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June 22, 2016

RECEIVED

JUN 22 2016

PUBLIC SERVICE COMMISSION

Via Hand-Delivery

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

Re: In the Matter of: The Application of East Kentucky Power Cooperative, Inc. For Deviation from Obligation Resulting from Case No. 2012-00169
PSC Case No. 2015-00358

Dear Executive Director:

On behalf of East Kentucky Power Cooperative, Inc. ("EKPC"), please find enclosed for filing with the Commission in the above-referenced case an original and ten (10) copies of EKPC's Motion for Leave to Amend Application. Attached as an exhibit to EKPC's Motion for Leave is a proposed Amended Application that contains certain confidential information that has been redacted. Enclosed in a separate sealed envelope marked confidential is one (1) copy of EKPC's Amended Application with the confidential information highlighted. Finally, enclosed is an original and ten (10) copies of a Motion for Confidential Treatment related to the Amended Application. Please note that original Verifications to accompany EKPC's Amended Application will be submitted to the Commission on or before Friday, June 24, 2016.

Please return file-stamped copies of each Motion to me, and please do not hesitate to contact me if you have any questions or concerns.

Very truly yours,

M. Evan Buckley

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

EAST KENTUCKY POWER COOPERATIVE, INC.'S MOTION FOR LEAVE TO AMEND APPLICATION

Comes now East Kentucky Power Cooperative, Inc. ("EKPC"), by counsel, and, pursuant to 807 KAR 5:001 Section 4(5), moves the Kentucky Public Service Commission ("Commission") for an Order granting EKPC leave to amend its Application filed in the above-styled matter on October 30, 2015. In support of this Motion, EKPC states as follows:

1. In its original Application, EKPC requested relief from an obligation contained in the Commission's Order entered December 20, 2012, in Case No. 2012-00169 (the "PJM Integration Order").[1] Specifically, EKPC sought an 18-month extension of the deadline by which it must file "an application for approval of a rate mechanism to flow back to customers the capacity market benefits expected to accrue from membership in PJM."[2]

2. During the weeks that followed the filing of EKPC's original Application, the Attorney General of the Commonwealth of Kentucky and Kentucky Industrial Utility Customers, Inc., each intervened in this matter and filed responses to EKPC's Application. Throughout the ensuing months, numerous informal conferences were held involving the parties and Commission

[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).

[2] *Id.* at p. 20.

Staff at which discussion focused on the development of a proposal defining the structure and implementation of the capacity benefits sharing mechanism ("CBS Mechanism") required by the PJM Integration Order.

3. EKPC, together with its Owner-Members, the intervenors in this matter, and other interested parties, has worked diligently to develop a workable solution for the structure and implementation of the CBS Mechanism required by the PJM Integration Order. EKPC has explored numerous possibilities, among them a base rate adjustment, direct surcredits to Owner-Members, and a capital credit allocation methodology. Ultimately, after consideration of its strategic objectives, the Commission's directives, and the financial and economic realities at play, EKPC has decided to pursue a proposal that is designed to both responsibly address outstanding obligations and promote a reasonable and equitable sharing of PJM capacity benefits. That proposal is set forth in the Amended Application attached hereto and incorporated herein as Exhibit A.

4. Moreover, the new proposal set forth in the attached Amended Application also establishes a framework for handling the Smith Unit 1 Regulatory Asset. By addressing this issue, the Amended Application presents a comprehensive plan for fairly, justly and reasonably resolving two lingering regulatory commitments involving EKPC.

5. EKPC requests that the Commission find good cause to permit the filing of the attached Amended Application, and further requests that the Commission order that the amendment shall relate back to the date of the original Application. EKPC has proceeded in good faith and no party will be prejudiced should the Commission grant the requested relief.

WHEREFORE, EKPC respectfully requests that the Commission enter an Order:

1. Granting EKPC leave to amend its Application filed in the above-styled matter on October 30, 2015;
2. Accepting for filing the Amended Application attached hereto as Exhibit A and ordering that it shall relate back to the date of the original Application; and
3. Granting all other relief to which EKPC may appear entitled.

This 22nd day of June, 2016.

Respectfully submitted,

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CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of the foregoing has been served, by delivering same to the custody and care of the U.S. Postal Service, postage pre-paid, this 22nd day of June, 2016, addressed to the following:

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PUBLIC SERVICE COMMISSION

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

AMENDED APPLICATION

Comes now East Kentucky Power Cooperative, Inc. ("EKPC"), by counsel, pursuant to KRS Chapter 278 and other applicable law, and for its Amended Application in the above-captioned matter, respectfully states as follows:

I. BACKGROUND

A. The PJM Integration Case

1. This matter arose from a directive of the Kentucky Public Service Commission ("Commission") borne of the proceedings in Case No. 2012-00169 (the "PJM Integration Case").[1] In that case, EKPC sought Commission approval to transfer functional control of certain of its transmission facilities to PJM Interconnection, LLC ("PJM"). The Commission found EKPC's request sufficiently supported by competent evidence, and thus it approved EKPC's request to fully integrate within PJM by Order entered December 20, 2012 (the "PJM Integration Order").[2]

2. In granting EKPC's request to fully integrate within PJM, the Commission noted the substantial cost-savings and reliability benefits that were projected to inure to EKPC as a result of

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[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* (filed May 3, 3012).

[2] Case No. 2012-00169, *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).

EXHIBIT
A

its membership in a regional transmission organization ("RTO").[3] Considered among the advantages of full PJM integration were considerable trade and capacity benefits that were expected to result from EKPC's participation in the PJM energy and capacity markets, respectively.

3. In the PJM Integration Order, the Commission observed that many quantitative benefits of EKPC's PJM participation, such as trade benefits, would be largely returned to EKPC's Owner-Members and their retail customers through the utilities' Fuel Adjustment Clauses.[4] However, the Commission also noted that the projected capacity benefits of EKPC's PJM participation were not readily capable of being shared with customers.[5] For this reason, the PJM Integration Order required EKPC to file, *inter alia*, "an application for approval of a rate mechanism to flow back to customers the capacity market benefits expected to accrue from membership in PJM."[6] The application for approval of a capacity benefits sharing mechanism ("CBS Mechanism") was due to the Commission no later than November 30, 2015.

B. The Case *Sub Judice*

4. This matter was commenced with the filing of EKPC's original Application on October 30, 2015. In its Application, EKPC requested that the Commission grant it permission to deviate from the PJM Integration Order's directive regarding the implementation of a CBS Mechanism and suspend EKPC's obligation to propose such a mechanism for a period of eighteen (18) months. In support of its requested relief, EKPC cited the need to further develop compliance strategies

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[3] *See, e.g., id.* at p. 16.

[4] *Id.*, at p. 20 ("Finally, the Commission finds that the bulk of the trade benefits that EKPC expects to accrue as a member of PJM will flow back to its 16 member cooperatives and their retail customers through the Fuel Adjustment Clause.").

[5] *Id.*

[6] *Id.*

with respect to the Clean Power Plan and other influential environmental regulations, as well as allow EKPC to gain a more complete understanding of the regulations' operational and financial impacts on both EKPC and the PJM capacity market at large. Moreover, EKPC posited that its requested extension would allow it and its Owner-Members to discuss and develop better-aligned rate structures that could provide workable solutions to the equitable sharing of benefits and costs, consistent with EKPC's strategic objectives.

5. During the weeks that followed the filing of EKPC's original Application, the Attorney General of the Commonwealth of Kentucky (the "AG") and Kentucky Industrial Utility Customers, Inc. ("KIUC"), were each granted intervention[7] and filed responses to EKPC's Application.[8] Upon motion of EKPC, an Informal Conference was held on November 20, 2015, to discuss the issues relevant to the case.

6. Shortly after the first Informal Conference, EKPC moved the Commission for an Order holding this proceeding in abeyance for a period of ninety (90) days. The purpose of the requested period of abeyance was to allow the parties an opportunity to develop a mutually-agreeable proposal related to the structure and implementation of the CBS Mechanism required by the PJM Integration Order. The Commission granted EKPC's motion by Order entered November 30, 2015.

7. Additional Informal Conferences involving the parties and Commission Staff took place on December 22, 2015, and January 29, 2016. At each of these Informal Conferences, the participants engaged in good-faith discussions concerning the various methods available to flow

[7] *See* Order granting KIUC's Motion to Intervene (Ky. P.S.C. Nov. 13, 2015); Order granting the AG's Motion to Intervene (Ky. P.S.C. Nov. 20, 2015).

[8] *See* KIUC's Response to EKPC's Application (filed Nov. 9, 2015); the AG's Response to EKPC's Application (filed Nov. 13, 2015).

the subject capacity benefits back to EKPC's Owner-Members. On February 12, 2016, EKPC moved for an additional ninety (90) day extension of the abeyance period to allow for further discussions and modeling of the alternative methodologies. The Commission granted EKPC's motion by Order entered March 2, 2016.

8. On March 17, 2016, a fourth Informal Conference was held involving the parties and Commission Staff. The March 17th Informal Conference included a high-level examination of an option for the CBS Mechanism designed to address certain unamortized costs associated with EKPC's J.K. Smith Power Station Unit 1 ("Smith 1"). This proposal, which is denoted herein as the "Smith Solution," took shape over the ensuing weeks. On May 24, 2016, EKPC moved for a final thirty (30) day extension of the abeyance period in order to reduce the Smith Solution to writing and meet to discuss its details with Commission Staff, the AG, and KIUC. The Commission granted EKPC's motion by Order entered June 10, 2016, a fifth Informal Conference is scheduled to be held on June 24, 2016, and the Smith Solution now serves as the cornerstone of this Amended Application.

C. The History of Smith 1

9. On January 31, 2005, EKPC applied to the Commission for a Certificate of Public Convenience and Necessity ("CPCN") to construct Smith 1, a 278 MW coal-fired, base load generating unit.[9] Based on the circumstances and load projections that existed at the time, the Commission authorized the construction of Smith 1 by Order entered August 29, 2006.

[9] Case No. 2005-00053, *Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity, and a Site Compatibility Certificate, for the Construction of a 278 MW (Nominal) Circulating Fluidized Bed Coal Fired Unit and Five 90 MW (Nominal) Combustion Turbines in Clark County, Kentucky* (filed January 31, 2005).

10. Subsequent to EKPC's receipt of a CPCN for Smith 1, Warren Rural Electric Cooperative Corporation ("Warren RECC"), a distribution cooperative in Kentucky that had decided in 2004 to switch its power supplier from the Tennessee Valley Authority ("TVA") to EKPC, elected to remain with the TVA. As a result of Warren RECC's decision to retain TVA as its supplier, the Commission initiated an investigation of EKPC's continued need for the additional generating facilities that were then approved but not yet constructed, including Smith 1.[10] Ultimately, the Commission found that EKPC's ratepayers and the public interest at-large would be best served by allowing EKPC to complete the construction of Smith 1 in light of the cancellation of other planned capacity construction.[11]

11. Following the Commission's May 11, 2007 Order reaffirming EKPC's CPCN for Smith 1, EKPC continued on a path toward constructing the generating unit, thereby incurring significant costs. However, due in large part to changed circumstances surrounding available financing and projected system load, the Commission initiated a second investigation of EKPC's continued need for Smith 1 by Order entered *sua sponte* on June 22, 2010.[12] That investigation was concluded with a unanimous settlement agreement (the "Smith 1 Settlement Agreement") entered into by EKPC, Gallatin Steel Company (now Nucor Steel Gallatin) ("Nucor"), the AG, and certain retail customers and environmental groups.[13] The terms of the Smith 1 Settlement Agreement included, *inter alia*, EKPC's agreement to voluntarily abandon the construction of Smith 1 and surrender the CPCN granted by the Commission in Case No. 2005-00053 and reaffirmed in Case No. 2006-

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[10] Case No. 2006-00564, *An Investigation into East Kentucky Power Cooperative, Inc.'s Continued Need for Certificated Generation* (Ky. P.S.C. May 11, 2007).

[11] *Id.*, at pp. 9-10.

[12] Case No. 2010-00238, *An Investigation of East Kentucky Power Cooperative, Inc.'s Need for the Smith 1 Generating Facility* (Ky. P.S.C. June 22, 2010).

[13] The Smith 1 Settlement Agreement was filed in Case No. 2010-00238 on November 18, 2010.

00564. The Commission approved the Smith 1 Settlement Agreement and dismissed its investigation by Order entered February 28, 2011.

12. In light of the fact that EKPC had already incurred significant costs in its pursuit of Smith 1 prior to relinquishing the relevant CPCN, the Smith 1 Settlement Agreement contemplated that EKPC would seek the establishment of a regulatory asset for its prudently-incurred Smith 1 costs (the "Smith 1 Regulatory Asset"). On November 18, 2010, EKPC filed an application seeking approval of such accounting treatment, and on February 28, 2011, the Commission authorized the establishment of the Smith 1 Regulatory Asset in the amount of $157,388,715.[14]

13. Importantly, the Smith 1 Settlement Agreement specifically noted that Smith 1 was not primarily planned to serve Nucor's load.[15] Due to this reality, the Smith 1 Settlement Agreement recognized that the "appropriate allocation of [the Smith 1] cost to [Nucor] and the other rate classes is based upon the firm demand of each rate class including [Nucor]."[16] This negotiated aspect of the Smith 1 Settlement Agreement was primarily designed to ensure that customers like Nucor would not be held disproportionately responsible for the costs of Smith 1.

14. Since the establishment of the Smith 1 Regulatory Asset, EKPC has undertaken, and continues to undertake, various mitigation and salvage efforts to reduce the value of the Smith 1 Regulatory Asset. As of April 30, 2016, the Smith 1 Regulatory Asset balance had been effectively reduced to $148,751,267. EKPC anticipates that its continued mitigation and salvage efforts will ultimately reduce the total amount of the Smith 1 Regulatory Asset by an additional [redacted].

[14] 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* (Ky. P.S.C. Feb. 28, 2011).

[15] *See* n. 13, *supra*, at p. 5.

[16] *Id.*

15. Notably, certain interest expense associated with Smith 1 is presently recovered by EKPC through its base rates. As detailed in the settlement agreement entered into by EKPC, the AG, and Nucor that was approved by the Commission in Case No. 2010-00167 (the "2010 Rate Case Settlement Agreement"),[17] EKPC's existing base rates reflect an amount of annual interest expense relating to Smith 1 of $6,000,000 plus a Times Interest Earned Ratio ("TIER") of 1.50, or $9,000,000 (the "Smith 1 Interest Expense"). Further pursuant to the 2010 Rate Case Settlement Agreement, and in order to prevent a double-recovery of interest expense by EKPC, the parties agreed that "[o]nce the final cancellation costs of Smith Unit 1 are determined, net of all mitigation, then EKPC shall reduce its base rates to all classes of customers proportionally by $6,000,000 plus TIER…."[18]

II. EKPC AS A FULLY-INTEGRATED MEMBER OF PJM

16. EKPC became a fully-integrated member of PJM as of June 1, 2013. Since that time, EKPC has refined its procurement and energy accounting practices and continuously improved its ability to plan and execute business operations within an RTO construct. EKPC has experienced three (3) full PJM Delivery Years (June 1 through May 31) and, pursuant to the PJM Integration Order, has filed with the Commission annual reports which detail its transmission rights, hedging strategies, and PJM benefits and costs.[19] EKPC's most recent annual report pertained to the

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[17] *Application of East Kentucky Power Cooperative, Inc. for General Adjustment of Electric Rates* (Ky. P.S.C. Nov. 14, 2011).

[18] *Id.*, at Appendix A, p. 5.

[19] *See* Case No. 2012-00169, Order at pp. 19-20 (Ky. P.S.C. Dec. 20, 2012); *see also* Case No. 2015-00116, *In the Matter of East Kentucky Power Cooperative, Inc.'s Request to Modify the Due Date of the Annual Report on Participation in the PJM Interconnection, LLC* (Ky. P.S.C. May 14, 2015) (modifying the date by which EKPC must file its annual reports to better align with PJM's operating year).

2014/15 PJM Delivery Year,[20] and it will tender an annual report concerning the 2015/16 PJM Delivery Year on or before July 31, 2016.

17. From both a reliability and cost perspective, EKPC's membership in PJM has proven exceedingly beneficial. Due to the efficient commitment and dispatch of its generating resources within the PJM energy markets, EKPC has experienced lower adjusted production costs and increased excess energy sales (often referred to as trade benefits).[21] Moreover, EKPC's participation in the PJM capacity market has allowed it to avoid costs associated with securing additional capacity through self-built generation or third-party purchases, as well as earn revenues from excess capacity sales. This last category of benefits (the "PJM Capacity Market Benefits") comprises what EKPC seeks to flow back to customers through the CBS Mechanism required by the PJM Integration Order.

18. Based upon its financial forecast, EKPC expects to realize PJM Capacity Market Benefits as follows:

PJM Delivery Year	Expected PJM Capacity Market Benefits
2016/17	[redacted]
2017/18	[redacted]
2018/19	[redacted]
Total	[redacted]

[20] EKPC tendered its 2015 PJM Annual Report to the Commission by letter dated July 31, 2015, and subsequently amended the report by letter dated December 9, 2015.

[21] As noted previously, trade benefits are largely returned to EKPC's Owner-Members and their retail customers through the utilities' Fuel Adjustment Clauses. *See* n. 4, *supra*.

19. Importantly, should EKPC be unable to provide the amount of capacity it has bid into one or more of the PJM Base Residual Auctions during the next three (3) PJM Delivery Years, it is subject to substantial market penalties under the PJM tariff. PJM is in the process of transitioning its capacity market, called the Reliability Pricing Model or RPM, into a Capacity Performance ("CP") market design. The CP market design includes stringent pay-for-performance standards and a requirement that generators must meet their commitments to deliver electricity whenever PJM determines they are needed to meet power system emergencies. Under the new paradigm, generators participating in the CP construct 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. As a result of the CP market design, EKPC generation that clears as a CP resource is now subject to much higher penalties for non-performance than it has been in the past. The penalty schedule for the 2016/17 PJM Delivery Year is $1,896 per MWh and escalates to $2,667 per MWh in the 2018/19 PJM Delivery Year. Actual penalties depend on which units do not perform as projected during PJM emergency hours and could range from zero to over $20,000,000 in any year. In order to manage potential exposure to such market penalties, EKPC has purchased penalty mitigation insurance for the 2016/17, 2017/18, and 2018/19 PJM Delivery Years. The premiums for this mitigation insurance total [redacted]. The insurance has the following coverage limits and deductibles:

PJM Delivery Year	Coverage Limit	Deductible
2016/17	[redacted]	[redacted]
2017/18	[redacted]	[redacted]
2018/19	[redacted]	[redacted]

III. THE SMITH SOLUTION

20. EKPC, together with its Owner-Members, the intervenors in this matter, and other interested parties, has worked diligently to develop a workable solution for the structure and implementation of the CBS Mechanism required by the PJM Integration Order. EKPC has explored numerous possibilities, among them a base rate adjustment, direct surcredits to Owner-Members, and a capital credit allocation methodology.[22] Ultimately, after consideration of its strategic objectives, the Commission's directives, and the financial and economic realities at play, EKPC has decided to pursue a proposal that is designed to both responsibly address outstanding obligations and promote a reasonable and equitable sharing of PJM capacity benefits. That proposal is the Smith Solution.[23]

21. There are two (2) general time periods that must be recognized in order to describe and understand the Smith Solution: the period of time that precedes EKPC's next general base rate adjustment, and the period of time that begins with EKPC's next general base rate adjustment and continues thereafter. While there can be no certainty with respect to when EKPC may next seek to adjust its base rates,[24] the provisions of the Smith Solution are best viewed in the context of that eventuality.

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[22] A detailed discussion of the alternative methodologies explored by EKPC for a CBS Mechanism is contained in the Direct Testimony of Mr. Michael McNalley, EKPC's Executive Vice President and Chief Financial Officer, a copy of which is attached hereto and incorporated herein as Exhibit 1. *See also* EKPC's First Status Report (filed herein on Jan. 14, 2016).

[23] EKPC's Board of Directors has authorized this filing, and a copy of the relevant Resolution from the Board Meeting held May 10, 2016, is attached hereto and incorporated herein as Exhibit 2.

[24] EKPC presently anticipates that it will seek to adjust its rates in or around 2019.

A. Prior to EKPC's Next General Base Rate Adjustment

1. Treatment of PJM Capacity Benefits and Costs

22. As aforementioned, EKPC projects that it will realize PJM Capacity Market Benefits of [redacted], [redacted], and [redacted] during the PJM Delivery Years of 2016/17, 2017/18, and 2018/19, respectively. Under the Smith Solution, EKPC will continue to record the amounts actually realized during the appropriate accounting periods as revenues. Correspondingly, EKPC will record as expenses during the appropriate accounting periods its PJM capacity market costs, which consist of amounts paid for mitigation insurance premiums, amounts paid (if any) for mitigation insurance deductibles, and amounts paid (if any) for market penalties that exceed the mitigation insurance coverage (collectively, the "PJM Capacity Market Costs") (the net of the PJM Capacity Market Benefits and PJM Capacity Market Costs is referred to herein as the "Net PJM Capacity Market Benefit"). These revenues and expenses will impact EKPC's margins in the appropriate accounting periods.

2. Amortization of the Smith 1 Regulatory Asset

23. Under the Smith Solution, EKPC will begin amortizing the book balance of the Smith 1 Regulatory Asset, net of the expected mitigation and salvage efforts (*i.e.*, [redacted][25]), beginning January 1, 2017. This amortization will be for accounting purposes only and will reflect an amortization schedule spanning a ten (10) year period.[26] The amortization expenses will impact EKPC's margins in the appropriate accounting periods.

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[25] The adjustment for mitigation and salvage efforts will be trued-up to reflect actual results as they occur.

[26] A 10-year amortization period is consistent with what was contemplated as part of the Smith 1 Settlement Agreement and 2010 Rate Case Settlement Agreement. *See* Smith 1 Settlement Agreement, *supra* n. 13, at p. 5; *see also* 2010 Rate Case Settlement Agreement, *supra* n. 18, at p. 5.

3. The Smith 1 Interest Expense

24. As previously stated, as a product of the 2010 Rate Case Settlement Agreement EKPC presently recovers through its base rates the Smith 1 Interest Expense totaling $9,000,000 annually. The 2010 Rate Case Settlement Agreement anticipated that when EKPC sought to recover the amortization of the Smith 1 Regulatory Asset through base rates, there would be a corresponding reduction in EKPC's base rates of $9,000,000 to prevent a double-recovery of interest expense.[27]

25. Under the Smith Solution, while the amortization of the Smith 1 Regulatory Asset is to begin on January 1, 2017, the amortization is for accounting purposes only and there will be no immediate adjustment of EKPC's base rates to recover the amortization expense. Consequently, the Smith 1 Interest Expense will remain in EKPC's base rates until its next general base rate proceeding and will continue to impact EKPC's margins in the appropriate accounting periods.

4. The Treatment of Nucor

26. As heretofore discussed, the Smith 1 Settlement Agreement contemplated that EKPC would seek the establishment of the Smith 1 Regulatory Asset and that, when it became time to seek recovery of the regulatory asset through base rates, an allocation methodology based upon the firm demand of each rate class (including Nucor) would be employed.[28] Such an allocation methodology was agreed upon in recognition of the fact that Smith 1 was not primarily planned to serve Nucor's load, and thus Nucor should not face a disproportionate burden when recovery of the Smith 1 costs is pursued.

27. Under the Smith Solution, the proposed treatment of the Smith 1 Regulatory Asset will necessarily reduce the value to Nucor of the allocation structure called for by the Smith 1

[27] *See* n. 31, *infra*.

[28] *See* numerical paragraphs 12 and 13, *supra*.

Settlement Agreement. Therefore, in recognition of these changes in the treatment of the Smith 1 Regulatory Asset amortization, EKPC and Nucor have agreed that some provision must be made to preserve the benefit Nucor originally negotiated as part of the Smith 1 Settlement Agreement. To that end, EKPC and Nucor have agreed that Nucor should receive a temporary monthly bill credit in the amount of $35,000.00.

B. EKPC's Next General Base Rate Adjustment and Thereafter

1. Amortization Adjustment for the Smith 1 Regulatory Asset

28. As part of its next general base rate proceeding, EKPC will request that its rates be adjusted to reflect the amortization expense of the Smith 1 Regulatory Asset. This amortization adjustment will be based on the Smith 1 Regulatory Asset balance as of January 1, 2017, reduced by: (i) the actual results of EKPC's mitigation and salvage efforts during the period of January 1, 2017, through the end of the test year employed in the rate case; and (ii) the Net PJM Capacity Market Benefit earned by EKPC beginning with the 2016/17 PJM Delivery Year and concluding at the end of the test year employed in the rate case.[29] The amortization adjustment will be spread over the remaining months of the 10-year amortization period that began on January 1, 2017.[30] EKPC believes that the entire Smith 1 Regulatory Asset balance is a cost of service and recoverable through rates. The Smith Solution provides for the recovery of the Smith 1 Regulatory Asset through three mechanisms: the actual results of EKPC's mitigation and salvage efforts, the Net

[29] If, at the time of EKPC's next general base rate proceeding, the PJM Capacity Market Costs associated with calendar year 2019 are known and measurable, EKPC will request an amortization adjustment that reflects the full Net PJM Capacity Market Benefit realized through 2019. If, however, the PJM Capacity Market Costs associated with calendar year 2019 are not known and measurable at the time of EKPC's next general base rate proceeding, EKPC will request an amortization adjustment that reflects only the Net PJM Capacity Market Benefit realized through the end of the test year employed in the rate case. Should this latter circumstance exist, EKPC will request that the Net PJM Capacity Market Benefit realized after the end of the rate case test year be recognized as part of the determination of the amortization adjustment in a subsequent general base rate proceeding.

[30] For example, if the effective date for new base rates in the next general base rate proceeding is January 1, 2020, then the amortization period for the adjustment will be seven (7) years.

PJM Capacity Market Benefits earned by EKPC, with the balance recovered through amortization expense included in base rates.

2. The Smith 1 Interest Expense and Treatment of Nucor

29. In its next general base rate proceeding, EKPC will discontinue its specific identification of the Smith 1 Interest Expense and include this expense as part of the cost of service to be recovered along with other interest expense. The Smith 1 Settlement Agreement and 2010 Rate Case Settlement Agreement were based on the assumption that the Smith 1 Regulatory Asset would be recovered through a separate surcharge mechanism. The specific identification of the Smith 1 Interest Expense was necessary to avoid a double-recovery of interest expense by EKPC.[31] The proposed treatment for the Smith 1 Regulatory Asset in the next general base rate proceeding will eliminate the need for the specific identification of the Smith 1 Interest Expense.

30. Upon the effective date for new rates resulting from EKPC's next general base rate proceeding, the temporary bill credit received by Nucor as a result of this case will cease. The rate paid by Nucor going forward will be that approved by the Commission in EKPC's next general rate case proceeding.

IV. OVERVIEW OF TESTIMONY

31. As part of its Amended Application, EKPC is tendering herewith the testimony of Mr. Michael McNalley, EKPC's Executive Vice President and Chief Financial Officer. Mr. McNalley provides an overview of the background of this proceeding, the history of Smith 1, and EKPC's recent and projected financial performance in PJM. Mr. McNalley also thoroughly describes the

[31] *See* Smith 1 Settlement Agreement, *supra* n. 13, at pp. 5-6 ("To avoid double recovery, all Smith I costs currently being recovered in existing rates and all Smith I costs proposed to be recovered in future rates will be removed from base rates or identified and excluded from recovery of the Regulatory Asset in EKPC's filing for recovery of the Regulatory Asset."); *see also* 2010 Rate Case Settlement Agreement, *supra* n. 18, and corresponding text.

Smith Solution and underscores the considerations which support the approval of such a CBS Mechanism. Mr. McNalley's testimony is attached hereto and incorporated herein as Exhibit 1.

V. CONCLUSION

After extensive examination of all relevant considerations and numerous discussions with interested parties, EKPC has concluded that the Smith Solution represents the best proposal for the implementation of a CBS Mechanism. Utilizing the PJM capacity market benefits to reduce the amount of the Smith 1 Regulatory Asset will directly benefit EKPC's Owner-Members and their customers by eliminating the need for a sizeable Smith 1 surcharge and effectively delaying EKPC's pursuit of a base rate adjustment; moreover, commencing the amortization of the Smith 1 Regulatory Asset as of January 1, 2017, is consistent with prudent utility management and is a means to responsibly address EKPC's outstanding obligations.

WHEREFORE, on the basis of the foregoing, EKPC respectfully requests that the Commission enter an Order:

1) Approving this Amended Application and the Smith Solution as proposed;
2) Concluding that the Smith Solution is both a reasonable means to permit the amortization of the Smith 1 Regulatory Asset as envisioned in the Smith 1 Settlement Agreement and the 2010 Rate Case Settlement Agreement and a reasonable means to flow the Net PJM Capacity Market Benefits to EKPC's Owner-Members and their retail customers as envisioned by the PJM Integration Order; and
3) Granting any other relief to which EKPC may appear entitled.

VERIFICATION

Michael McNalley, Executive Vice President and Chief Financial Officer of East Kentucky Power Cooperative, Inc., in his official capacity, verifies and affirms that he has read the foregoing Amended Application and that the averments set forth therein are true and correct to the best of his knowledge, information and belief formed after reasonably inquiry.

This 21 day of June, 2016.

MICHAEL McNALLEY, Executive Vice President and
Chief Financial Officer of East Kentucky Power
Cooperative, Inc.

This 22nd day of June, 2016.

Respectfully submitted,

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Counsel for East Kentucky Power Cooperative, Inc.

Index of Exhibits

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)

SUPPLEMENTAL DIRECT TESTIMONY OF MICHAEL MCNALLEY ON BEHALF OF EAST KENTUCKY POWER COOPERATIVE, INC.

Filed: June 22, 2016

EXHIBIT

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I. Introduction

Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS.

A. My name is Mike McNalley and my business address is East Kentucky Power Cooperative, Inc. ("EKPC"), 4775 Lexington Road, Winchester, Kentucky 40391. I am Executive Vice President and Chief Financial Officer for EKPC.

Q. PLEASE BRIEFLY DESCRIBE YOUR EDUCATION AND PROFESSIONAL EXPERIENCE.

A. I obtained my undergraduate degree in economics from Reed College in Portland, Oregon, and my Masters of Business Administration from Dartmouth College. Prior to joining EKPC, I held various positions with DTE Energy ("DTE"), including Chief Financial Officer and Chief Operating Officer of one of DTE's subsidiaries, DTE Energy Technologies. Prior to joining DTE, I served as the corporate leader of finance or as a senior executive at various companies including Corrillian Corp., System2, Inc., and Oliver & Thompson, Inc., all located in Portland, Oregon. I have been employed by EKPC since July 2010.

Q. PLEASE BRIEFLY DESCRIBE YOUR DUTIES AT EKPC.

A. I am responsible for accounting, finance, performance measures, pricing and regulatory services, risk management, marketing, information technology, and supply chain at EKPC.

Q. DID YOU PREVIOUSLY CAUSE TO BE SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, in conjunction with EKPC's original Application filed herein on October 30, 2015.

Q. PLEASE DESCRIBE THE RELIEF REQUESTED BY EKPC IN ITS ORIGINAL APPLICATION FILED OCTOBER 30, 2015.

A. The Kentucky Public Service Commission ("Commission") granted EKPC permission to fully integrate within PJM Interconnection, LLC ("PJM"), by Order entered December 20, 2012, in Case No. 2012-00169 (the "PJM Integration Order"). The PJM Integration Order requires EKPC to take certain actions related to its PJM membership; most notably, the PJM Integration Order required EKPC to file, "no later than November 30, 2015, an application for approval of a rate mechanism to flow back to customers the capacity market benefits expected to accrue from membership in PJM." In light of the tremendous uncertainty and potentially massive complications that accompany recent federal environmental regulations, EKPC requested through its original Application that the Commission grant EKPC permission to deviate from the PJM Integration Order's directive regarding the implementation of a capacity benefits sharing mechanism ("CBS Mechanism") and suspend the obligation for a period of eighteen (18) months, or until May 31, 2017.

Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL DIRECT TESTIMONY IN THIS PROCEEDING?

A. The purpose of my supplemental direct testimony is to support the relief requested by EKPC in its Amended Application filed contemporaneously herewith. Specifically, I will provide an overview of the background of this proceeding, the history of EKPC's J.K. Smith Power Station Unit 1 ("Smith 1"), and EKPC's recent and projected financial performance in PJM. I will also thoroughly describe the so-called "Smith Solution," which is the proposal EKPC requests permission to pursue in compliance with the PJM Integration Order's directive regarding the implementation of a CBS Mechanism.

Q. ARE YOU SPONSORING ANY EXHIBITS?

A. No.

II. Background

Q. PLEASE FURTHER EXPLAIN THE RELIEF REQUESTED BY EKPC IN ITS ORIGINAL APPLICATION.

A. As aforementioned, the PJM Integration Order required EKPC to file a proposed CBS Mechanism on or before November 30, 2015. In its original Application, EKPC requested that the Commission suspend EKPC's obligation to propose such a mechanism for a period of eighteen (18) months. In support of its requested relief, EKPC cited the need to further develop compliance strategies with respect to the Clean Power Plan and other influential environmental regulations, as well as allow EKPC to gain a more complete understanding of the regulations' operational and financial impacts on both EKPC and the PJM capacity market at large. Moreover, EKPC posited that its requested extension would allow it and its Owner-Members to discuss and develop better-aligned rate structures that could provide workable solutions to the equitable sharing of benefits and costs, consistent with EKPC's strategic objectives.

Q. HOW HAS THIS CASE PROGRESSED SINCE EKPC FILED ITS ORIGINAL APPLICATION?

A. During the weeks that followed the filing of EKPC's original Application, the Attorney General of the Commonwealth of Kentucky (the "AG") and Kentucky Industrial Utility Customers, Inc. ("KIUC"), were each granted intervention and filed responses to EKPC's Application. Upon motion of EKPC, an Informal Conference was held on November 20, 2015, to discuss the issues relevant to the case. Shortly after this first Informal Conference, EKPC moved the Commission for an Order holding this proceeding in abeyance for a period of ninety (90) days. The purpose of the requested period of abeyance was to allow the parties an opportunity to develop a mutually-agreeable proposal related to the structure and implementation of the CBS Mechanism required by the PJM Integration Order. The Commission granted EKPC's request and subsequently extended the period of abeyance, first through May 28, 2016, then through June 27, 2016, to allow further development and refinement of an acceptable proposal. Additional Informal Conferences involving the parties and Commission Staff were held December 22, 2015, January 29, 2016, and March 17, 2016, and one is presently scheduled for June 24, 2016.

Q. PLEASE DESCRIBE THE VARIOUS METHODOLOGIES THAT HAVE BEEN EXPLORED FOR THE IMPLEMENTATION OF A CBS MECHANISM.

A. In addition to the Smith Solution (which I further describe below), there have been four primary methodologies explored for a CBS Mechanism:

Surcredit Methodology. Under this approach, a surcredit for annual capacity market benefits, net of penalties, would be credited to EKPC's Owner-Members on the basis of firm demands. It was suggested that, as part of this approach, the surcredit should be netted with a surcharge for the recovery of the Smith 1 Regulatory Asset (as that term is defined herein), since both are capacity-related. Combined with the Smith 1 recovery, this approach would be a net charge in most years until the Smith 1 Regulatory Asset was fully recovered.

Margin Sharing Methodology. 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 methodology is simply that all revenues, costs, and equity are to the benefit of EKPC's Owner-Members and thus all should be considered in totality. A margin sharing approach would be tied to EKPC's Debt Service Coverage ("DSC") ratio, which is the key credit metric EKPC uses to determine the need for rate increases. EKPC suggested that the DSC ratio should be targeted to 1.30, with a "deadband" established to prevent trivial adjustments. The methodology would be symmetrical, which would lead to automatic base rate increases if the DSC ratio fell below a specified threshold.

One-Time Capital Credit Payment Methodology. Under this methodology, 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 were known. The payment would likely be made in late 2017 or, if appropriate, a two or three year payment plan would instead be developed, recognizing the potential for two consecutive "good"

PJM years spanning three EKPC fiscal years. This methodology would not impact credit metrics, but would require approval from EKPC's lender, the U.S. Department of Agriculture Rural Utilities Service ("RUS"), if EKPC's equity ratio was below 20 percent. This methodology had the advantage of being temporary and specific to the one large capacity market benefit year. After the one-time payment, any further capacity market benefits would be considered in base rate cases.

Base Rates Methodology. Under this methodology, the capacity market benefits would be considered as one element of base rates which would 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 Owner-Members, holding equity to reasonable levels while rates continue to support credit metrics.

Q. WHY DID EKPC DECIDE AGAINST PURSUING THE METHODOLOGIES YOU HAVE DESCRIBED?

A. EKPC decided against pursuing any of these methodologies due to concerns identified with each approach.

Surcredit Methodology. A demand-based surcredit/surcharge methodology was problematic for Owner-Members, as they did not have a simple way to flow the surcredit/surcharge through to retail customers, especially residential members. A surcredit methodology would require annual reporting and reconciliation, as well as modifications to the billing systems of EKPC and its Owner-Members. At the

Owner-Member level, this could increase bill complexity and create confusion among retail customers, since the methodology would typically be a net charge. When EKPC modeled the impacts of this methodology on its financial forecast, the modeling indicated that this methodology, along with the margin sharing methodology, had the potential of triggering base rate cases sooner than would be anticipated in the financial forecast without those methodologies.

Margin Sharing Methodology. Automatic rate increases required for under-earning situations could 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.

One-Time Capital Credit Payment Methodology. There is no clear method to flow a capital credit from EKPC, through each Owner-Member, to the retail customer. This somewhat frustrates the Commission's desire to match the credit to those retail members who have paid for capacity in their rates. The one-time capital credit payment would not, by itself, trigger a base rate case given the structure of that methodology. However, while not outright rejecting the proposal, RUS suggested the Net PJM Capacity Benefit (as that term is defined herein) could be used to fund low-income energy efficiency programs or be placed in a cushion of credit account with RUS. EKPC's Owner-Members also did not support the one-time capital credit payment methodology, citing concerns of being directed to pay capital credits, the existence of different capital credit payment approaches, and potential litigation.

<u>Base Rates Methodology</u>. To timely match the capacity benefits with a base rate case would likely trigger the filing of a base rate case sooner than would be anticipated in the financial forecast.

Q. WHY DID EKPC DECIDE TO PURSUE THE SMITH SOLUTION?

A. EKPC, together with its Owner-Members, the intervenors in this matter, and other interested parties, has worked diligently to develop a workable solution for the structure and implementation of the CBS Mechanism required by the PJM Integration Order. Ultimately, after consideration of its strategic objectives, the Commission's directives, multiple alternatives and the financial and economic realities at play, EKPC has decided to pursue a proposal that is designed to both responsibly address outstanding obligations and promote a reasonable and equitable sharing of PJM capacity benefits. That proposal is the Smith Solution.

III. History of Smith 1

Q. DID THE COMMISSION GRANT EKPC A CERTIFICATION OF PUBLIC CONVENIENCE AND NECESSITY FOR SMITH 1?

A. Yes. On January 31, 2005, EKPC applied to the Commission for a Certificate of Public Convenience and Necessity ("CPCN") to construct Smith 1, a 278 MW coal-fired, base load generating unit. Based on the circumstances and load projections that existed at the time, the Commission authorized the construction of Smith 1 by Order entered August 29, 2006, in Case No. 2005-00053.

Q. DID THE COMMISSION SUBJECT SMITH 1 TO ADDITIONAL SCRUTINY AFTER IT GRANTED EKPC A CPCN FOR ITS CONSTRUCTION?

A. Yes. Subsequent to EKPC's receipt of a CPCN for Smith 1, Warren Rural Electric Cooperative Corporation ("Warren RECC"), a distribution cooperative in Kentucky that had decided in 2004 to switch its power supplier from the Tennessee Valley Authority ("TVA") to EKPC, elected to remain with the TVA. As a result of Warren RECC's decision to retain TVA as its supplier, the Commission initiated Case No. 2006-00564, which was an investigation of EKPC's continued need for the additional generating facilities that were then approved but not yet constructed, including Smith 1. Ultimately, the Commission found that EKPC's ratepayers and the public interest at-large would be best served by allowing EKPC to complete the construction of Smith 1 in light of the cancellation of other planned capacity construction.

Q. DID EKPC COMPLETE CONSTRUCTION OF SMITH 1?

A. No. Due in large part to changed circumstances surrounding available financing and projected system load, the Commission initiated a second investigation of EKPC's continued need for Smith 1 by Order entered June 22, 2010, in Case No. 2010-00238. That investigation was concluded with a unanimous settlement agreement (the "Smith 1 Settlement Agreement") entered into by EKPC, Gallatin Steel Company (now Nucor Steel Gallatin) ("Nucor"), the AG, and certain retail customers and environmental groups. The terms of the Smith 1 Settlement Agreement included, among other things, EKPC's agreement to voluntarily abandon the construction of Smith 1 and surrender the CPCN granted by the Commission in Case No. 2005-00053 and reaffirmed in Case No. 2006-00564. The Commission approved the Smith 1 Settlement Agreement and dismissed its investigation by Order entered February 28, 2011.

Q. PLEASE GENERALLY DESCRIBE SOME OF THE KEY TERMS OF THE SMITH 1 SETTLEMENT AGREEMENT.

A. In addition to EKPC's voluntary relinquishment of its CPCN for Smith 1, the Smith 1 Settlement Agreement also contemplated that EKPC would seek the establishment of a regulatory asset for its prudently-incurred Smith 1 costs (the "Smith 1 Regulatory Asset"). Additionally, in light of the stated fact that Smith 1 was not primarily planned to serve the load of Nucor, the Smith 1 Settlement Agreement recognized that the "appropriate allocation of [the Smith 1] cost to [Nucor] and the other rate classes is based upon the firm demand of each rate class including [Nucor]." This negotiated aspect of the Smith 1 Settlement Agreement was primarily designed to ensure that customers like Nucor would not be held disproportionately responsible for the costs of Smith 1.

Q. HAS THE COMMISSION APPROVED THE SMITH 1 REGULATORY ASSET?

A. Yes. The Commission authorized the establishment of the Smith 1 Regulatory Asset in the amount of $157,388,715 by Order entered February 28, 2011, in Case No. 2010-00449.

Q. HAS EKPC BEGUN AMORTIZATION OF THE SMITH 1 REGULATORY ASSET?

A. No, it has not. However, since the establishment of the Smith 1 Regulatory Asset, EKPC has undertaken, and continues to undertake, various mitigation and salvage efforts to reduce the value of the Smith 1 Regulatory Asset. As of April 30, 2016, the Smith 1 Regulatory Asset balance had been effectively reduced to $148,751,267. EKPC anticipates that its continued mitigation and salvage efforts will ultimately reduce the total amount of the Smith 1 Regulatory Asset by another [redacted].

Q. DOES EKPC RECOVER THROUGH BASE RATES THE INTEREST EXPENSE ASSOCIATED WITH THE SMITH 1 REGULATORY ASSET?

A. Yes, certain interest expense associated with Smith 1 is presently recovered by EKPC through its base rates. As detailed in the settlement agreement entered into by EKPC, the AG, and Nucor that was approved by the Commission in Case No. 2010-00167 (the "2010 Rate Case Settlement Agreement"), EKPC's existing base rates reflect an amount of annual interest expense relating to Smith 1 of $6,000,000 plus a Times Interest Earned Ratio ("TIER") of 1.50, or $9,000,000 (the "Smith 1 Interest Expense"). Further pursuant to the 2010 Rate Case Settlement Agreement, and in order to prevent a double-recovery of interest expense by EKPC, the parties agreed that "[o]nce the final cancellation costs of Smith Unit 1 are determined, net of all mitigation, then EKPC shall reduce its base rates to all classes of customers proportionally by $6,000,000 plus TIER…."

IV. The Smith Solution

Q. WHAT BENEFITS OF PJM PARTICIPATION DOES THE SMITH SOLUTION SEEK TO FLOW BACK TO EKPC'S CUSTOMERS?

A. From both a reliability and cost perspective, EKPC's membership in PJM has proven exceedingly beneficial. EKPC has experienced considerable trade and capacity benefits from its participation in the PJM energy and capacity markets, respectively, and it expects such benefits to continue to accrue in the near term.

As observed by the Commission in the PJM Integration Order, the trade benefits which result from EKPC's participation in the PJM energy markets are largely returned to EKPC's Owner-Members and their retail customers through the utilities' Fuel Adjustment Clauses. However, the quantitative benefits of EKPC's participation in the PJM capacity market (the "PJM Capacity Market Benefits") do not readily flow back to customers. For this reason, EKPC has worked cooperatively to develop a proposal for a CBS Mechanism through which the PJM Capacity Market Benefits will flow to the benefit of customers. That proposal is the Smith Solution.

Q. WHAT AMOUNT OF PJM CAPACITY MARKET BENEFITS DOES EKPC ANTICIPATE EARNING IN THE NEAR TERM?

A. Based upon its financial forecast, EKPC expects to realize PJM Capacity Market Benefits as follows:

PJM Delivery Year	Expected PJM Capacity Market Benefits
2016/17	[redacted]
2017/18	[redacted]
2018/19	[redacted]
Total	[redacted]

Q. ARE THERE COSTS ASSOCIATED WITH EKPC'S PARTICIPATION IN THE PJM CAPACITY MARKET?

A. Yes. Should EKPC be unable to provide the amount of capacity it has bid into one or more of the PJM Base Residual Auctions during the next three (3) PJM Delivery Years, it is subject to substantial market penalties under the PJM tariff. PJM is in the process of transitioning its capacity market, called the Reliability Pricing Model or RPM, into a Capacity Performance ("CP") market design. The CP market design includes stringent pay-for-performance standards and a requirement that generators must meet their commitments to deliver electricity whenever PJM determines they are needed to meet power system emergencies. Under the new paradigm, generators participating in the CP construct 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.

As a result of the CP market design, EKPC generation that clears as a CP resource is now subject to much higher penalties for non-performance than it has been in the past. The penalty schedule for the 2016/17 PJM Delivery Year is $1,896 per MWh and escalates to $2,667 per MWh in the 2018/19 PJM Delivery Year. Actual penalties depend on which units do not perform as projected during PJM emergency hours and could range from zero to over $20,000,000 in any year. For example, Spurlock 2 is EKPC's largest generator and has cleared as a CP resource. If Spurlock 2 were not available for 5 emergency hours, the penalty exposure in the 2016/17 PJM Delivery Year would be: 5 hours x 473 MW UCAP x $1,896 / MWh = $4,484,040. The exposure for this example in the 2017/18 PJM Delivery Year would be $5,723,300 and in the 2018/19 PJM Delivery Year would be $6,307,455. In order to manage potential exposure to such market penalties, EKPC has purchased penalty mitigation insurance for the 2016/17, 2017/18, and 2018/19 PJM Delivery Years. The premiums for this mitigation insurance total [redacted]. The insurance has the following coverage limits and deductibles:

PJM Delivery Year	Coverage Limit	Deductible
2016-2017	[redacted]	[redacted]
2017-2018	[redacted]	[redacted]
2018-2019	[redacted]	[redacted]

Q. UNDER THE SMITH SOLUTION, HOW DOES EKPC PROPOSE TREATING THE PJM CAPACITY MARKET BENEFITS AND COSTS FOR 2017, 2018, AND 2019?

A. Under the Smith Solution, EKPC will continue to record as revenues during the appropriate accounting periods the amounts it actually realizes as PJM Capacity Market Benefits. Correspondingly, EKPC will record as expenses during the appropriate accounting periods its PJM capacity market costs, which consist of amounts paid for mitigation insurance premiums, amounts paid (if any) for mitigation insurance deductibles, and amounts paid (if any) for market penalties that exceed the mitigation insurance coverage (collectively, the "PJM Capacity Market Costs") (the net of the PJM Capacity Market Benefits and PJM Capacity Market Costs is referred to herein as the "Net PJM Capacity Market Benefit"). These revenues and expenses will impact EKPC's margins in the appropriate accounting periods.

Q. DOES THE SMITH SOLUTION INVOLVE THE AMORTIZATION OF THE SMITH 1 REGULATORY ASSET?

A. Yes. EKPC believes that the entire Smith 1 Regulatory Asset balance is a cost of service and recoverable through rates. The Smith Solution provides for the recovery of the Smith 1 Regulatory Asset through three mechanisms: the actual results of EKPC's mitigation and salvage efforts, the Net PJM Capacity Market Benefits earned by EKPC, with the balance recovered through amortization expense included in base rates. Under the Smith Solution, EKPC will begin amortizing the book value of the Smith 1 Regulatory Asset, net of the expected mitigation and salvage efforts (*i.e.*, [redacted]), beginning January 1, 2017. This amortization will be for accounting purposes only and will reflect an amortization schedule spanning a ten (10) year period. The amortization expenses will impact EKPC's margins in the appropriate accounting periods.

Q. HOW IS EKPC'S NEXT GENERAL BASE RATE PROCEEDING RELEVANT TO THE SMITH SOLUTION?

A. Under the Smith Solution, EKPC will request as part of its next general base rate proceeding that its rates be adjusted to reflect the amortization expense of the Smith 1 Regulatory Asset. This amortization adjustment will be spread over the remaining months of the 10-year amortization period that began on January 1, 2017, and it will be based on the Smith 1 Regulatory Asset balance as of January 1, 2017, reduced by: (i) the actual results of EKPC's Smith 1 mitigation and salvage efforts during the period of January 1, 2017, through the end of the test year employed in the rate case; and (ii) the Net PJM Capacity Market Benefit earned by EKPC beginning with the 2016/17 PJM Delivery Year and concluding at either the end of the test year employed in the rate case or the end of calendar year 2019. This latter determination will be made depending on whether, at the time of EKPC's next general base rate proceeding, the PJM Capacity Market Costs associated with calendar year 2019 are known and measurable. If they are, EKPC will request an amortization adjustment that reflects the full Net PJM Capacity Market Benefit realized through 2019. If, however, the PJM Capacity Market Costs associated with calendar year 2019 are not known and measurable at the time of EKPC's next general base rate proceeding, EKPC will request an amortization adjustment that reflects only the Net PJM Capacity Market Benefit realized through the end of the test year employed in the rate case. Should this second circumstance exist, EKPC will request that the Net PJM Capacity Market Benefit realized after the end of the rate case test year be recognized as part of the determination of the amortization adjustment in a subsequent general base rate proceeding.

Q. WILL EKPC CONTINUE TO RECOVER THROUGH RATES THE SMITH 1 INTEREST EXPENSE AFTER ITS NEXT GENERAL BASE RATE PROCEEDING?

A. In its next general base rate proceeding, EKPC will discontinue its specific identification of the Smith 1 Interest Expense and include this expense as part of the cost of service to be recovered along with other interest expense. The Smith 1 Settlement Agreement and 2010 Rate Case Settlement Agreement were based on the assumption that the Smith 1 Regulatory Asset would be recovered through a separate surcharge mechanism. The specific identification of the Smith 1 Interest Expense was necessary to avoid a double-recovery of interest expense by EKPC. The proposed treatment for the Smith 1 Regulatory Asset in the next general base rate proceeding will eliminate the need for the specific identification of the Smith 1 Interest Expense.

Q. IN WHAT OTHER WAYS DOES THE SMITH SOLUTION RESPECT THE PROVISIONS OF THE SMITH 1 SETTLEMENT AGREEMENT?

A. The Smith 1 Settlement Agreement contemplated that EKPC would seek the establishment of the Smith 1 Regulatory Asset and that, when it became time to seek recovery of the regulatory asset through base rates, an allocation methodology based upon the firm demand of each rate class (including Nucor) would be employed. Such an allocation methodology was agreed upon in recognition of the fact that Smith 1 was not primarily planned to serve Nucor's load, and thus Nucor should not face a disproportionate burden when recovery of the Smith 1 costs is pursued.

Under the Smith Solution, the proposed treatment of the Smith 1 Regulatory Asset will necessarily reduce the value to Nucor of the allocation structure called for by the Smith 1 Settlement Agreement. Therefore, in recognition of these changes in the treatment of the Smith 1 Regulatory Asset amortization, EKPC and Nucor have agreed that some provision must be made to preserve the benefit Nucor originally negotiated as part of the Smith 1 Settlement Agreement. To that end, EKPC and Nucor have agreed that Nucor should receive a temporary monthly bill credit in the amount of $35,000.00. This temporary credit will commence once approved by the Commission in this case and cease as of the effective date for new rates resulting from EKPC's next general base rate proceeding.

V. Conclusion

Q. WHY HAS EKPC PROPOSED THE SMITH SOLUTION?

A. After extensive examination of all relevant considerations and numerous discussions with interested parties, EKPC has concluded that the Smith Solution represents the best proposal for the implementation of a CBS Mechanism. Utilizing the PJM capacity market benefits to reduce the amount of the Smith 1 Regulatory Asset will directly benefit EKPC's Owner-Members and their customers by eliminating the need for a sizeable Smith 1 surcharge and effectively delaying EKPC's pursuit of a base rate adjustment; moreover, commencing the amortization of the Smith 1 Regulatory Asset as of January 1, 2017, is consistent with prudent utility management and is a means to responsibly address EKPC's outstanding obligations.

Q. IS THE SMITH SOLUTION IN THE BEST INTEREST OF EKPC, ITS OWNER-MEMBERS, AND THE ULTIMATE CONSUMERS?

A. Yes.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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

VERIFICATION OF MICHAEL McNALLEY

Michael McNalley, Executive Vice President and Chief Financial Officer of East Kentucky Power Cooperative, Inc., in his official capacity, verifies and affirms that he has read the foregoing prepared supplemental direct testimony and that he would respond in the same manner to the questions if so asked upon taking the stand, and that the matters and things set forth therein are true and correct to the best of his knowledge, information and belief formed after reasonably inquiry.

This 21 day of June, 2016.

MICHAEL McNALLEY, Executive Vice President and Chief Financial Officer of East Kentucky Power Cooperative, Inc.

FROM THE MINUTE BOOK OF PROCEEDINGS OF THE BOARD OF DIRECTORS OF EAST KENTUCKY POWER COOPERATIVE, INC.

At a regular meeting of the Board of Directors of East Kentucky Power Cooperative, Inc. held at the Headquarters Building, 4775 Lexington Road, located in Winchester, Kentucky, on Tuesday, May 10, 2016, at 9:30 a.m., EDT, the following business was transacted:

Approval to Seek from the Kentucky Public Service Commission Authorization to Use EKPC's PJM Capacity Market Benefits to Fund Recovery of the Smith 1 Regulatory Asset and to Begin Amortization of the Remaining Balance of the Smith 1 Regulatory Asset

After review of the applicable information, a motion to approve to Seek from the Kentucky Public Service Commission Authorization to Use EKPC's PJM Capacity Market Benefits to Fund Recovery of the Smith 1 Regulatory Asset and to Begin Amortization of the Remaining Balance of the Smith 1 Regulatory Asset was made by Strategic Committee Chairman Landis Cornett, and passed by the full Board to approve the following:

Whereas, East Kentucky Power Cooperative, Inc., ("EKPC") is required by the Kentucky Public Service Commission's ("Commission") December 20, 2012 Order in Case No. 2012-00169 to file a PJM Capacity Market Benefits mechanism; and

Whereas, The dollar value of the demand credit resulting from the PJM Capacity Market Benefits mechanism to retail customers would at present be small; and

Whereas, The standard residential rate structure for EKPC's Member Distribution Cooperatives does not include a demand charge component, making the development of a methodology to provide a demand credit for this customer class unworkable; and

Whereas, Any such rate reduction will require a base rate increase to maintain EKPC's creditworthiness; and

Whereas, No agreeable mechanism using capital credits could be developed; and

Whereas, EKPC has an outstanding balance of the Smith 1 regulatory asset which should be amortized and recovered; and

Whereas, Using the PJM capacity market benefits to reduce the amount of the Smith 1 regulatory asset will directly benefit members by eliminating the need for the Smith 1 surcharge; and

Whereas, EKPC desires to begin amortization of the remaining balance of the Smith 1 regulatory asset and absorb that cost in its margin for as long as possible,

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while identifying the amortization as a cost of service for ratemaking purposes; and

Whereas, EKPC intends to honor its previous commitment to Gallatin by negotiating a bill credit of comparable value; now, therefore, be it

Resolved, The EKPC Board hereby authorizes the Chief Executive Officer, or his designee, to seek regulatory approval from the Commission to use EKPC's PJM Capacity Market Benefits to reduce the Smith 1 regulatory asset balance and to begin to amortize the remaining balance of the Smith 1 regulatory asset. The EKPC Board hereby authorizes the Chief Executive Officer, or his designee, to negotiate a bill credit with Gallatin which preserves the intent of the original Smith1 arrangement.

The foregoing is a true and exact copy of a resolution passed at a meeting called pursuant to proper notice at which a quorum was present and which now appears in the Minute Book of Proceedings of the Board of Directors of the Cooperative, and said resolution has not been rescinded or modified.

Witness my hand and seal this 10th day of May 2016.

Michael Adams, Secretary

Corporate Seal