COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR GENERAL ADJUSTMENT OF ELECTRIC RATES	)))	CASE NO. 2010-00167

INDEX

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ORDER

East Kentucky Power Cooperative, Inc. ("EKPC") is an electric utility that generates, transmits and sells wholesale electricity to its 16 member distribution cooperatives. Those distribution cooperatives, in turn, distribute and sell electricity at retail to approximately 520,000 consumers in all or portions of 89 counties in Kentucky.

BACKGROUND

On April 26, 2010, EKPC filed a letter giving notice of its intent to file an application for approval of an increase in its electric rates based on a forecasted test year ending December 31, 2011. On May 27, 2010, EKPC filed its application, which included new rates to be effective July 1, 2010, based on a request to increase its electric revenues by $49,377,447.

A review of the application revealed that it did not meet the minimum filing requirements set forth in 807 KAR 5:001, Section 10, and a notice of filing deficiencies was issued June 2, 2010. EKPC filed information on June 8, 2010 to cure the noted deficiencies. Our June 21, 2010 Order found that the additional information satisfied the minimum filing requirements and that the earliest possible date EKPC's proposed rates could become effective was July 8, 2010. To determine the reasonableness of the proposed increase, we suspended the proposed rates for six months from their effective date, pursuant to KRS 278.190(2), up to and including January 7, 2011.

Our June 21, 2010 Order also established the schedule for processing this case. The schedule provided for discovery, intervenor testimony, rebuttal testimony by EKPC, a formal evidentiary hearing, and an opportunity for parties to file post-hearing briefs.[1]

Parties requesting and granted full intervention in this matter were Gallatin Steel Company ("Gallatin") and the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"). Gallatin filed testimony September 7, 2010.[2] EKPC filed rebuttal testimony on October 15, 2010.

On November 29, 2010, an informal conference was held at the Commission's offices during which time the parties informed Commission Staff that a settlement of the issues in the case had been reached but that the AG had not determined if he would agree to all of the provisions contained in the settlement. Because the terms of the settlement had not been finalized and because of the uncertainty of the AG's position, the evidentiary hearing set for November 30, 2010, was convened solely for the purposes of hearing (1) the status of the settlement discussions and (2) taking comments by any members of the public who wished to express their views on the issues presented in the case.

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[1] After establishing the procedural schedule for the evidentiary portion of the case, the Commission scheduled and conducted four public meetings in the service territories of EKPC member cooperatives. The meetings were held November 4, 2010, in Somerset; November 8, 2010, in Morehead; November 9, 2010, in Nicholasville; and November 22, 2010, in Bardstown.

[2] The AG did not file testimony in this proceeding.

On December 3, 2010, another informal conference was held at which time Commission Staff was notified that the AG did not agree with the amount of additional revenue stipulated in the settlement, but agreed with the revenue allocation and rate design provisions contained therein. On December 3, 2010, EKPC, Gallatin and the AG filed a Settlement Agreement ("Settlement") intended to address all of the issues raised in the case.[3] The hearing was reconvened on December 9, 2010, in order for EKPC to present evidence in support of the Settlement and be subject to cross-examination on matters related to the revenue increase stipulated in the Settlement.

On December 13, 2010, EKPC filed its responses to requests for information made at the December 9, 2010 hearing.[4] On December 17, 2010, EKPC and Gallatin submitted a joint brief in support of the Settlement and the AG submitted a brief setting forth his position on the amount of additional revenue that EKPC should be awarded. The matter now stands submitted for a decision.

SETTLEMENT

The Settlement, attached hereto as Appendix A, reflects the agreement of the parties concerning all issues raised in the case, except with respect to the stipulated level of revenue requirement to which the AG does not agree. The major provisions of the Settlement as they to relate to EKPC's revenues and rates are as follows:

- EKPC's revenues should be increased $43 million with rates to be effective January 1, 2011, or when a final Order is issued, whichever is later.

[3] While the Settlement addressed all of the issues, it clearly stated that the AG did not agree with EKPC and Gallatin regarding the amount of the revenue increase.

[4] EKPC filed a revision to one of the responses on December 14, 2010.

- Billing determinants used to develop rates that generate the $43 million increase will be derived from EKPC's 2010 load forecast.

- The allocation of the increase in EKPC's revenues are set forth in Exhibit 1 to the Settlement and are fair, just and reasonable rates for the parties and EKPC's members.

- The rates in Exhibit 2 to the Settlement are the fair, just, and reasonable rates for the parties and EKPC's members.

- The agreed-upon rates reflect a reduction in the allocation to Gallatin of $500,000 to partially address the subsidy currently being provided by Gallatin.

- An over-earning mechanism will be established so that, in the event EKPC's Times Interest Earned Ratio ("TIER") for 2011 exceeds 1.50, the excess will be refunded to EKPC's members in proportion to the allocation of the $43 million increase by way of a surcredit application to be filed by EKPC.

- EKPC will file a base rate application as soon as practical after its 2011 financial results are known, but not more than one year thereafter, if its 2011 TIER exceeds 1.50.

- EKPC will file an application prior to the time frame established for the over-earning mechanism for the purpose of recovery of the regulatory asset for which it seeks approval in Case No. 2010-00449.[5]

- EKPC shall consider interest expense relating to Smith Unit 1 included in its base rates pursuant to the Settlement when it seeks cost recovery of the regulatory asset for which it seeks approval in Case No. 2010-00449. The parties agree that the amount of interest expense relating to Smith Unit 1 contained in the Settlement is $6 million plus TIER.

- EKPC is not prohibited by the Settlement from filing a base rate application before the time frame envisioned in relation to the over-earning mechanism in the event the Commission approves an increase less than the $43 million included in the Settlement.

[5] Case No. 2010-00449, Application of East Kentucky Power Cooperative, Inc. for an Order Approving the Establishment of a Regulatory Asset for the Amount Expended on its Smith 1 Generating Unit, filed Nov. 18, 2010.

- EKPC's Board of Directors and Management have accepted all recommendations in the Focused Management and Operations Audit Report of Liberty Consulting Group ("Liberty Report") and have implemented or are in the process of implementing same.

- The 10-minute interruptible credit for Gallatin will be increased to $6.22 per kW and will remain fixed for three years from the effective date of the new rates.

- The unamortized portion of the cost of the Spurlock outage shall be amortized over a three-year period.

- The parties agree that, due to the special contract between Gallatin, EKPC, and Owen Electric Cooperative, Inc. ("Owen"), the increase determined for Gallatin under the Settlement should be passed on to Gallatin by Owen. The parties further agree and recommend that this approach is appropriate to retail customers on EKPC's system whose wholesale power is provided under its Rate Schedule G.

In its application, EKPC proposed an increase in revenues of $49,377,447. In his post-hearing brief, based on Gallatin's testimony, the AG recommended that EKPC's revenue increase be limited to no more than $3,030,000.[6] With the exception of the AG, the parties agree that an annual increase in revenues of $43,000,000, as provided in the Settlement, is reasonable. Since all parties did not reach a unanimous settlement on the level of revenues, the Commission must consider the evidentiary record on this issue and render a decision based on a determination of EKPC's rate base, operating revenues, operating expenses, TIER, and financing requirements, as would be done if the case had been fully litigated.

TEST PERIOD

Pursuant to KRS 278.192, an application based on a forward-looking test period shall include a base period and the proposed test period. The base period cannot begin

[6] As the testimony reference indicates, Gallatin initially recommended a revenue increase of no more than $3,030,000 for EKPC.

more than nine months prior to the date of filing and cannot include less than six months of actual historical data and no more than six months of projected data at the time of filing. The forward-looking test period is to correspond to the 12 months immediately following the six-month suspension period permitted by KRS 278.190(2).

EKPC's base period is the 12 months from September 1, 2009 through August 31, 2010. Its proposed test period is the 12-months ending December 31, 2011. There were no challenges to EKPC's proposed base period or forward-looking test period.

When a forward-looking test period is used, the Commission typically reviews the utility's budgeting processes, budget manuals, variance analyses, and budget results versus actual results. While it has performed this review, the Commission notes that EKPC's proposed forward-looking test period results were not strictly based on budgeted information as is typically done. The Commission's determination of the reasonableness of EKPC's proposed test period, accordingly, must consider other factors. The primary factor available for the Commission's consideration is EKPC's actual historical base period results compared to the results of its partially historical and partially projected base period as reflected in its application.

At the time of its application, EKPC's base period consisted of seven months of actual data and five months of projected data. With its filing of October 15, 2010, EKPC provided actual historical results for its entire base period. While recognizing that its actual base period results and preliminary base period results are differentiated by only the last five months of the period, EKPC's projections of those five months are quite accurate. The following table provides a summary of the preliminary and the actual base period results.

	Preliminary Base Period Results	Actual Base Period Results	Percentage Variance
Revenues:	$813,391,655	815,403,284	0.25%
Operating Expenses:	542,128,063	544,949,590	0.52%
Maintenance Expenses:	62,667,719	59,981,640	4.31%
Fixed Costs:	193,457,281	190,426,170	1.56%
Total Cost of Service:	$798,253,063	$795,357,400	0.36%

In his post-hearing brief, repeating Gallatin's testimony, the AG stated that this case marks the first time EKPC has used a forecasted test period in support of a proposed rate increase. He also points to EKPC's testimony which described the manner in which data for the proposed test period was developed and concludes that it was prepared solely for purposes of this case. He then states that the test-year data was not prepared "[d]uring EKPC's normal budgeting" process and, when these circumstances are considered together, they shed more suspicion on the reliability of the data.

Contrary to the AG's comments concerning EKPC's use of a forward-looking test year, this was not the first instance in which EKPC has utilized such an approach in a base rate case. As was pointed out in a Commission Staff data request and confirmed in Gallatin's response thereto, EKPC used a forward-looking test year in its prior general rate case, Case No. 2008-00409, a case to which the AG was a party.[7] While it is true that EKPC developed the data for its test period specifically for this case, and that it was

[7] Case No. 2008-00409, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc. (Ky. PSC Mar. 31, 2009).

not developed during EKPC's *normal budgeting* process, contrary to the AG's claim, the data was generally developed under EKPC's established budgeting processes.[8]

Having reviewed EKPC's budgeting processes and manuals, its budget variance analyses, and the actual results versus preliminary results of its base period, we find it reasonable to use the 12 months ending December 31, 2011 as the test period.

RATE BASE

EKPC proposed a rate base of $2,213,160,944, which included the items used in the majority of rate cases before the Commission based on a historical or forward-looking test period. There were no challenges to EKPC's proposed rate base. The Commission has accepted EKPC's rate base for rate-making purposes except for the cash working capital allowance, which is adjusted based on the adjustments to operation and maintenance expenses discussed later in this Order. Based on our findings, we have determined EKPC's pro forma electric rate base for rate-making purposes based on the test period ending December 31, 2011 to be as follows:

[8] The development of the data specifically for this case and not during EKPC's "normal budgeting" protocol is a matter of timing. To prepare the data for this case by the time it wished to file its application, EKPC had to begin the process at an earlier point in time than it would have for the purpose of preparing its 2011 budget.

Total Utility Plant in Service	$2,682,114,806
Add:	
Construction Work in Progress	268,213,393
Materials & Supplies	46,709,321
Fuel Stock	50,805,477
Cash Working Capital Allowance	26,436,136
Subtotal	392,164,327
Deduct:	
Accumulated Depreciation	861,514,162
Pro Forma Rate Base	$2,212,764,971

CAPITALIZATION

In its application, EKPC determined that its 13-month average capitalization for its forward-looking test period was $3,238,689,539, which consisted of $283,637,462, or 8.76 percent, equity, and $2,955,052,077, or 91.24 percent, long-term debt. Eliminating $770,625,671, the amount which supports utility plant and assets, the cost of which is being recovered through EKPC's environmental surcharge, resulted in a 13-month average capitalization of $2,468,063,868 supporting EKPC's base rate utility plant and assets. Applying the above equity and debt ratios produces, for base rate purposes, an adjusted equity balance of $216,202,395 and adjusted debt balance of $2,251,861,473.

While the AG did not address EKPC's capitalization, the Commission finds that an adjustment is in order. According to EKPC's testimony filed in Case No. 2010-00238,[9] the amount spent on Smith 1 as of September 30, 2010 was $153.4 million, or $21.6 million less than the $175 million EKPC had included in its forward-looking test year capitalization to finance Smith 1. Given the decision by EKPC to surrender its

[9] Case No. 2010-00238, An Investigation of East Kentucky Power Cooperative, Inc.'s Need for the Smith 1 Generating Facility (filed Nov. 18, 2010).

certificate on Smith 1, the evidence does not support including any more in EKPC's capitalization for expenditures on the unit than the actual expenditures to date. Therefore, we have reduced EKPC's capitalization by $21.6 million and applied the entire reduction to its long-term debt, resulting in an adjusted debt balance of $2,230,261,473 and an adjusted capitalization of $2,446,463,868.

REVENUES AND EXPENSES

In its application, EKPC determined that its net margins for the forward-looking test period were $11,231,784.[10] EKPC proposed 22 adjustments to the revenues and expenses for the forward-looking test period, resulting in adjusted net margins of $6,794,534.[11]

The AG opposed six of the adjustments proposed by EKPC. We find that the other adjustments proposed by EKPC and not opposed by the AG are reasonable and should be accepted by the Commission. With regard to the six contested adjustments, which relate to: 1) interest on long-term debt; 2) interest rate on EKPC's credit facility; 3) salaries, wages and related payroll taxes; 4) employee benefits expense; 5) purchase power expenses related to forced outages; and 6) rate case expense, the Commission makes the following conclusions:

[10] Oliva Exhibit 1.

[11] Wood Exhibit 1.

Interest on Long-Term Debt

EKPC proposed $112,339,926 in interest on long-term debt in its forward-looking test year.[12] Citing Gallatin's testimony in his post-hearing brief, the AG states that this represents a 30 percent increase in interest expense from 2009 to 2011 and claims that the increase in long-term debt, on which the proposed interest expense is based, is excessive and unnecessary. The AG, continuing to rely on Gallatin's testimony, states that none of the increase in long-term debt and the related interest expense would go to finance EKPC's rate base. He then states that the decision to abandon construction of Smith Unit 1 should obviate the need for the $175 million in private placement debt included in EKPC's proposed test period specifically to finance the construction of Smith Unit 1. He recommends that EKPC's interest on long-term debt be reduced by $18.2 million which, recognizing the impact on EKPC's TIER requirements, would reduce its revenue requirement by $27.3 million.

It appears the AG relied on Gallatin's testimony to the exclusion of the remainder of the evidence of record. In data responses and in rebuttal testimony, EKPC explained that it generally finances its capital expenditures in arrears, meaning that only after construction projects, or phases of projects, are completed, will it obtain long-term funding. It also pointed out that, from December 2009 to December 2011, its projected capital expenditures of $471.9 million would exceed its projected $333.7 million increase in long-term debt by $138.2 million. Concerning the Smith 1 financing, EKPC stated on rebuttal that funds expended on that project had been used for a long-term

[12] EKPC's total interest on long-term debt for its forward-looking test period, including the amount recoverable through its environmental surcharge, is $147,316,797. This amount, as noted by Gallatin, reflects an increase of $29.0 million over EKPC's base period interest on long-term debt.

asset certificated by the Commission and that it would be appropriate to finance those expenditures on a long-term basis.

The Commission is not persuaded by the AG's argument. Aside from the impact of cancelling Smith 1, the evidence supports the levels of long-term debt and interest on long-term debt that EKPC projected for its forward-looking test year. However, given the change in circumstances concerning Smith 1 since the filing of EKPC's rate application, it is incumbent upon the Commission to recognize the impact of EKPC's decision to cancel the Smith project.

We recognized a $21.6 million reduction in EKPC's debt capitalization earlier in this Order. Since that reduction is due to the decision to cancel the Smith 1 generating unit, it is logical to assign the full reduction to the private placement debt which EKPC planned to use to finance Smith 1. At 7.5 percent, the interest rate EKPC estimated for the private placement debt it planned to issue to fund its Smith 1 expenditures, such a decrease in the amount to be financed will result in a reduction in interest expense on long-term debt of $1,620,000. Accordingly, the Commission will recognize a decrease in interest expense of this amount, which reduces EKPC's interest on long-term debt from $112,339,926 to $110,719,926.

Interest Rate on Unsecured Credit Facility

Included in EKPC's projected interest on long-term debt was interest expense on its recently approved unsecured credit facility, which it estimated based on an average interest rate for 2011 of 5.5 percent. Relying on Gallatin's testimony, the AG believes the rate of interest should be reduced to 4.0 percent, which would result in a decrease in interest expense, and TIER requirements, of $6.188 million.

On rebuttal, EKPC explained that it had projected a 5.5 percent interest rate based on the terms of the credit facility, the fact that the rate was variable, and in light of the historically low levels of interest rates at the time it executed the new credit facility in the fall of 2010.[13] It also pointed out how volatile short-term variable interest rates have been historically and that, given current economic conditions, it was reasonable to anticipate future volatility as well.

Again, the Commission is not persuaded by the AG's arguments. There was no support for Gallatin's proposal that the rate should be lowered to 4.0 percent other than its witness's review of the credit facility's pricing terms and belief that a lower rate was appropriate. We will make no adjustment to EKPC's projected interest on its unsecured credit facility.

Salaries, Wages, and Related Payroll Tax Expense

In his brief, the AG recommends that EKPC's salaries and wages expense for the test period be reduced by $3.2 million and that its related payroll tax expense be reduced by $244,000. These recommendations are based on limiting growth in these expense categories to 4.0 percent from the base period to the test period.

Gallatin's testimony on this issue, on which the AG relies, recognized total dollar amounts. However, it did not distinguish between increases in salary and wage rates and increases in numbers of employees. When more detailed information is available, the Commission tends to base its determination of what is a reasonable amount, or a reasonable adjustment, on its review of those very details.

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[13] It was clarified that EKPC was referring to the expectation that interest rates would be increasing subsequent to when the new facility was executed.

EKPC's proposed salaries and wages expense includes two components. The first component reflects an overall 3.5 percent merit increase in salaries and wages EKPC has budgeted for 2011. The second component reflects the addition of 20 employees during 2010 and 2011, for which support was provided in response to various data requests.[14]

The Commission has been carefully scrutinizing salary and wage increases in recent rate cases, particularly in light of current economic conditions. We continue to apply that type of scrutiny to the salary and wage increases proposed in this case.[15] While we appreciate the AG's concerns for the increase in the level of salaries and wages proposed by EKPC, we are not persuaded to adopt the adjustment the AG recommends because it fails to recognize the detail and underlying reasons for EKPC's proposal.

In considering the proposed level of salaries and wages, we note that EKPC implemented a cost-containment program roughly five years ago and that in both 2007

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[14] EKPC showed that the 20 additional positions relate primarily to its construction and environmental functions. Some positions were tied to the Smith Unit 1 project, which has been cancelled; however, being construction-related, the salaries and wages for those positions were not included in the projected test-year operation and maintenance expenses. Most of the remaining positions are either environmental or connected to the Cooper Station construction project.

[15] The Commission takes this opportunity to remind EKPC and all jurisdictional utilities of the need to fully consider current economic conditions and their impact on customers among other factors being considered when budgeting and awarding increases in employee salaries and wages.

and 2010 it provided no salary or wage increases.[16] We also note the AG's hearing exhibit which reflects that, for energy utilities nationally, base pay increases in 2010 averaged 2.9 percent and are projected to average 3.0 percent in 2011.[17] Taking this evidence into consideration, we find EKPC's budgeted 2011 increase of 3.5 percent to be reasonable.

EKPC provided several data responses concerning its proposed increase in employees.[18] EKPC's response to item 8 of the Commission Staff's Third Request for Information included a schedule listing the positions it planned to fill during 2010 and 2011. The schedule contained in the response includes two replacement employees, plus eight positions which had not been approved by its human resources group, all of which were not intended to be part of the 20 new employees. When these 10 positions are deducted from the total of the new positions shown in the response, 20 positions are left. However, the data response reflects that the salaries and wages for these 10 positions were not deducted from the amounts budgeted for the test year. Removing the 2011 salaries and wages of those employee positions reduces EKPC's 2011 salaries and wages by $383,159 and its related payroll taxes by $29,235, for a total

[16] At the Somerset public meeting, in response to a question from a member of the public concerning the steps it was taking to restrain costs under present economic conditions, an EKPC official stated that salaries and wages had been frozen in 2010. We do not believe these comments were designed to mislead the public about the level of employee compensation requested in this rate case.

[17] Attorney General Exhibit 1.

[18] EKPC's responses reflect, among other things, that, in 2008 and 2009, its overtime costs were $6.3 and $6.2 million, respectively. They also reflect that, with the increase in employees, its budgeted overtime costs for 2010 and 2011 were $4.7 and $4.2 million, respectively.

amount of $412,394.[19] Applying the test-year 87 percent expense ratio to this amount results in a reduction of $358,783 in EKPC's salaries, wages, and related payroll taxes expense.

We find EKPC's plans to fill the 20 additional positions reasonable, subject to the elimination of the positions related to the construction of Smith Unit 1. Although we recognize the costs of the additional positions as part of EKPC's proposed test-year salaries and wages expense, we find that the costs of the 10 positions, which were not meant to be included, should be removed from the proposed salaries and wages expense. Accordingly, we will deduct $358,783 for rate-making purposes, as discussed in the preceding paragraph.

Employee Benefits Expense

Relying on Gallatin's testimony, the AG recommends a reduction to EKPC's employee benefits expense for the test period of $2.661 million. Gallatin's testimony on this issue cited several concerns with the support, or lack thereof, for EKPC's projected level of benefits expense. Based on the Commission's review of these same issues, and given that EKPC did not address Gallatin's concerns in its rebuttal testimony, we conclude that those concerns are reasonable and agree with the AG's recommended $2.661 million reduction in EKPC's test-year employee benefits expense.

Purchased Power Expense Related to Forced Outages

EKPC included $10 million in purchased power expense associated with forced outages in its proposed test period. This amount is consistent with the level proposed by EKPC in its prior rate case. In his post-hearing brief, based on the argument from

[19] Some positions were scheduled to be filled at various times during 2011, so the test period does not reflect a full twelve months' salaries or wages for them.

Gallatin's testimony on this particular issue, the AG recommended that the expense be reduced to $5.54 million, citing the average amount EKPC has incurred for this expense in recent years, plus the fact that EKPC now carries insurance to cover forced outages.

On rebuttal, EKPC stated that it has incurred purchased power expenses related to forced outages exceeding $9.7 million in three of the last five years. It pointed out that its forced outage insurance policy is designed to provide protection in the event of a catastrophic outage of an extended duration and will not cover the costs of outages of a more typical nature.[20] EKPC also explained that estimates of the savings associated with its forced outage insurance policy were unreliable due to the random nature of outage events and that subtracting the insurance premium from its estimated unrecoverable forced outage costs does not provide an adequate estimate of the savings.

The record reflects that EKPC's average unrecoverable forced outage costs for the past five years are $8.252 million. It also reflects that neither of EKPC's newest coal-fired units, Gilbert and Spurlock 4, was in commercial operation for the full five-year period. It was well documented in EKPC's prior base rate case, Case No. 2008-00409, that, while having several positive aspects, circulating fluidized bed units, such as Gilbert and Spurlock 4, require longer cool-down periods during outages prior to beginning the needed restorative work. Considering all the relevant evidence, we conclude that $10 million is an appropriate level of expense to allow for rate-making purposes.

[20] EKPC also pointed out that, as a generation and transmission cooperative, it has no shareholders to absorb any unrecoverable forced outage costs.

Rate Case Expense

EKPC included an estimate of $625,000 in rate case expenses related to this proceeding in its application, or more than twice the expense, $296,000, it incurred in conjunction with its prior rate case, Case No. 2008-00409. Consistent with the typical treatment of rate case expenses for rate-making purposes, EKPC proposed to amortize this amount over three years, resulting in an annual expense of $208,333. In his post-hearing brief, the AG pointed out the discrepancy between EKPC's estimate for this case and the actual expense for its prior case. He also noted that, as of late November 2010, EKPC's actual expenses incurred for this case were approximately $181,000. The AG recommended that the amount EKPC should be permitted to include for rate-making purposes be its actual expenses, not the amount it estimated.

The AG's recommendation is consistent with the Commission's long-standing practice regarding the rate-making treatment of rate case expenses. Accordingly, we will limit the amount of rate case expense EKPC may recover to $181,000 which, amortized over three years, results in an annual expense of $60,333. This will result in reducing the amount allowed as part of EKPC's revenue requirement by $148,000.

Net Operating Income Summary

After considering all pro forma adjustments, EKPC's adjusted net margins are as follows:

Operating Revenues	$ 392,653,110
Operating Expenses, including Interest Expense	384,580,940
Adjusted Net Operating Income	$ 8,072,170
Non-Operating Income & Deductions (Net)	3,510,147
Adjusted Net Margins	$ 11,582,317

REVENUE REQUIREMENTS

The Commission has determined that, based upon the adjusted interest on long-term debt found reasonable herein of $110,719,926, and a 1.50 X TIER, EKPC's net margins that could be justified by the evidence of record are $55,359,963.[21] Based on the adjustments found reasonable herein, EKPC's pro forma net margins for the forward looking test period are $11,582,317. Based on a 1.50 TIER, it would need an increase in net margins of $43,777,646. After providing for the PSC assessment, EKPC would have a revenue deficiency of $43,846,946. The calculation of this revenue deficiency is as follows:

Net Margins Found Reasonable	$ 55,359,963
Pro Forma Net Margins	11,582,317
Net Margin Deficiency	43,777,646
Gross-up based on PSC assessment	1.001583
Required Revenue Increase	$ 43,846,946

The Commission has found that EKPC's proposed TIER of 1.50 is reasonable in light of the findings and recommendations contained in the Liberty Report. Applying the findings herein on the reasonable cost of debt and a TIER of 1.50 would result in a justifiable revenue increase of $43,846,946. The alternative proposal provided in the Settlement is $43,000,000. Based on the findings and conclusions herein, we find that the margins resulting from the adoption of EKPC's alternative proposal will produce a reasonable result for EKPC, its member owners, and its members' retail customers. The $43,000,000 revenue increase EKPC is willing to accept will result in fair, just, and

[21] $110,719,926 in interest on long-term debt X a 1.50 TIER results in interest plus margins of $166,079,889. Interest plus margins of $166,079,889 minus the interest = margins of $55,359,963.

reasonable electric rates for EKPC, its members and its members' retail customers. Therefore, the Commission will accept EKPC's alternative proposal that its revenues be increased by $43,000,000 rather than the higher level justified by the record.

FINDINGS ON SETTLEMENT

Based upon a review of all the provisions in the Settlement, an examination of the entire record, and being otherwise sufficiently advised, the Commission finds that the provisions of the Settlement are in the public interest and should be approved since they will result in a smaller increase than justified by a traditional rate-making analysis. Our approval of the Settlement is based solely on its reasonableness in toto and does not constitute precedent on any issue except as specifically provided for therein. There are, however, two provisions contained in the Settlement which require further analysis and discussion.

First, paragraph 4 under the heading "Ancillary Matters" on page 6 of the Settlement addresses the manner in which the increase for Gallatin, pursuant to the Settlement, should be passed through to Gallatin by its retail distribution cooperative, Owen. The text of the paragraph specifically states that, due to the fact that Gallatin is served via a special contract between EKPC, Owen and itself, the increase determined for Gallatin in the Settlement is the amount that should be passed through by Owen to Gallatin.

The parties to the Settlement recommend that the Commission find this approach to be consistent with KRS 278.455(3), which provides that rate increases or decreases for special contracts are subject to change or adjustment only as stipulated in the contract. The parties also recommend that we find this approach to be appropriate and reasonable for flowing through the wholesale increases for customers taking service under EKPC's Rate Schedule G. Having considered the recommendations and being well aware of the complexities of deriving the pass-through amounts of large volume customers such as Gallatin, we find that the amount of the increase allocated to Gallatin under the Settlement should be the amount passed through to Gallatin by Owen. We also find that this approach is consistent with the provisions of KRS 278.455(3) and is appropriate for large-volume customers served under EKPC's Rate Schedule G.

Second, the Settlement established an over-earning mechanism under which EKPC would file a surcredit application to refund any excess earnings if its TIER exceeds 1.50 for calendar year 2011. As EKPC's 16 member distribution cooperatives were not parties to this proceeding and were not signatories to the Settlement, the individual distribution cooperatives are not bound by any of the terms contained in the Settlement. To ensure that any excess earnings achieved by EKPC which would trigger the over-earning mechanism established by the Settlement would be refunded to retail ratepayers, the Commission will require EKPC to obtain written verification from each of its 16 member distribution cooperatives, acknowledging and affirming their agreement that, should EKPC file a surcredit application pursuant to the over-earning provision of the Settlement, the distribution cooperatives would file concurrent application to refund such excess earnings to their respective ratepayers.

OTHER ISSUES

In several of EKPC's distribution cooperatives' recent rate cases, we have emphasized our interest in the cooperatives pursuing energy efficiency and Demand-Side Management ("DSM") programs. We note that, in this case, EKPC projected a level of transfer payments under its DSM programs of $1.5 million for its forecasted test year. We also note that, pursuant to the settlement agreement filed in Case No. 2010-00238,[22] EKPC will be forming a collaborative for the purposes of evaluating and recommending "[a]ctions to expand deployment of renewable energy and demand-side management . . . ." According to the terms of that agreement, EKPC plans to devote $100,000 to perform studies to evaluate such programs. In light of its need for additional peaking capacity, we strongly encourage EKPC and its distribution cooperatives to aggressively pursue all energy efficiency and DSM programs that EKPC's studies and analyses deem to be cost-effective.

ORDERING PARAGRAPHS

Based on the evidence of record and the findings contained herein, the Commission HEREBY ORDERS that:

1. The rates and charges proposed by EKPC are denied.

2. The provisions in the Settlement, as set forth in Appendix A hereto (without exhibits), are approved in their entirety.

3. The rates and charges for EKPC, as set forth in Appendix B hereto, are the fair, just, and reasonable rates for EKPC, and are approved for service rendered on and after the date of this Order.

4. Within 20 days of the date of this Order, EKPC shall file its revised tariffs with this Commission setting out the rates authorized herein and reflecting that they were approved pursuant to this Order.

[22] Case No. 2010-00238, An Investigation of East Kentucky Power Cooperative, Inc.'s Need for the Smith 1 Generating Facility (filed Jun. 22, 2010).

5. Within 10 days of the date of this Order, EKPC shall file fully executed verification and acknowledgement statements from each of its 16 member distribution cooperatives affirming the intent of the over-earning mechanism as described in the previous section of this Order.

By the Commission

ENTERED
JAN 14 2011
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00167 DATED JAN 14 2011

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

GENERAL ADJUSTMENT OF ELECTRIC RATES OF EAST KENTUCKY POWER COOPERATIVE, INC.	)))	**CASE NO. 2010-00167**

SETTLEMENT AGREEMENT

This Settlement Agreement ("Settlement Agreement") is entered into this 30th day of November 2010, by and between East Kentucky Power Cooperative, Inc. ("EKPC"); Commonwealth of Kentucky, ex. rel. Jack Conway, Attorney General, by and through the Office of Rate Intervention ("AG"); and Gallatin Steel Company ("Gallatin"). Its terms are set forth below:

WITNESSETH:

WHEREAS, on May 27, 2010, EKPC filed with the Kentucky Public Service Commission ("Commission") its Application for a General Adjustment of its Wholesale Electric Rates in a case styled, *In the Matter of: General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc.*, Case No. 2010-00167; and,

WHEREAS, the AG and Gallatin were granted intervention by Order of the Commission in this proceeding; and,

WHEREAS, a prehearing meeting for the purpose of discussing settlement, and related procedural and substantive issues, took place at the Lexington Office of Frost Brown Todd LLC on November 24, 2010, which was attended in person by representatives of the AG, Gallatin, and EKPC (the "Parties") ; and,

WHEREAS, the Parties hereto desire to settle many of the issues pending before the Commission in the above-referenced proceeding; and,

WHEREAS, the adoption of this Settlement Agreement will decrease the need for the Commission and the parties to expend unnecessary resources litigating these proceedings; and, further, will greatly reduce the possibility of, and any need for, rehearing or appeals of the Commission's final order herein; and,

WHEREAS, it is understood by all Parties hereto that this Settlement Agreement is subject to the approval of the Commission, insofar as it constitutes an agreement by the parties for settlement, and, absent express agreement stated herein, does not represent agreement on any specific claim, computation, formula, allegation, assertion, contention, methodology, theory or ratemaking principle supporting the appropriateness of any proposed or recommended adjustments to EKPC's rates, terms, and conditions; and,

WHEREAS, the Parties agree that this Settlement Agreement, viewed in its entirety, is a fair, just, and reasonable resolution of many of the issues in the above-referenced proceeding; and,

WHEREAS, it is the position of the Parties hereto that the terms about which they can all agree as reflected in this Settlement Agreement are supported by sufficient and adequate data and information, and should be approved in its entirety by the Commission; and,

WHEREAS, the Parties understand and agree that the results of EKPC's 2010 Load Forecast have significantly impacted the billing determinants (i.e. kW, kWh) used by EKPC to generate its proposed rates in the original Application.

NOW, THEREFORE, for and in consideration of the good-faith negotiations entered into by the parties and the terms and conditions set forth herein, the Parties hereby stipulate and agree as follows:

ARTICLE I- Revenue Requirements and Revenue Allocation

1. The Parties, except for the AG, hereto agree and stipulate that a Forty-Three Million dollar ($43,000,000) increase in annual revenue for EKPC, which represents a "black box" settlement, is fair, just, and reasonable for the Parties, except for the AG, and for all members of EKPC.

2. The Parties hereto agree and stipulate that the billing determinants used to develop rates will be those billing determinants derived from EKPC's 2010 load forecast. However, the AG does not agree to or stipulate to the rates developed from the $43,000,000 annual revenue increase.

3. The Parties hereto agree that the annual revenue increase will be effective for service rendered on and after January 1, 2011, or the date of the Commission's Order placing such rates into effect, whichever is later, and this rate implementation date is fair, just, and reasonable for the Parties and for all members of EKPC.

4. The Parties hereto agree that the allocations of the increase in annual revenue for EKPC, as set forth on the schedule designated "Exhibit 1," and the rates set forth on the tariff sheets in "Exhibit 2" hereto are fair, just, and reasonable for the Parties and for all members of EKPC.

5. The Parties hereto agree that the rates contained in "Exhibit 1" reflect a reduction in the allocation to Gallatin of $500,000 to partially address the subsidy currently being paid by Gallatin, and allocates said subsidy reduction proportionally to all rate classes except the pumping stations.

6. The Parties hereto recognize and agree that the 2010 load forecast, which was developed and filed subsequent to the completion of discovery in the instant action, represents a significant change to EKPC's projected load, and which also has a significant effect on EKPC's finances. The Parties therefore agree to the establishment of an "over-earning mechanism" which will hereafter be implemented as follows:

   a. EKPC will provide its calendar year 2011 audited financial statements to the Commission and Parties no later than March 31, 2012.

   b. EKPC agrees to file a base rate case as soon as practical, but no less than one year in the event EKPC's TIER exceeds 1.50, after 2011 financial results are known in order for the Commission to determine that rates are appropriate. This base rate case will also allow the Parties an opportunity, through discovery, to review EKPC's expenditures. If the results of the base rate case produce an increase or decrease to rates, such increases or decreases will be allocated proportionally to all eligible rate schedules so as to produce an equal percentage increase or decrease in the total rates of all eligible rate schedules.

   c. If EKPC earns greater than a 1.50 Times Interest Earned Ratio ("TIER") based on its calendar year 2011 audited financial statements, EKPC shall refund the amount in excess of the 1.50 TIER in a proportional manner according to the

ARTICLE II- Ancillary Matters

1. EKPC affirms to the Parties that the EKPC Board of Directors and Management have accepted all recommendations outlined in the Focused Management and Operations Audit Report prepared by the Liberty Consulting Group ("Liberty"), and have implemented or are in the process of implementing said recommendations.

2. EKPC will follow the recommendations in Liberty's report and provide proof of same to the Commission and the AG.

3. The Parties hereto agree that the 10-minute interruptible credit for Gallatin will be increased to $6.22/kW and this credit shall remain fixed for a period of three years from the effective date of the rates. After three years, this interruptible credit may be increased or decreased by Order of the Commission. The Parties agree that EKPC will absorb the revenue loss created by the increase in the 10-minute interruptible credit for Gallatin.

4. The Parties agree that, due to the existence of a special contract between Gallatin, EKPC, and Owen Electric Cooperative (Owen), it is fair, just, and reasonable that the increase determined for Gallatin under the terms of this Agreement should be the amount passed through by Owen to Gallatin. The Parties recommend that the Commission find that this approach is consistent with the provisions of KRS 278.455(3) and the Parties further agree and recommend to the Commission that this approach and finding is appropriate to other customers on tariff rate Schedule G.

5. The Parties agree that the unamortized costs of the Spurlock 1 outage will be amortized over a three-year period.

ARTICLE III -Miscellaneous Provisions

1. Except as specifically stated otherwise in this Settlement Agreement, the Parties agree that making this Settlement Agreement shall not be deemed in any respect to constitute an admission by any party hereto that any computation, formula, allegation, assertion, contention, methodology, or ratemaking principle otherwise made by any other party in these proceedings is true or valid.

2. The Parties hereto agree that the foregoing stipulations and agreements represent a fair, just, and reasonable resolution of the issues addressed herein and request the Commission to approve the Settlement Agreement.

3. The Parties hereto agree that, following the execution of this Settlement Agreement, the Parties shall cause the Settlement Agreement to be filed with the Commission by November 30, 2010, together with a request to the Commission for consideration and approval of this Settlement Agreement for rates to become effective on and after January 1, 2011.

4. Each party stipulates and recommends that the Notice of Intent, Notice, Application, testimony, pleadings, and responses to data requests filed in this proceeding be admitted into the record. The Parties, except for the AG, stipulate that after the date of this Settlement Agreement they will not otherwise contest EKPC's proposals, as modified by this Settlement Agreement, in the hearing of the above-referenced proceeding regarding the subject matter of the Settlement

Agreement, and that they will refrain from cross-examination of the Parties' witnesses during the hearing, except insofar as such cross-examination is in support of the Settlement Agreement.

5. The Parties hereto agree that this Settlement Agreement is subject to the acceptance of and approval by the Commission. The Parties hereto further agree to act in good faith and to use their best efforts to recommend to the Commission that this Settlement Agreement be accepted and approved.

6. If the Commission issues an order adopting this Settlement Agreement in its entirety, each of the Parties agrees that it shall file neither an application for rehearing with the Commission, nor an appeal to the Franklin Circuit Court with respect to such order.

7. The Parties hereto agree that, if the Commission does not accept and approve this Settlement Agreement in its entirety, then: (a) this Settlement Agreement shall be void and withdrawn by the parties hereto from further consideration by the Commission and none of the parties shall be bound by any of the provisions herein, provided that no party is precluded from advocating any position contained in this Settlement Agreement; and (b) neither the terms of this Settlement Agreement nor any matters discussed or raised during the settlement negotiations shall be binding on any of the Parties to this Settlement Agreement, be construed against any of the Parties in any fashion, nor be the subject of cross-examination in any subsequent court or administrative proceeding.

8. The Parties hereto agree that, should the Settlement Agreement be voided or vacated for any reason after the Commission has approved the Settlement

Agreement, then the parties shall be returned to the *status quo* existing at the time immediately prior to the execution of this agreement.

9. The Parties hereto agree that this Settlement Agreement shall in no way be deemed to divest the Commission of jurisdiction under Chapter 278 of the Kentucky Revised Statutes.

10. The Parties hereto agree that this Settlement Agreement shall inure to the benefit of and be binding upon the parties hereto, their successors and assigns.

11. The Parties hereto agree that this Settlement Agreement constitutes the complete agreement and understanding among the parties hereto, and any and all oral statements, representations or agreements made prior hereto or contained contemporaneously herewith shall be null and void and shall be deemed to have been merged into this Settlement Agreement.

12. The Parties hereto agree that, for the purpose of this Settlement Agreement only, the terms are based upon the independent analysis of the parties to reflect a fair, just, and reasonable resolution of the issues herein and are the product of compromise and negotiation.

13. The Parties hereto agree that neither the Settlement Agreement nor any of the terms shall be admissible in any court or administrative proceeding except insofar as such court or administrative body is addressing litigation arising out of the implementation of the terms herein or the approval of this Settlement Agreement. This Settlement Agreement shall not have any precedential value in this jurisdiction.

14. The signatories hereto warrant that they have appropriately informed, advised, and consulted their respective Parties in regard to the contents and significance of this Settlement Agreement and based upon the foregoing are authorized to execute this Settlement Agreement on behalf of their respective Parties.

15. The Parties hereto agree that this Settlement Agreement is a product of negotiation among all parties hereto, and no provision of this Settlement Agreement shall be strictly construed in favor of or against any party. Notwithstanding anything contained in the Settlement Agreement, the Parties recognize and agree that the effects, if any, of any future events upon the operating income of EKPC is unknown and this Settlement Agreement shall be implemented as written.

16. The Parties hereto agree that this Settlement Agreement may be executed in multiple counterparts.

IN WITNESS WHEREOF, the parties have hereunto affixed their signatures:

East Kentucky Power Cooperative, Inc.

HAVE SEEN AND AGREED:

By: ________________________

Mark David Goss, Counsel

Commonwealth of Kentucky, ex. rel. Jack Conway, Attorney General, by and through the Office of Rate Intervention

HAVE SEEN AND AGREED:

By: ______________________________

Dennis G. Howard II, ~~Counsel~~

Gallatin Steel Company

HAVE SEEN AND AGREED:

By: Michael L. Kurtz

Michael L. Kurtz, Counsel

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APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2010-00167 DATED JAN 14 2011

The following rates and charges are prescribed for the member system cooperatives served by East Kentucky Power Cooperative, Inc. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

WHOLESALE POWER RATE SCHEDULE

Monthly Rate

Metering Point Charge:

1. Applicable to each metering point and to each substation
2. Charge: $144.00

Substation Charge:

1. Applicable to each substation based on its size
2. Charges:

1,000 to 2,999 kVA substation	$ 1,088.00
3,000 to 7,499 kVA substation	2,737.00
7,500 to 14,999 kVA substation	3,292.00
15,000 and over kVA substation	5,310.00

SECTION A

Monthly Rate – Per Load Center

Demand Charge per kW of Billing Demand	$	9.98
Energy Charge per kWh	$	.049272

SECTION B

Monthly Rate

Demand Charge per kW of Minimum Demand	$	7.17
Demand Charge per kW of Billing Demand in Excess of Minimum Demand	$	9.98
Energy Charge per kWh	$	.049272

SECTION C

Monthly Rate

Demand Charge per kW of Billing Demand	$	7.17
Energy Charge per kWh	$	.049272

SECTION E

Monthly Rate -- Per Load Center

Option 1

Demand Charge per kW of Billing Demand	$	7.99
Energy Charge per kWh:		
On-Peak	$	.051522
Off-Peak	$	.050944

Option 2

Demand Charge per kW of Billing Demand	$	6.02
Energy Charge per kWh:		
On-Peak	$	.059669
Off-Peak	$	.050944

SECTION G
SPECIAL ELECTRIC CONTRACT RATE

Monthly Rate

Demand Charge per kW of Billing Demand	$	6.98
Energy Charge per all kWh	$	.047237

LARGE SPECIAL CONTRACT

Monthly Rate

Demand Charge per kW of Billing Demand:		
Firm Demand	$	6.92
10 Minute Interruptible Demand		(6.22)
90 Minute Interruptible Demand		(4.20)
Energy Charge per kWh:		
On-Peak	$	.049195
Off-Peak	$	.045767

STEAM SERVICE

Monthly Rate

Demand Charge per MMBTU	$	577.15
Energy Charge per MMBTU	$	5.195

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