

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTH KENTUCKY RURAL)
ELECTRIC COOPERATIVE CORPORATION)
FOR APPROVAL TO PURCHASE THE FIXED) CASE NO. 2007-00374
ASSETS OF THE MONTICELLO ELECTRIC)
PLANT BOARD, MONTICELLO, KY)

O R D E R

On August 20, 2007, South Kentucky Rural Electric Cooperative Corporation ("South Kentucky") filed an application requesting approval to purchase the fixed assets of the Monticello Electric Plant Board ("MEPB"). Although the application sought approval for the purchase of MEPB's fixed assets, the Commission Staff had previously responded to South Kentucky's inquiry on the same subject matter and, in a February 16, 2007 Staff opinion, advised South Kentucky that Commission approval of the acquisition was not required under KRS 278.020. KRS 278.020(5)¹ and KRS 278.020(6)² require prior Commission approval of the transfer of control or

¹ No person shall acquire or transfer ownership of, or control, or the right to control, any utility under the jurisdiction of the commission by sale of assets, transfer of stock, or otherwise, or abandon the same, without prior approval by the commission. The commission shall grant its approval if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service.

² No individual, group, syndicate, general or limited partnership, association, corporation, joint stock company, trust, or other entity (an "acquirer"), whether or not organized under the laws of this state, shall acquire control, either directly or indirectly, of any utility furnishing utility service in this state, without having first obtained the approval of the commission. As used in this subsection, the term "control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a utility, whether through the ownership of voting securities, by effecting a change in the composition of the board of directors, by contract or otherwise.

ownership of any “utility.” The MEPB, as a city-owned facility, is not a “utility” subject to the Commission’s jurisdiction as that term is defined in KRS 278.010(3).³ However, South Kentucky was informed in the same letter that Commission approval would be required for the financing of the acquisition pursuant to KRS 278.300 in the event that South Kentucky intended to assume any indebtedness or issue any new evidence of indebtedness to purchase MEPB’s assets. Because South Kentucky intends to issue new evidence of indebtedness to purchase MEPB’s assets, the Commission will treat this application as one for approval of the financing of the acquisition pursuant to KRS 278.300.

The fixed assets sought to be purchased by South Kentucky include MEPB’s electric distribution plant and the general plant.⁴ It does not include any of the current assets, investments, or intangible assets.⁵ On November 2, 2007, the Attorney General, by and through his Office of Rate Intervention (“AG”), intervened in the matter. For the reasons set forth in this Order, South Kentucky’s application is approved pursuant to KRS 278.300.

BACKGROUND

South Kentucky is a rural electric corporation organized under KRS Chapter 279 and it is engaged in the distribution of electric energy to 62,356 customers in Pulaski, Wayne, McCreary, Cumberland, Rockcastle, Casey, Russell, Lincoln, Laurel, Clinton,

³ Utility means any person except . . . a city, who owns, controls, operates, or manages any facility used or to be used for or in connection with . . . [t]he generation, production, transmission, or distribution of electricity to or for the public, for compensation, for lights, heat, power, or other uses.

⁴ South Kentucky’s Application at 2.

⁵ *Id.*

and Adair counties, Kentucky. South Kentucky's load factor for the 12 months ended December 2006 is 42.6 percent⁶ and its current customer density per mile of line is 9.49 customers.⁷ South Kentucky purchases all of its power from its wholesale supplier, East Kentucky Power Cooperative, Inc. ("EKPC").

On September 16, 1947, the MEPB was formed by an ordinance of the Monticello City Council pursuant to KRS 96.740, which authorized a city to acquire and operate an electric plant.⁸ On November 3, 1953, the MEPB purchased its electric plant from its then provider of electricity, Monticello Electric Light Company, upon a majority vote of the qualified voters of the city of Monticello.⁹ The assets were subsequently transferred on January 20, 1954 and the MEPB has operated the electric plant since that time.¹⁰ MEPB has for many years purchased its wholesale electric supply from the Tennessee Valley Authority ("TVA").

Currently, the MEPB has 3,480 customers on its system.¹¹ MEPB's load factor for the 12 months ending June 2007 is 46 percent¹² and has a customer density per

⁶ *Id.*, Item 2(b).

⁷ *Id.*

⁸ South Kentucky's Informal Conference Memorandum at 1.

⁹ *Id.*

¹⁰ *Id.* at 2.

¹¹ South Kentucky's Response to Commission Staff's First Data Request, Item 1(a).

¹² *Id.*, Item 1(b).

mile of line of 39.48 customers.¹³ Significantly, MEPB's service area is completely surrounded by that of South Kentucky.¹⁴

According to South Kentucky's 2006 Annual Report,¹⁵ the origins of the instant transfer date back to 2003. In November of 2003, MEPB provided a 5-year notice to TVA of MEPB's intent to terminate its wholesale power supply contract with TVA.¹⁶ At the same time, MEPB also sent out Requests for Proposals ("RFP") to other potential power providers. Although the RFP was for the purpose of wholesale power, the language of the RFP also provided MEPB with the right to pursue alternative courses of action.¹⁷ Because of a desire to increase its load and customer base, the need for more substations, a plan to build a new district office in the Monticello area, and the fact that the co-op's service area surrounds Monticello, South Kentucky expressed an interest in acquiring the MEPB system.

After undertaking negotiations, in January 2007, the MEPB board of directors voted unanimously in favor of presenting the city of Monticello with a resolution outlining the sale of MEPB to South Kentucky for \$4.686 million to be paid to the city at an interest rate of 4.75 percent over a 30-year period. In exchange for the consideration, South Kentucky would acquire MEPB's fixed assets, including the electric distribution

¹³ *Id.*

¹⁴ South Kentucky's Application, Exhibit A, at 1.

¹⁵ South Kentucky's 2006 Annual Report was provided in response to Commission Staff's Second Data Request, Item 3(a).

¹⁶ MEPB's TVA contract allowed an option for utilities being presently served by the power supplier, upon a 5-year notice, to discontinue service with them.

¹⁷ South Kentucky's Responses to Attorney General's Data Requests, Exhibit D.

plant and the general plant. The fixed assets did not include any of the current assets, investments or intangible assets. South Kentucky would not be liable for any of the payables, short-term debt or long-term debt of the MEPB with the exception of the customer deposit liability and related accrued interest liability which are estimated to be \$152,897 and \$9,174, respectively.

EKPC has agreed to purchase the MEPB distribution substation from South Kentucky for \$1.2 million. EKPC will also purchase TVA's 69 kV transmission line that is used to serve MEPB. EKPC will purchase the line directly from TVA, or from South Kentucky, at the price paid by South Kentucky to TVA. Further, EKPC will supply power at its tariffed rates to South Kentucky for the MEPB load once those customers become members of South Kentucky and the TVA supply contract ends in November 2008. Lastly, if South Kentucky is not successful in the purchase of the fixed assets of the MEPB due to voter disapproval, EKPC offered to make a wholesale power sale at its tariffed rates to South Kentucky equal to the MEPB needs until such time as MEPB is able to obtain an alternative power supply.

In February 2007, the Monticello City Council agreed to the proposal. In April 2007, the Monticello City Council adopted an ordinance authorizing the placing of the question on the ballot of the November 2007 general election asking the voters of Monticello whether they approved the sale of MEPB to South Kentucky. On November 6, 2007, the voters of Monticello approved the transaction.

DISCUSSION

Legality of the Asset Sale

During the pendency of this proceeding, the Commission received documents on an *ex parte* basis from a non-party which called into question the procedures that MEPB followed regarding the proposed sale of its fixed assets to South Kentucky.¹⁸ Specifically, the issue was whether KRS 82.083 or KRS 96.860 governed the instant transaction. KRS 82.083 governs when a city disposes of its real or personal property and requires, among other things and subject to certain limited exceptions, a competitive bidding process. KRS 96.860 applies to the situation where an electric plant board or a municipality disposes of their electric plant. KRS 96.860 requires adoption of a board resolution, approval of the resolution by the governing body of the municipality and approval by a majority of the qualified voters of the municipality voting in the November general election. One of the documents received by the Commission was an AG's¹⁹ informal opinion letter, dated September 26, 2007, implying that KRS 82.083 governed the instant transaction.

KRS 82.083, entitled "Sale or other disposition of city property," provides in relevant part as follows:

- (3) Real or personal property may be:
 - (e) Sold by sealed bids in accordance with the procedure for sealed bids under KRS 45A.365(3) and (4).

¹⁸ Given the substantive nature of the documents and the manner in which the Commission received it, the Commission filed the documents as part of the record of this case.

¹⁹ The informal opinion letter was drafted by a division within the Office of the Attorney General other than the AG's Office of Rate Intervention, who is an intervenor in this matter.

(4) If a city receives no bids for the real or personal property, either at public or electronic auction or by sealed bid, the property may be disposed of, consistent with the public interest, in any manner deemed appropriate by the city. In those instances, a written description of the property, the method of disposal, and the amount of compensation, if any, shall be made.

KRS 96.860 provides, in relevant part, as follows:

The board or the municipality may sell or dispose of all or substantially all of that part of an electric plant located within the boundary of the municipality, owned and operated by it, only by first complying with the following provisions, to wit:

(1) The board shall adopt a resolution which shall state in substance (a) that the board has approved the proposed sale or disposition, (b) a full description of the property to be sold or disposed of, (c) the transferee or transferees or purchasers thereof, (d) the consideration to be received by the board for such sale or disposition, (e) the terms or conditions of such sale or disposition, (f) the date on which an election shall be held, which shall be the day of the regular November election.

(2) The resolution of the board shall be submitted to the governing body of the municipality; and if approved by the governing body of the municipality, the question shall be submitted to an election of the qualified voters in the manner provided in KRS 96.640, except that the question to be presented to the voters in the general election shall be: "Are you in favor of the sale or disposition of the electric plant, for the consideration of \$..... (here state the consideration)." The voters shall indicate a "Yes" or a "No" vote. If a majority of all the qualified voters of the municipality voting in said general election on the question shall vote in favor of the sale or disposition of the electric plant, the sale shall be consummated, otherwise the sale or disposition shall not be made.

South Kentucky asserts that KRS 82.083 does not apply to the instant transaction. First, South Kentucky argues that KRS 82.083 pertains to cities. Citing Louisville Water Company v. Wells, 664 S.W.2d 525 (Ky. App. 1984), South Kentucky

argues that MEPB is an entity separate and apart from the city of Monticello and thus cannot be considered a city in the context of KRS 82.083. Second, South Kentucky argues that, even if KRS 82.083 is held to apply, the provisions of the statute relating to auctions and bids are not mandatory. Lastly, South Kentucky maintains that KRS 82.083 is a general statute and must yield to KRS 96.860, which is a specific statute concerning the same subject matter.

South Kentucky contends that the procedure for the sale of an electric plant by a municipal plant board is set forth by the Kentucky TVA Act, KRS 96.550 *et seq.* Thus, South Kentucky argues that KRS 96.860 governs the transaction herein. Further, South Kentucky maintains that all of the requirements imposed by KRS 96.860 have been satisfied in the instant transaction.

The AG filed a legal memorandum which agrees with South Kentucky's position. The AG opines that the procedures followed by the MEPB in soliciting bids were appropriate and in compliance with applicable law. The AG states that KRS 82.083(3)(e) falls within the provisions of the Kentucky Model Procurement Code ("KMPC") but the KMPC as well as KRS 96.901(3) expressly exempts a municipal utility purchasing wholesale electric power from the requirements of the KMPC. Thus, the AG concludes that the MEPB was not obligated to conduct sealed bidding as required by KRS 82.083.

Although it was not required to conduct sealed bidding, the AG stated that the MEPB went beyond the dictates of the applicable law and adhered to the requirements of the KMPC's sealed bidding requirements. The AG noted that the evidence indicated that bids were solicited from multiple parties and that they were sealed. Moreover, the

language of the RFP provided MEPB with the right to pursue alternative courses of action in addition to the RFP's stated purpose of purchasing of wholesale power. The AG concluded that it was within the MEPB's purview to accept South Kentucky's response to the RFP, which was an offer to purchase MEPB's operating assets and plant.

Given that the parties to this case are in agreement as to the MEPB's sale of its fixed assets being in compliance with applicable law, the Commission deems this particular issue to be moot. In addition, the Commission finds that the AG's informal opinion letter has no precedential value. As the AG points out in his legal memorandum, the informal opinion letter was issued while South Kentucky's application was pending before the Commission. 40 KAR 1:020, Section 4, precludes the AG from rendering opinions in response to questions involving matters being litigated or questions submitted in contemplation of litigation.

South Kentucky's Financing of the Acquisition of the MEPB's Fixed Assets

KRS 278.300(1) requires Commission approval before any utility can issue any securities or evidences of indebtedness with certain limited exceptions.²⁰ In this case, pursuant to the purchase and sale agreement, South Kentucky will issue to the city of Monticello a note in the amount of \$4.4 million,²¹ payable in 30 annual installments at an interest rate of 4.75 percent. As security for this note, South Kentucky agreed to grant the city of Monticello a first mortgage lien on all of the real estate being purchased from

²⁰ None of the exceptions provided in KRS 278.310(8), (10), and (11) are applicable to this proposed acquisition.

²¹ The Purchase and Sales Agreement filed as Exhibit R of the application states that, although \$4.686 million is the purchase price, \$286,000 will be paid upon approval by the voters with the balance of \$4.4 million paid over 30 years.

MEPB and also a first security agreement and financing statement for all personal property, fixtures, accounts receivable and contract rights being purchased from MEPB. Accordingly, Commission approval for the financing of the acquisition is required pursuant to KRS 278.300.

KRS 278.300(3) provides that the Commission shall not approve any issue or assumption of securities or evidences of indebtedness:

[U]nless . . . the issue or assumption is for some lawful object within the corporate purposes of the utility, is necessary or appropriate for or consistent with the proper performance by the utility of its service to the public and will not impair its ability to perform that service, and is reasonably necessary and appropriate for such purpose.

Several issues emerged during the Commission's review of the application herein. The first issue is South Kentucky's choice of a financing option. South Kentucky asserts that it selected the city of Monticello's financing option because the interest rate was more favorable than the rate available from South Kentucky's usual lender, the Rural Development Utilities Program. In addition, South Kentucky stated that other available financing options were more expensive than the city's proposal. South Kentucky maintained that the purchase and sales agreement did not allow for prepayment of the note because the city of Monticello desired a constant stream of income for the entirety of the financing period. Lastly, South Kentucky advised that the Rural Utilities Service has approved the lien subordination.

The Commission finds the financing option selected by South Kentucky to be reasonable given that it contained a favorable interest rate and was the least cost proposal. The Commission also finds the provision precluding prepayment of the note

to be reasonable in light of the city of Monticello's desire for a constant stream of income.

The second issue concerned the purchase price being in excess of the MEPB's net book value.²² South Kentucky maintained that the purchase price for the MEPB's fixed assets was a result of a negotiated process. An appraisal of the MEPB fixed assets had been performed, and the purchase price was within the range of values stated in the appraisal. South Kentucky asserts that the purchase price is fair, just and reasonable particularly when considering that EKPC has agreed to purchase for \$1.2 million a distribution substation, which is currently owned by MEPB, and is part of the transferring assets. South Kentucky further justified the purchase price by indicating that the acquisition would enable it to forgo plans to construct a branch office in Monticello to serve its existing customers since it can now utilize MEPB's existing office building as its new Monticello branch office. Eliminating the need to construct a branch office will save \$2.2 million. South Kentucky also stated that it is currently incurring capital costs of \$2,000 to \$2,200 for each new customer added, whereas the acquisition of MEPB's 3,000 customers represents a capital investment of approximately \$500 per customer.

The Commission finds the reasoning provided by South Kentucky on this issue persuasive. The purchase price is fair, just, and reasonable in light of the factors provided by South Kentucky in arriving at the final, negotiated purchase price. Notwithstanding the justification provided by South Kentucky regarding the purchase price, the Commission notes that it has historically not allowed rate recovery of a plant

²² MEPB's net book value at June 30, 2007 was approximately \$3.7 million.

acquisition adjustment resulting from the payment of a purchase price above net book value. In Case No. 9059,²³ the Commission declared that “the net original cost of plant devoted to utility use is the fair value for rate-making purposes, unless the utility can prove, with conclusive evidence, that the overall operations and financial condition of the utility have benefited from acquisitions at prices in excess of net book value.” We further held that the utility seeking the adjustment bears the burden to justify its purchase decision based “on economic and quality of service criteria.”²⁴ South Kentucky has acknowledged such historical treatment by the Commission and has stated that it does not intend to seek recovery of an acquisition adjustment for this transaction in its next rate case.

The third issue concerned the effect of potential increases in TVA wholesale rates and how such potential increases would be reflected in the base rates for former MEPB customers. Once the transaction has been completed, South Kentucky is obligated by its contract with MEPB to provide electric service at TVA-approved rates until December 31, 2008, since TVA will continue to be the wholesale power supplier through November 2008. To address this situation, the Commission will require South Kentucky to file, as part of the record in this case, a tariff for service to MEPB customers at approved rates until December 31, 2008. South Kentucky must include in that tariff a TVA fuel adjustment mechanism and file with the Commission within 10 days any notices received from TVA regarding changes in TVA’s rates during the time that MEPB’s former customers are still receiving TVA power. South Kentucky has agreed to

²³ Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc. (Ky. PSC, Sep. 11, 1985) at 3.

²⁴ *Id.*

file such a tariff and has also agreed that the Commission would have authority over the rates and service applicable to customers located inside the former MEPB service territory upon closing the transfer even though TVA would continue to be their wholesale power supplier through November 2008.

After careful review of the application, an examination of the record, and being otherwise sufficiently advised, the Commission will approve South Kentucky's financing of its acquisition of the fixed assets of the MEPB. The Commission finds South Kentucky's financing appropriate and consistent with the proper performance by South Kentucky of its service to the public and will not impair its ability to perform that service. The Commission further finds that the financing option selected by South Kentucky is reasonably necessary and appropriate since it was the lowest-cost financing option available.

IT IS THEREFORE ORDERED that:

1. South Kentucky's issuance to the city of Monticello of a 30-year note in the amount of \$4.4 million at an interest rate of 4.75 percent, and the issuance of a first mortgage and other security instruments in conjunction with the financing of the acquisition of the fixed assets of the MEPB is approved.
2. South Kentucky shall notify the Commission in writing within 10 days of completing the acquisition.
3. South Kentucky shall file, within 20 days of completion of the acquisition, a tariff for service to MEPB's existing customers at TVA-approved rates, with an expiration date of December 31, 2008. South Kentucky must include in that tariff a TVA fuel adjustment mechanism.

4. South Kentucky shall file with the Commission, within 10 days of receipt, any notices from TVA regarding changes in TVA's rates during that period of time that MEPB's former customers are still receiving TVA power.

5. South Kentucky shall file, within 20 days of the completion of the acquisition, new service territory maps reflecting the addition of the city of Monticello to its service territory.

6. South Kentucky shall record the purchase in accordance with the requirements of the RUS Uniform System of Accounts.

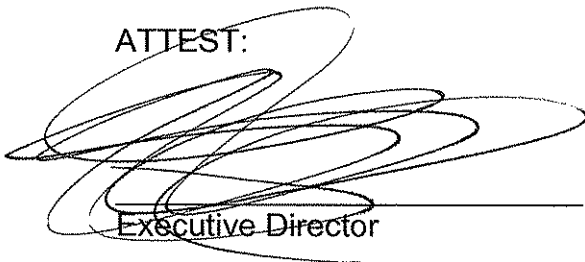
7. South Kentucky shall file, within 20 days of the completion of the acquisition, copies of the accounting entries to record the fixed assets purchased.

Nothing contained herein shall be construed as a finding of value for any purpose or as a warranty on the part of the Commonwealth of Kentucky or any agency thereof as to the securities authorized herein.

Done at Frankfort, Kentucky, this 18th day of December, 2007.

By the Commission

ATTEST:



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