COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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

ORDER

On October 30, 2015, EKPC filed an application requesting approval to deviate from a directive of the Commission's final Order in Case No. 2012-00169 ("PJM Case")[1] requiring EKPC to file an application no later than November 30, 2015, for approval of a rate mechanism to flow back to customers the capacity market benefits expected to accrue from EKPC's full membership in PJM Interconnection, LLC ("PJM"). In the PJM Case, EKPC sought approval to transfer to PJM functional control of all of EKPC's transmission lines and substations that operate at 100 kilovolts and above. This transfer of functional control was needed to effectuate EKPC's full integration into the PJM system, effective June 1, 2013.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), and Kentucky Industrial Utility Customers, Inc. ("KIUC") are the intervenors in this matter. Pursuant to an Order dated November 30, 2015, the Commission granted EKPC's request to have the matter placed in abeyance for a period of 90 days and to temporarily relieve EKPC from the requirement

[1] Case No. 2012-00169, *Application of East Kentucky Power Cooperative, Inc. to Transfer Functional Control of Certain Transmission Facilities to PJM Interconnection, LLC* (Ky. PSC Dec. 20, 2012).

that it file an application for approval of a rate mechanism to flow back to customers certain benefits from its participation in the PJM capacity markets. At the request of EKPC, the initial abeyance period was subsequently extended for another 90 days by Order dated March 2, 2016, and an additional 30 days by Order dated June 10, 2016. During the abeyance period, the parties engaged in numerous informal conferences for the purposes of discussing the issues related to the instant matter and to allow the parties an opportunity to develop a mutually agreeable proposal related to the structure and implementation of a capacity benefits mechanism required by the final Order in the PJM Case. EKPC also submitted timely status reports, as required, during the pendency of the abeyance periods.

On June 22, 2016, EKPC filed a motion requesting leave to file an amended application which included a proposal establishing a framework for the handling of the Smith Unit 1 regulatory asset in conjunction with the sharing of the PJM capacity benefits. On August 8, 2016, EKPC filed a Stipulation and Recommendation ("Stipulation") entered into by and among EKPC, the AG, and KIUC and an accompanying motion requesting approval of the Stipulation. EKPC noted that the Stipulation reflects the parties' agreement as to the fair, just, and reasonable resolution of this matter. The matter now stands submitted for a decision based upon the existing evidentiary record. For the reasons mentioned below, the Commission will grant EKPC's motion for leave to file its amended application and will conditionally approve the Stipulation.

PJM INTEGRATION CASE

PJM is a regional transmission organization that, among other things, coordinates the movement of wholesale electricity in all or parts of 13 states and the District of Columbia. PJM also operates an energy market and a capacity market. The energy market sets a market price for electricity by matching supply and demand for both a day-ahead and a real-time market. The capacity market uses a three-year planning horizon to create a long-term price signal for the cost of capacity needed to reliably serve load within the PJM system. EKPC has been a member of PJM since 2005 for purposes of participating in PJM's energy market and to reserve transmission service within the PJM region. After conducting several independent economic studies, EKPC determined that it would be economically advantageous to fully integrate into PJM. Based on the economic analyses performed by Charles Rivers Associates, EKPC projected it could achieve a net expected economic benefit of $131.9 million, on a ten-year present value basis, resulting from its full integration into PJM. The analysis concluded that EKPC could achieve three key benefits[2] from full membership in PJM:

- Trade benefits of $40 million over the ten-year study period, consisting of more efficient commitment and dispatch of EKPC's generating resources leading to lower adjusted production costs for EKPC, i.e., fuel, variable operations and maintenance expenses, and emissions costs. By decreasing impediments to trade and fully participating in PJM's integrated regional energy market, EKPC will be able to purchase more power at lower costs to substitute for higher-cost generation on its own system;

- Capacity market benefits of $137 million over the 10-year study period, reflecting impacts on PJM's capacity market resulting from EKPC's being a winter-peaking utility while PJM is a summer-peaking system, which creates advantageous peak-load diversity for EKPC relative to PJM as a whole. This peak-load diversity results in significantly less planning reserves needed by EKPC and produces cost

[2] These three key benefits amount to approximately $233.1 million. Factoring administrative and transmission costs of approximately $101.3 million, EKPC projected it would receive a net benefit of $131.9 million by fully integrating into PJM.

savings by maintaining a lower reserve margin. The ability to maintain a lower reserve margin is expected to produce additional revenue for EKPC because any generating capacity in excess of its load and reserve margin can be sold at the PJM capacity market price. EKPC will also be able to bid its customers' interruptible load into the PJM demand-response program to provide additional revenue; and

- Avoided long-term, firm point-to-point transmission charges of approximately $7.5 million annually that EKPC is currently paying associated with the annual reservation of 400 megawatts ("MW") of transmission capacity on the PJM system. This transmission capacity was needed by EKPC to economically meet its load requirements during certain times of the year. As a member of PJM, EKPC will be entitled to receive transmission service without paying the $7.5 million annual charge, resulting in estimated benefits of $56.1 million over the ten-year study period.

By Order dated December 20, 2012, the Commission approved EKPC's request to transfer functional control of certain of its transmission facilities to PJM, finding, among other things, that full membership in PJM would not have an adverse impact on EKPC's rates or quality of service and that there will be substantial benefits from cost savings in each of the years covered by the study period. The Commission also found that although 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, EKPC had no mechanism outside of a base rate proceeding to flow back to customers the capacity market benefits. Accordingly, the Commission directed 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.

<u>INSTANT APPLICATION TO DEVIATE FROM CASE NO. 2012-00269</u>

On October 30, 2015, EKPC filed an application seeking permission to deviate from the PJM Case's Final Order's directive regarding the implementation of a capacity benefits sharing mechanism and a suspension of the obligation for a period of 18 months, or until May 31, 2017. In support of the requests, EKPC stated that it would be imprudent and unreasonable to implement a capacity benefits sharing mechanism at this time in light of a number of current and pending federal environmental regulations that would have a significant impact on EKPC's operations and its ability to provide reliable and affordable energy. EKPC noted that compliance with one or more of the Clean Power Plan, the Coal Combustion Residual Rule, the Effluent Limitations Guideline, and the Ozone National Ambient Air Quality Standards would require it to consider solutions that include upgrading its generating units, constructing new generation resources, exploring power purchase agreements or relying on market purchases. Due to the uncertainty associated with these more stringent federal environmental regulations, particularly with the Clean Power Plan, EKPC expressed its belief that it is prudent to request an extension of time to file the capacity benefits sharing mechanism. EKPC noted that the extension would grant EKPC an opportunity to better develop environmental compliance strategies and would allow EKPC and its member cooperatives to develop better-aligned rate structures that provide workable solutions to the equitable sharing of benefits and costs, consistent with EKPC strategic objectives. EKPC indicated that the PJM energy market has been more robust than originally anticipated, but that in most years the PJM capacity market has not produced the type of revenues that EKPC had projected. This market trend coupled with the early 2016 closure of the Dale Generating Station has caused EKPC to re-evaluate not only the type of mechanism, but also the timing of the implementation of any such mechanism.

EKPC, the AG and KIUC as intervenors, and Commission Staff participated in five informal conferences to discuss the issues relevant to the case and the various methods available to flow the capacity benefits back to EKPC's customers. The informal conferences were held on November 20, 2015; December 22, 2015; January 29, 2016; March 17, 2016; and June 24, 2016. At the request of EKPC, the matter was placed in abeyance to allow the parties an opportunity to develop a mutually agreeable proposal related to the structure and implementation of the rate mechanism. EKPC and the parties explored a number of possibilities, including a base rate adjustment, direct surcredits to the member cooperatives, and a capital credit allocation methodology. In analyzing how to best flow the capacity revenues generated by its membership in PJM to its members, EKPC expressed two overriding guiding principles. First, EKPC stated, any margins it earns belong to its members because EKPC is a member-owned non-profit company. Second, the capacity benefits anticipated to be received by EKPC will be over a short period, i.e., one to two PJM planning years. EKPC provided information regarding the trade benefits that it has realized to date, the capacity benefits that it has received to date, and the capacity benefits that it expects to receive over the next several PJM planning years. EKPC stated that actual capacity revenues received for the 2016/2017 and the 2017/2018 PJM planning years would produce margins that could be returned to members, but that projected capacity revenues for the remaining years of the ten-year study period would not generate margins.

EKPC indicated that it has considered several methods to flow the capacity benefits back to its members, including: (1) a surcredit mechanism joined with a surcharge to amortize the regulatory asset and recover the costs related to the construction of Smith 1 (2) refunding via a rate change, and (3) capital credit rotation. EKPC stated that a refund would negatively impact its financial metrics such that EKPC would need to seek a base rate increase by the end of 2016 to offset the financial impact. EKPC also ruled out a capital credit rotation, noting that the federal Rural Utilities Service would not approve of such a measure and that the EKPC distribution cooperatives were not supportive of this mechanism due to concerns about each of the distribution cooperatives' having differing capital credit payment methodologies. EKPC also cited the threat of litigation over capital credit payments that are occurring across the country. EKPC stated that the distribution cooperatives were supportive of using the capacity benefits to reduce the outstanding balance of the Smith 1 regulatory asset.

Ultimately, the parties to this matter were able to come to an agreement concerning the rate mechanism to flow back to EKPC's customers the capacity market benefits. The agreement proposes that EKPC should be permitted to implement the "Smith Solution," which will be described later in this Order, as the rate mechanism that would flow the capacity market benefits to EKPC's member cooperatives and their retail customers through the amortization of the Smith 1 regulatory asset.

In Case No. 2005-00053,[3] the Commission granted EKPC a Certificate of Public Convenience and Necessity ("CPCN") to construct Smith 1, a 278-MW coal-fired, base load generating unit, and five 90-MW combustion-turbine gas peaking units based in part on the anticipated load of the Warren Rural Electric Cooperative Corporation, which had decided to switch its power supplier from the Tennessee Valley Authority ("TVA") to EKPC. After Warren RECC subsequently elected to remain with the TVA, the Commission initiated an investigation in 2006 to determine EKPC's continued need for

[3] 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* (Ky. PSC Aug. 29, 2006).

the additional generating facilities, including Smith 1, that had been approved in Case No. 2005-00053, but not yet constructed.[4] Among other things, the Commission ultimately found that Smith 1 was still needed to serve EKPC's growing native load, to ease demand for more expensive purchased power, and to improve the overall reliability of its system. By mid-2010, EKPC was unable to obtain the necessary permits to allow it to continue construction of Smith 1. Due to the resulting significant increases in the estimated cost of Smith 1 and changes in EKPC's forecasted load, the Commission initiated a second investigation of EKPC's continued need for Smith 1.[5] The parties to that investigation, EKPC, Gallatin Steel Company, the AG, and three retail customers, reached a unanimous settlement agreement that provided for, among other things, the voluntary abandonment by EKPC of the construction of Smith 1 and surrender of the CPCN for that generating plant. The settlement agreement also provided that EKPC would seek the establishment of a regulatory asset for the costs incurred in connection with the Smith 1 project. The unanimous settlement in Case No. 2010-00238 was approved by the Commission. EKPC subsequently filed an application seeking approval of the accounting treatment and the Commission authorized the establishment of the Smith 1 regulatory asset in the amount of $157,399,715.[6]

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

[5] Case No. 2010-00238, *An Investigation of East Kentucky Power Cooperative, Inc.'s Need for the Smith 1 Generating Facility* (Ky. PSC Feb. 28, 2011).

[6] 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. PSC Feb. 28, 2011).

Since the establishment of the Smith 1 regulatory asset, EKPC has undertaken mitigation and salvage efforts to reduce the value of the Smith 1 regulatory asset. As of August 31, 2016, the Smith 1 regulatory asset has been reduced to $148,756,307.

PROPOSED MECHANISM TO FLOW THE CAPACITY BENEFITS TO EKPC'S RETAIL MEMBERS

As reflected in the Stipulation, the Smith Solution provides that, prior to EKPC's next base rate case, EKPC will continue to record the capacity benefit 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. These revenues and expenses will impact EKPC's margins in the appropriate accounting periods. The Smith Solution also allows EKPC to begin amortizing the book balance of the Smith 1 regulatory asset, net of the expected mitigation and salvage efforts, beginning January 1, 2017. This amortization will be for accounting purposes only and, consistent with what was contemplated in the Smith 1 settlement agreement, will reflect a ten-year amortization period. The amortization will impact EKPC's margins in the appropriate accounting periods. Because the amortization of the Smith 1 regulatory asset is for accounting purposes only, and there being no immediate adjustment of EKPC's base rates to recover the amortization expense, the Smith 1 annual interest expense of $9 million will remain in EKPC's base rates until its next general base rate proceeding. EKPC's recovery of the $9 million Smith 1 annual interest expense in base rates was the product of the settlement agreement in EKPC's most recent base rate case, Case No. 2010-00167.[7] The rate

[7] Case No. 2010-00167, *Application of East Kentucky Power Cooperative, Inc. for General Adjustment of Electric Rates* (Ky. PSC Jan. 14, 2011).

case settlement agreement also provided 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 million to prevent a double recovery of interest expense. The Smith Solution carries out the rate treatment of the Smith 1 interest expense as provided in the rate case settlement agreement.

Pursuant to the Smith Solution, EKPC agrees to provide Nucor with a temporary monthly bill credit of $35,000 to preserve the benefits that Nucor, previously known as Gallatin Steel, negotiated as part of the Smith 1 settlement agreement.

Under the Smith Solution, EKPC will, as part of its next base rate proceeding, 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: (1) the actual results of EKPC's mitigation and salvage efforts; and (2) the Net PJM Capacity Market Benefit earned by EKPC beginning with the 2016/2017 PJM Delivery Year and concluding at the end of the test year employed in the rate case. The amortization adjustment will be spread over the remaining months of the ten-year amortization period that began on January 1, 2017. EKPC states that 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; and amortization expense, included in base rates, for the balance.

As part of 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 the 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 EKPC's next general base rate proceeding will eliminate the need for the specific identification of the Smith 1 interest expense. Lastly, upon the effective date for the new rates resulting from EKPC's next general base rate proceeding, the temporary bill credit received by Nucor will cease.

DISCUSSION

Having reviewed the record and being otherwise sufficiently advised, the Commission finds that the Smith Solution is a reasonable proposal to effectuate a mechanism to flow the capacity benefits to EKPC's retail members. Amortizing the Smith 1 regulatory asset for accounting purposes beginning January 1, 2017, allows EKPC to start reducing the balance of the regulatory asset and to reflect the amortizations in its financial statements. Reflecting the amortization expense along with the actual PJM capacity market benefits eliminates what would have been EKPC's need to file an immediate base rate case if the PJM capacity market benefits were required to be passed through by reducing base rates as of January 1, 2017. Once EKPC files its next rate case, rate recovery will be requested for the amortization of the Smith 1 regulatory asset balance as of January 1, 2017, less the actual mitigation and salvage efforts and less the PJM capacity market benefits earned through the rate case test year. Crediting all of the PJM capacity market benefits earned through the test year, in lieu of the accounting amortizations booked, benefits EKPC's members and their customers both by reducing the Smith 1 regulatory asset by all of the benefits earned and by eliminating the need for what would have been a sizeable Smith 1 surcharge, while not penalizing EKPC financially for beginning the amortizations without an equal amount of additional revenue. In addition, EKPC has agreed that if the PJM capacity market benefits anticipated to be earned after the test year in its next rate case are more than minimal, it will be open to discussion of a rate mechanism to credit those benefits to its members and their customers.[8]

IT IS THEREFORE ORDERED that:

1. EKPC's motion for leave to file an amended application is granted.

2. EKPC's motion to accept and approve the Stipulation is granted and the Stipulation is approved.

By the Commission

ENTERED
JAN 10 2017
KENTUCKY PUBLIC
SERVICE COMMISSION

ATTEST:

Talina R. Mathews

Executive Director

[8] PSC Informal Conference Memo dated December 27, 2016 at 2.

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