under either agreement, EKPC would be insolvent.¹⁰

Taken individually, none of these factors would appear to constitute a material impairment of credit as contemplated by the plain and ordinary language of the statute. While EKPC asserts many grounds to support a credit impairment finding, some are simply too remote to be given much credence. For instance, the Commission attaches little significance to EKPC's reliance upon the potential elimination of the RUS generation loan program in the proposed federal budget for 2008. As EKPC concedes, a proposed budget is far removed from an enacted budget,¹¹ and the likelihood of any detrimental impairment of EKPC's credit flowing from the passage of the federal budget is simply too speculative to be given any weight at this time. Likewise, EKPC firmly contends that its decision to reserve \$32 million in 2005 to satisfy potential fines and penalties arising from its environmental litigation is reflective of a prudent business practice and not an admission that the fines and penalties will actually be due and

⁹ See id.

¹⁰ See T.E., March 22, 2007, at 104.

¹¹ See id. at 64-65.

payable at some point in the future.¹² EKPC thereby undercuts its own argument that the \$32 million reserve results in a credit impairment. Accordingly, this factor is also given little weight.

The remaining assertions raised by EKPC are more responsive to the statutory criteria of credit impairment. As demonstrated by the outage of the Spurlock No. 1 unit in 2004, the costs of purchasing power are generally higher than generating power. In the event that EKPC is forced to purchase power in any significant amounts, its credit-worthiness will certainly be an issue.¹³ Likewise, it was the continuing decline in EKPC's Times Interest Earned Ratio ("TIER") that caused the Commission to commence an investigation into EKPC's financial condition in October of 2006.¹⁴ Despite some improvement in EKPC's margin in 2006, Mr. Eames rightly points out that EKPC's overall financial condition has not improved.¹⁵ The positive margin EKPC produced in 2006 is largely a product of its revised depreciation schedule and its AFUDC accounting.¹⁶ When these factors are removed, EKPC posted another substantial deficit for 2006 at a time when its exposure to credit costs were increasing. Given its failure to satisfy the debt covenants contained in the Mortgage Agreement,

¹² See id. at 37.

¹³ See id. at 120.

¹⁴ Case No. 2006-00455, An Investigation into the Financial Condition of East Kentucky Power Cooperative, Inc.

¹⁵ See T.E., March 22, 2007, at 67-68, 71.

¹⁶ See id. at 60-61, 71.

EKPC's financial viability appears at this point to be almost entirely within the discretion and good grace of RUS.

The most compelling evidence, however, comes from the testimony of Jonathan Don, Vice President of Capital Market Member Products for CFC. Mr. Don testified that although the 2006 amendment to the Credit Facility eliminated the immediate danger of EKPC defaulting under the terms of the Credit Facility, EKPC was subject to a declaration of default under the Mortgage Agreement and a subsequent cross-default declaration under the Credit Facility.¹⁷ Mr. Don further stated that EKPC's existing unsecured creditors would be unlikely to enlarge the Credit Facility until such time as EKPC's financial condition improved.¹⁸ EKPC's financial condition has deteriorated to the point, according to Mr. Don, that several of the unsecured lenders have placed EKPC on a credit watch list and have instituted a heightened tracking system of EKPC's financial indicators.¹⁹ Most telling, Mr. Don indicated that EKPC's credit rating had fallen from somewhere in the BBB to BBB- range at the time the Credit Facility was originally entered into, to a current rating in the subinvestment grade or "junk" classification.²⁰ Mr. Don explained that with a subinvestment grade credit rating, EKPC may be simply unable to find a creditor willing to establish an unsecured revolving line of credit.²¹

¹⁷ See id. at 134-35.

¹⁸ See id. at 135.

¹⁹ See id. at 137, 143-144.

²⁰ See id. at 140-141.

²¹ See id. at 141-142.

On the basis of the foregoing, the Commission hereby finds that: (1) beginning with the unplanned outage of the Spurlock No. 1 unit in July of 2004, EKPC's financial condition has steadily and consistently deteriorated and shows no immediate signs of improvement; (2) due to a significant capital construction program, EKPC has incurred increasing levels of interest expense at a time when it is least able to absorb such increasing costs; (3) EKPC's credit-worthiness has deteriorated to the point that its credit score would likely be in the subinvestment grade category; and (4) but for the willingness of RUS to forebear from making any declaration of default under the Mortgage Agreement, which would also trigger the cross-default provisions of the Credit Facility, EKPC would be insolvent. Although the Commission recognizes and appreciates the commitment of EKPC's new management to reduce costs wherever possible, such reductions, at least in the short term, will be insufficient to reverse its credit impairment. The Commission therefore concludes that these findings taken as a whole will result in the credit of EKPC being materially impaired or damaged unless a portion of the general rate increase proposed in EKPC's application is permitted to become effective under the terms and conditions set forth herein.

Operational Impairment

Though it is unnecessary at this point for the Commission to look beyond EKPC's credit impairment, we find additional support for our decision when EKPC's potential for operational impairment is also considered. In its response to data requests relating to an alleged operational impairment, EKPC asserted that without interim rate relief, it would likely be forced to defer maintenance on unidentified generation and transmission

projects, which could potentially affect electric system reliability.²² EKPC also asserted that its construction program could be halted if RUS were to “freeze” future loan advances.²³ At the March 22, 2007 hearing, EKPC stated that without interim rate relief, it would be unable to hire for positions “that need to be filled” resulting in EKPC “falling behind in our construction programs and other programs that affect our operation....”²⁴ Mr. Marshall also testified that while the situation regarding the level of Lake Cumberland had no operational effect on EKPC during the historic test year,²⁵ “certainly it has an effect and is a concern as we move forward.”²⁶ Mr. Eames helped quantify the cost of the potential draw-down of Lake Cumberland by stating that necessary improvements to the John Sherman Cooper Station (“Cooper Station”) would be approximately \$25 million while the costs of purchasing replacement power would be

²² See EKPC’s Response to Commission Staff’s Second Data Request, Response 6(b). On cross-examination, Mr. Eames elaborated on this response and indicated the referenced deferrals were for overhauls of the turbines at Spurlock No. 2 and Dale No. 3. Specifically, the overhauls would be deferred for 6 months beyond their normal 10-year cycle, which is already beyond industry standards. See T.E., March 22, 2007, at 86, 106.

²³ See EKPC’s Response to Commission Staff’s Second Data Request, Response 6(b).

²⁴ See T.E., March 22, 2007, at 105.

²⁵ On January 22, 2007, the U. S. Army Corps of Engineers announced plans to lower the Cumberland Lake level at Wolf Creek Dam in Russell County, Kentucky, to 680 feet in response to internal and independent studies that have classified the dam as being at high risk for structural failure. See U.S. Army Corps of Engineers, Nashville District news release 07-01, http://www.orn.usace.army.mil/pao/news_releases/2007%20news%20releases/07-01.pdf. The Corps subsequently announced the lake level could be drawn down to 650 feet.

²⁶ See T.E., March 22, 2007, at 157.

“far in excess of that on an annual basis.”²⁷ While EKPC indicated that it was cutting costs by carefully reviewing expenditures and offering qualifying employees early retirement,²⁸ it held out the possibility that layoffs would result if interim rate relief were not granted and additional cost saving measures were not effective.²⁹

While the danger associated with any operational impairment may not be as immediate as EKPC’s ongoing credit impairment, there is little doubt that the two are closely related. In the absence of some form of interim rate relief, EKPC is caught in a difficult position – to preserve its financial viability, it would be forced to embark upon an even more aggressive cost-cutting program at the expense of its workforce and perhaps at the expense of its reliability and safety programs. This is, of course, a recipe for disaster. As stated before, while low rates are desirable, this must be balanced against the necessity that a cooperative remains financially and operationally viable. Unless and until EKPC regains a solid financial footing, its operations will be under threat of material impairment.

On the basis of the foregoing, the Commission hereby finds that: (1) the U.S. Army Corps of Engineers’ decision to lower the level of Lake Cumberland has placed the continued reliable operation of the Cooper Station at risk; and (2) as a result of its cash shortage, EKPC has decided to defer scheduled maintenance of the Spurlock No. 2 and Dale No. 3 generation units, despite the fact that these units are already beyond industrial standards for maintenance. The Commission therefore concludes

²⁷ See id. at 97.

²⁸ See id. at 160-161.

²⁹ See id. at 89.

that the combination of these factors will result in the operations of EKPC being materially impaired or damaged unless a portion of the general rate increase proposed in EKPC's application is permitted to become effective under the terms and conditions set forth herein.

SCOPE OF SUSPENSION PERIOD RATE RELIEF

In light of the fact that the Commission has determined that a material credit and operational impairment will occur at EKPC unless interim rate relief is granted during the suspension period, we now turn to the scope, terms, and conditions of such rate relief. The Commission notes that all of the parties to the case initially reached a settlement in principle on March 6, 2007. Subsequently, however, the Sierra Club determined to withhold its consent to the proposed settlement agreement. Consequently, the Commission cannot accept the settlement agreement as drafted. However, we have reviewed the proposed settlement agreement and find many of its terms to be a reasonable resolution of the issues associated with the implementation of an interim rate increase for EKPC.

The proposed settlement agreement requests EKPC to be awarded an annualized rate increase of \$19.0 million, commencing on April 1, 2007. Though EKPC itself concedes that this level of relief will be insufficient to satisfy its debt covenants in 2007,³⁰ we will accept EKPC's judgment that this level of interim increase is

³⁰ Mr. Eames testified that even with an annualized \$19.0 million in interim rate relief, "that, as far as meeting our [debt] covenants, we are in a very dire situation." T.E., March 22, 2007, at 113. He later testified that EKPC would still fail to achieve the requisite debt service coverage ratio for 4 years in a row under the Mortgage Agreement. See id. at 116.

reasonable.³¹ The Commission will permit a portion of EKPC's requested increase – \$19.0 million on an annualized basis – to go into effect for service rendered on and after April 1, 2007. This interim rate relief shall be collected subject to refund and, in the event that EKPC ultimately collects more under the rates established in this Order than the Commission authorizes as permanent rates at the conclusion of this proceeding, EKPC shall refund the difference along with interest at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release.

The rate relief awarded herein shall be allocated to the individual sections of EKPC's wholesale rate schedule on the same percentage basis and according to the same rate design methodology as in the proposed tariffs filed in EKPC's application. The rate increase reflected in the proposed tariffs will be adjusted proportionally to reflect the annual increase of \$19.0 million and not the \$43.4 million originally requested. Any refunds required as a result of EKPC's over-collection or a finding that EKPC's proposed tariff is unreasonable shall be passed through to EKPC's member cooperatives, with interest, through the approach required by KRS 278.455(2). The Commission will not impose the provisions contained in paragraphs four and five of the proposed settlement agreement as we find those terms, in this context, to be a disincentive to controlling and containing expenses.

³¹ EKPC contends that it will be able to achieve the financial ratios required by the debt covenants by cutting expenditures. See T.E., March 22, 2007, at 126-127. EKPC also notes, however, that this could require at least an additional 3 to 5 percent reduction in discretionary spending. See id. at 174.

Due to the unique and extraordinary circumstances of this proceeding, the Commission finds it is reasonable to monitor EKPC's financial condition more closely during the pendency of this proceeding. Beginning on April 1, 2007 and ending on the effective date of the Commission's final Order in this case, EKPC will file with the Commission a monthly accounting of its expenses and revenues in both a monthly format and a 12-month ending format to enable the Commission and the parties to monitor EKPC's margins. EKPC will also provide monthly budget information for calendar year 2007 and a calculation of its TIER and DSC as of the 12-month period ending for each month included in this monitoring period. The required financial information will be filed no later than 30 days after the end of the reporting month.

IT IS THEREFORE ORDERED that:

1. EKPC shall be granted an increase in its base rates by the sum of \$19.0 million on an annualized basis for service rendered on and after April 1, 2007. EKPC shall maintain its records in such manner as will allow the proper determination of any amount to be refunded, in the event refund is required, upon final resolution of this matter.

2. This interim rate relief shall be collected subject to refund and, in the event that EKPC ultimately collects more under the rates established in this Order than it is finally allowed to collect under permanent rates established at the end of this proceeding, EKPC shall refund the difference along with interest at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release. Any refunds required as a result of EKPC's over-collection or a finding that EKPC's proposed tariff is unreasonable shall be passed

through to EKPC's member cooperatives, with interest, through the approach required by KRS 278.455(2).

3. The rate relief awarded herein shall be allocated to the individual sections of EKPC's wholesale rate schedule on the same percentage basis and according to the same rate design methodology as in the proposed tariffs filed in EKPC's application.

4. The rate increase reflected in the proposed tariffs shall be adjusted proportionally to reflect the annualized increase of \$19.0 million and not the \$43.4 million originally requested.

5. Within 10 days of the date of this Order, EKPC shall file its tariffs reflecting the \$19.0 million annualized increase granted herein.

6. Beginning on April 1, 2007 and ending on the effective date of the Commission's final Order in this case, EKPC shall file with the Commission a monthly accounting of its expenses and revenues in a monthly format and a 12-month ending format to enable the Commission and the parties to monitor EKPC's margins. EKPC shall also provide monthly budget information for calendar year 2007 and a calculation of its TIER and DSC as of the 12-month period ending for each month included in this monitoring period. The required financial information shall be filed no later than 30 days after the end of the reporting month.

Done at Frankfort, Kentucky, this 1st day of April, 2007 @ 12:04 p.m.

By the Commission

ATTEST:

A handwritten signature in black ink, consisting of several overlapping loops and a long horizontal stroke at the bottom.

Executive Director