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January 14, 2016

HAND DELIVERED

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JAN 14 2016
PUBLIC SERVICE COMMISSION

Mr. Jeff Derouen
Executive Director
Kentucky Public Service Commission
P.O. Box 615
211 Sower Boulevard
Frankfort, KY 40602

Re: PSC Case No. 2015-00358

Dear Mr. Derouen:

Please find enclosed for filing with the Commission in the above-referenced case an original and ten redacted copies of the first status report of East Kentucky Power Cooperative, Inc. ("EKPC"), as directed by the Commission's November 30, 2015 Order.

Also enclosed are an original and ten copies of EKPC's Motion for Confidential Treatment of Information ("Motion"). One unredacted copy of the designated confidential portions of these responses, which are the subject of the Motion, is enclosed in a sealed envelope.

Very truly yours,

David S. Samford (by Roger R. Cowden)

David S. Samford

Enclosures

COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR DEVIATION FROM OBLIGATION RESULTING FROM CASE NO. 2012-00169	)) Case No. 2015-00358)

MOTION FOR CONFIDENTIAL TREATMENT

Comes now East Kentucky Power Cooperative, Inc. ("EKPC"), by and through counsel, pursuant to KRS 61.878, 807 KAR 5:001, Section 13 and other applicable law, and for its Motion requesting that the Kentucky Public Service Commission ("Commission") afford confidential treatment to certain portions of EKPC's first status report filed in the above-captioned proceeding, respectfully states as follows:

1. In its Application, EKPC requested permission to deviate from a directive contained in the Commission's final Order entered in Case No. 2012-00169 (the "PJM Integration Case").[1] Specifically, EKPC sought an eighteen (18) month extension of the deadline by which it must file a rate mechanism to share with customers certain capacity benefits earned through EKPC's participation in PJM Interconnection, LLC ("PJM"). By way of an Order entered on November 30, 2015, the Commission: (1) granted EKPC's motion to hold the case in abeyance for ninety (90) days to allow the parties to discuss an appropriate resolution of the issues raised therein;

[1] *In the Matter of the Application of East Kentucky Power Cooperative, Inc. to Transfer Functional Control of Certain Transmission Facilities to PJM Interconnection, LLC* (Ky. P.S.C., Dec. 20, 2012).

and (2) directed EKPC to file a status report on January 14, 2016. Contemporaneous with this filing, EKPC is tendering its first status report.

2. Information which is proprietary, confidential, sensitive, and commercially valuable is set forth in the first status report. All of this information relates to EKPC's actual and projected financial performance as a fully-integrated member of PJM. EKPC seeks Confidential Treatment for this information (the "Confidential Information"), which is more particularly described as: (1) the trade benefits realized by EKPC from June 2013 through March 2014 and from June 2014 through May 2015; and (2) the actual and projected revenues from PJM's Capacity Market auctions for the 2013-2014 through 2018-2019 Delivery Years.

3. The Confidential Information includes detailed, highly sensitive economic data related to EKPC's market positions within PJM. The Confidential Information reflects proprietary financial results and projections developed internally by EKPC that is not available from any commercial or other source, and the public disclosure of the Confidential Information would potentially harm EKPC's competitive position in the marketplace, to the detriment of EKPC and its customers. The Kentucky Open Records Act exempts the Confidential Information from disclosure. *See* KRS 61.878(1)(c)(1).

4. KRS 61.878(1)(c)(1) protects "records confidentially disclosed to an agency or required by an agency to be disclosed to it, generally recognized as confidential or proprietary, which if openly disclosed would permit an unfair commercial advantage to competitors of the entity that disclosed the records." The Kentucky Supreme Court has stated, "information concerning the inner workings of a corporation is 'generally accepted as confidential or proprietary'" *Hoy v. Kentucky Industrial Revitalization* Authority, 907 S.W.2d 766, 768 (Ky. 1995). All of the Confidential Information is critical to EKPC's effective execution of business decisions and strategy. If disclosed, the Confidential Information would give EKPC's competitors insights into EKPC's

business operations and strategies that are otherwise publicly unavailable. Accordingly, the Confidential Information satisfies both the statutory and common law standards for affording confidential treatment.

5. The Confidential Information is proprietary information that is retained by EKPC on a "need-to-know" basis and that is not publicly available.[2] The Confidential Information is distributed within EKPC only to those employees who must have access for business reasons, and is generally recognized as confidential and proprietary in the energy industry.

6. EKPC does not object to limited disclosure of the Confidential Information described herein, pursuant to an acceptable confidentiality and nondisclosure agreement, to intervenors with a legitimate interest in reviewing the same for the sole purpose of participating in this case.

7. In accordance with the provisions of 807 KAR 5:001, Section 13(2), EKPC is filing one (1) copy of the unredacted first status report separately under seal with the Confidential Information highlighted. Ten redacted copies of the first status report have also been tendered to the Commission.

8. In accordance with the provisions of 807 KAR 5:001, Section 13(2), EKPC respectfully requests that the Confidential Information be withheld from public disclosure for ten (10) years.

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[2] EKPC has sought confidential treatment of the same information in the course of filing the two PJM participation annual reports. *See* Letter from Mark David Goss to Jeff Derouen requesting confidential treatment for actual and projected PJM membership benefits and costs in EKPC's first Annual Report on PJM Integration, Case No. 2012-00169 Post-Case Correspondence (filed June 2, 2014); Letter from Mark David Goss to Jeff Derouen requesting confidential treatment for actual and projected PJM membership benefits and costs in EKPC's second Annual Report on PJM Integration, Case No. 2012-00169 Post-Case Correspondence (filed July 31, 2015).

9. If, and to the extent, the Confidential Information becomes publicly available or otherwise no longer warrants confidential treatment, EKPC will notify the Commission and have its confidential status removed, pursuant to 807 KAR 5:001 Section 13(10).

WHEREFORE, on the basis of the foregoing, EKPC respectfully requests that the Commission classify and protect as confidential the specific Confidential Information described herein for a period of ten (10) years.

This 14th day of January, 2016.

Respectfully submitted,

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Counsel for East Kentucky Power Cooperative, Inc.

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing was served by depositing same into the custody and care of the U. S. Mail, postage pre-paid, on this 14th day of January 2016, addressed to the following:

Michael L. Kurtz
Jody M. Kyler Cohn
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Counsel for East Kentucky Power Cooperative, Inc.

January 14, 2016

Mr. Jeff Derouen, Executive Director
Kentucky Public Service Commission
P. O. Box 615
211 Sower Boulevard
Frankfort, KY 40602

VIA HAND DELIVERY

RE: *In the Matter of the Application of East Kentucky Power Cooperative, Inc. for Deviation from Obligation Resulting from Case No. 2012-00169,* Case No. 2015-00358 – First Status Report

Dear Mr. Derouen,

In accordance with the Commission's November 30, 2015 Order in the above-styled case, please accept this as the first status report of East Kentucky Power Cooperative, Inc. ("EKPC") regarding the efforts of EKPC, the Kentucky Industrial Utility Customers, Inc. ("KIUC"), the Attorney General's Office of Rate Intervention ("AG"), and the Commission Staff to reach a consensus on the issue of a flow-back rate mechanism for the PJM Interconnection, L.L.C. ("PJM") capacity market benefits.

Representatives of EKPC, KIUC, the AG, and Commission Staff met at the Commission's Offices in Frankfort on December 22, 2015 for initial discussions. EKPC began by discussing several topics: expected versus actual net benefits from PJM participation; capacity market developments and EKPC capacity considerations; and flow-back rate mechanism considerations.

Net Benefits from PJM Participation

As discussed in the December 20, 2012 Order in Case No. 2012-00169, EKPC had engaged Charles River Associates to evaluate the estimated costs and benefits associated with membership in PJM. The results of the Charles River Analysis ("CRA") is summarized in the following table.

10-Year Estimated Cost and Benefits, Net Present Value Basis		
Category	Costs	Benefits
Administrative Costs	$48.3 million	
Transmission Costs	$53.0 million	
Trade Benefits		$40.0 million
Capacity Benefits		$137.0 million
Avoided PTP Transmission Charges		$56.1 million
Subtotal	$101.3 million	$233.1 million
Net Benefits		$131.9 million

The benefits that actually reflected revenues coming into EKPC were a component of the trade benefits and capacity benefits.

Trade Benefits. EKPC and the CRA expected minimal savings as a result of improved dispatch opportunities or savings from purchasing lower cost energy supply. These were identified as trade benefits. The estimated trade benefits over a 10-year period were:

	2013	2014	2015	2016	2017	2018	2019	2020-2022
Yearly Benefit ($MM)	$2.3	$3.9	$3.9	$3.8	$3.8	$5.3	$6.8	$28.8
Cumulative Benefit ($MM)	$2.3	$6.2	$10.1	$13.9	$17.7	$23.0	$29.8	$58.6

The yearly benefit for 2013 reflected a partial year from June through December. The total estimated trade benefit for the 10-year period, on a net present value basis, was $40.0 million.

Trade benefits have been substantially higher than estimated. As reported by EKPC in its annual report regarding participation in PJM, for the period June 2013 through March 2014 trade benefits were [redacted] million and for the period June 2014 through May 2015 trade benefits were [redacted] million. Trade benefits are realized when EKPC can serve its load at a net variable cost less than what would have happened when EKPC was a stand-alone balancing authority. Trade benefits are determined by running a production cost model using actual loads, actual unit availabilities, actual fuel costs, and known market prices. The modeled analysis is compared to the costs that EKPC actually incurred as a member operating within the PJM system. The vast majority of the cost differential is comprised of reduced fuel costs, which flow directly through to the Members via the Fuel Adjustment Clause. Additional trade benefits result when EKPC is able to sell excess generation into the market. These off-system sales benefits improve EKPC margins and accrue to Members as capital allocations (equity).

Capacity Benefits. The CRA results showed substantial PJM revenues for EKPC's future capacity sales. As a winter peaking system, EKPC had obtained capacity to cover the normal winter peak plus operating reserves. PJM is a summer peaking system and requires that EKPC provide or purchase adequate capacity to cover its summer peak load plus its proportionate operating reserves. Changing to a summer based requirement would allow EKPC to sell its additional winter capacity into the PJM capacity auctions and realize revenues for doing so.

However, capacity benefits have been substantially lower than projected. The following table compares the CRA estimates with the actual results for six capacity market auction periods.

Auction Period	CRA Estimates			Actual Capacity Market Auction Results ($MM)	CRA Estimated Capacity Clearing Price ($/MW-day)	Actual Capacity Clearing Price ($/MW-day)
	Avoided Capacity Cost ($MM)	Net Revenue from Capacity Auctions ($MM)	Total Capacity Net Benefits ($MM)			
2013/14	$2.8	$13.4	$16.2	[redacted]	$5.64	$4.05
2014/15	$3.6	$11.8	$15.4	[redacted]	$99.58	$25.00
2015/16	$4.7	$13.7	$18.4	[redacted]	$99.58	$43.00
2016/17	$5.3	$12.1	$17.4	[redacted]	$125.99	$134.00 / $59.37
2017/18	$5.9	$10.7	$16.6	[redacted]	$125.99	$151.50 / $120.00
2018/19	$7.4	$13.0	$20.4	[redacted]	$125.99	$164.77 / $149.98

It should be noted that avoided capacity costs do not represent a revenue stream to EKPC but instead reflect an avoided cost which is not cash related and not available for return to Members. In addition, the $137.0 million net present value basis for capacity benefits originally predicted by the CRA included approximately $51.2 million in avoided capacity costs. The comparison of revenue streams should compare the CRA estimated net revenue from capacity auctions with the actual capacity market auction results.

The capacity benefits in the first three years of operation within PJM were less than projected because the market prices cleared well below the projected prices estimated by the CRA. The 2016/17 year actually cleared higher and is expected to produce a higher result than projected by the CRA. The 2017/18 year cleared close to what the CRA projected for the market clearing. While the 2018/19 year actual capacity clearing price was higher than the CRA's estimated capacity clearing price, the capacity market auction results were below the projected analysis because the amount of extra capacity being sold into the market is significantly less than originally projected by the CRA. This is due to the fact that the Dale Station's four units were no longer available to be sold into the capacity market, so EKPC had 150 MW less than originally projected by the CRA. Additionally, the small gap between the capacity performance prices and base prices results in a higher net cost for the load, which reduces the margin on the generation sales. EKPC would also note that PJM recently reduced its load forecasts for the 2016, 2019, and 2021 delivery years. These reduced load forecasts would indicate that the low capacity market benefits we already have from the out-year auctions may be sustained, or could even be lower, in future years.

Capacity Market Developments and EKPC Capacity Considerations

Market Developments. PJM is transitioning its RPM capacity market into a Capacity Performance ("CP") market. This change has been driven by generator performance during the Polar Vortex. The CP market includes a requirement that generators must meet their commitments to deliver whenever PJM calls power system emergencies. The Base Residual Auction clearing prices have not been adequate for merchant generators to reliably respond to calls for power. Under the new paradigm, generators participating in the CP market are expected to invest in modernizing equipment, firming up fuel supplies, and adapting to use different fuels – all in order to assure that called-upon generation is available. PJM expects CP to significantly reduce the energy portion of electricity bills during extreme temperatures. The lower energy costs are expected to offset the higher capacity costs and produce overall savings.

EKPC receives additional revenues for its generation that clears the CP market. However, that generation is now subject to much higher penalties for non-performance than it has been in the past. The penalties can far exceed the revenues received if a generator experiences unexpected issues during emergency operational conditions. The penalty schedule for the next three PJM operating years is:

2016/17 period	\$1,896 / MWh
2017/18 period	\$2,420 / MWh
2018/19 period	\$2,667 / MWh

In light of the steep penalties for non-performance, a relatively small number of non-performing hours during emergency conditions can result in significant penalties for CP units. For example, Spurlock 2 is EKPC's largest generator and has cleared the CP market. If Spurlock 2 were not available for 5 emergency hours, the penalty exposure in the 2016/17 period would be: 5 hours x 473 MW UCAP x \$1,896 / MWh = \$4,484,040. The exposure for this example in the 2017/18 period would be \$5.7 million and in the 2018/19 period would be \$6.3 million. Actual penalties depend on which units fail to operate during PJM emergency hours, and could range from zero to over \$20 million in any year.

In summary, the future capacity market revenues and the cost of capacity to serve load are known for several years because the auctions have already cleared. These determine the maximum potential capacity market net benefit to EKPC for each PJM planning year. However, the final EKPC capacity market net benefit is not known because the potential penalties are dependent on actual performance at critical times. After considering potential penalties, it is clear that only the 2016/17 PJM planning year has the potential to produce significant net capacity market benefits.

EKPC Considerations. EKPC's generation assets are all bid into the PJM capacity market auctions. All generation asset costs are recovered in base rates, with the exception of the Bluegrass Station units, which are expected to be paid for by PJM capacity market benefits. Therefore, it would be appropriate to exclude the Bluegrass Station units from any capacity market benefit flow-back. A great amount of uncertainty has been introduced by federal regulation in 2015, especially the Coal Combustion Residuals rule, the Effluent Limitation Guidelines rule, and the Clean Power Plan rule. Each of these requires substantial new capital spending related to generation capacity.

The Clean Power Plan may necessitate new capacity construction, such as a combined cycle plant and/or renewable generation assets. EKPC is concerned about the prudency of providing a capacity market refund to Members while at the same time investing substantial amounts in new or upgraded capacity, forcing base rate increases which would be more frequent and larger than if EKPC retained capacity market benefits as partial funding source for these expenditures.

Speaking on behalf of EKPC's end consumers, EKPC's Members and Board have indicated a preference for EKPC to retain the capacity market benefits and utilize them to help offset the cost of amortizing the Smith 1 regulatory asset and other needs. Their desire is for rate and bill stability over the immediate return of capacity market benefits.

Flow-back Rate Mechanism Considerations

When evaluating options for a flow-back rate mechanism, EKPC suggests some principles to keep in mind:

1) As a cooperative, all of the net capacity benefits are Member money and will be flowed back in some way, regardless of the mechanism;

2) Short-term issues should be resolved with short-term solutions, not long-term or permanent mechanisms;

3) Rate volatility and bill volatility should be avoided to the greatest extent possible; and

4) With any mechanism, EKPC will need its Members' involvement in the design and implementation to be sure it is workable.

With these principles in mind, EKPC has been considering four approaches to flow back the capacity market benefits:

Surcredit Mechanism. Under this approach, a surcredit for annual capacity market benefits, net of penalties, could be credited to Members on the basis of firm demands. It would also make sense for this credit to be netted with a surcharge for the recovery of the Smith 1 regulatory asset since both are capacity-related. Combined with the Smith 1 recovery, this mechanism would be a net charge in most years until Smith 1 is fully recovered.

A demand-based surcredit/surcharge is problematic for Members, however, as they do not have a simple way to flow the surcredit/surcharge through to retail customers, especially residential members. A surcredit mechanism would require annual reporting and reconciliation, as well as modification to billing systems, both by EKPC and its Members. At the Member level this could increase bill complexity, creating confusion among retail customers. Since the mechanism would typically be a net charge, this potential confusion is not favored.

Margin Sharing Mechanism. Under this approach, margins reflecting an over-earning situation would trigger the payment of capital credits while margins reflecting an under-earning situation would trigger an automatic rate increase. The logic for a margin sharing mechanism is simply that all revenues, costs, and equity are to the benefit of EKPC's Members. Therefore, it makes sense to consider them in totality.

A margin sharing mechanism should be tied to EKPC's Debt Service Coverage ratio ("DSC"), which is the key credit metric EKPC uses to determine the need for rate increases. DSC should be targeted to 1.30, with a "deadband" established to prevent trivial adjustments. The mechanism should be symmetrical, which would lead to automatic base rate increases if the DSC fell below a threshold. For example, a credit could be triggered when margins result in a DSC greater than 1.35 while margins below a DSC of 1.26 would trigger base rate increases.

Automatic rate increases may be problematic for the Commission and intervenors, which could suggest periodic formal rate cases. However, rate cases are lengthy and expensive for EKPC and its owner-members, so an appropriate balance would be needed.

<u>One-Time Capital Credit Payment.</u> Under this approach, a one-time capital credit payment would be made after the end of the PJM 2016/17 planning year, when any penalties for that period are known. The payment would likely be made in late 2017, or if appropriate, a two or three year payment plan could be developed instead, recognizing the potential for two consecutive "good" PJM years spanning three EKPC fiscal years. This would not impact credit metrics, but would require approval from the Rural Utilities Service ("RUS") if EKPC's equity ratio is below 20 percent. This approach has the advantage of being temporary and specific to the one large capacity market benefit year. After that, any further capacity market benefits would be considered in base rate cases.

There is no clear method to flow a capital credit from EKPC, through each Member, to the retail customer, however. This somewhat frustrates the Commission's desire to match the credit to those retail members who have paid for capacity in their rates. Employment of a Last-In, First-Out ("LIFO") capital credit retirement strategy might be appropriate, or possibly a blend of LIFO and First-In, First-Out methods to ensure all members get some capital credit payment. There are very likely other issues relating to this mechanism that would impact the Members which would need to be considered. Identifying and sorting these out should include discussions with the Members.

<u>Base Rates.</u> Under this approach, the capacity market benefits would be considered to be one element of base rates which would properly be considered and evaluated in the context of a future base rate case. EKPC would continue to be rate regulated as it has been and accumulate equity through margin accretion over time. Eventually, when authorized by EKPC's Board, general capital credits would be paid to Members, holding equity to reasonable levels while rates continue to support credit metrics. Of course EKPC remains regulated and the Commission will maintain appropriate oversight of rates and new construction (via the CPCN process).

Next Steps

At the conclusion of the December 22, 2015 discussion, the participants agreed that in addition to the filing of this status report EKPC would:

- Further research the capital credit approach, including consideration of Member issues and RUS authorization;
  - EKPC has had discussions with some Member CEOs and Board members and several issues were raised for further discussions.

- Prepare updated financial forecasts showing the impact of the flow-back payments under the various approaches and the magnitude and timing of future base rate increases;
  - EKPC continues to develop and evaluate scenarios and plans to share progress at the next informal conference.

- And, schedule another meeting with the intervenors and the Commission Staff for late January to discuss the topics further.
  - The parties and Commission Staff are working on the date for the next meeting.