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Commissioner

November 14, 2016

PARTIES OF RECORD

Re: Case No. 2016-00335

Attached is a copy of a memorandum which is being filed in the record of the above-referenced case. If you have any comments you would like to make regarding the contents of the memorandum please do so within five days of receipt of this letter.

If you have any questions, please contact Molly Katen, Staff Attorney, at 502-782-2591.

Sincerely,

A handwritten signature in blue ink that reads "Talina F. Mathews".

Talina Mathews
Executive Director

Enclosures

INTRA-AGENCY MEMORANDUM

KENTUCKY PUBLIC SERVICE COMMISSION

TO: Case File – Case No. 2016-00335

FROM: Mary Whitaker, Financial Analyst

DATE: November 14, 2016

RE: Informal Conference of November 9, 2016

Pursuant to the procedural schedule appended to the Commission's October 12, 2016 order establishing this case, an informal conference was held in this matter on November 9, 2016. A list of attendees is attached.

The purpose of the informal conference was to allow East Kentucky Power Cooperative, Inc. ("EKPC") and several of its member distribution cooperatives ("Member Cooperatives") an opportunity to discuss issues related to EKPC's environmental surcharge mechanism and the Member Cooperatives' pass-through mechanism.

A representative of EKPC distributed a presentation and an appendix of graphs, a copy of which is attached. The presentation discussed the volatility in EKPC's environmental surcharge factor and a proposed solution. EKPC and the Member Cooperatives explained that, while EKPC's environmental compliance costs have been relatively stable, the calculation of EKPC's environmental surcharge factor creates volatility that is mirrored in the pass-through factors the Member Cooperatives calculate and bill to retail member customers. The Member Cooperatives explained that the complexity of the surcharge calculation, along with no clear correlation between changes in EKPC's compliance costs and the Member Cooperatives' pass-through factors, makes it difficult to satisfactorily explain to their retail member customers the environmental surcharge line item on their bills. Farmers Rural Electric Cooperative Corporation explained that industrial customers with relatively consistent electrical use have experienced significant bill fluctuations because of environmental surcharge pass-through factors that vary from month to month. Additionally, the volatility in EKPC's surcharge factor is affecting the cash flow and financial positions of some Member Cooperatives.

EKPC calculates the surcharge factor using a 12-month average revenue in an attempt to smooth the surcharge amounts collected in any month. However, this approach creates over- and under-recoveries that add to the bill volatility. The Member Cooperatives also use a 12-month average revenue that results in over- and under-

recoveries. While the methodology changes discussed in Case No. 2014-00051¹ and refined and approved in Case No. 2015-00281² have helped decrease the volatility in the pass-through factor caused by these over- and under-recoveries, the majority of the fluctuation now stems from variation in EKPC's surcharge factor.

EKPC and the Member Cooperatives have discussed and modeled several approaches to smoothing the surcharge and pass-through factors. One method they evaluated was a surcharge roll-in to base rates as authorized by the environmental surcharge statute. However, this approach was rejected because of concerns about the magnitude of the necessary roll-in and the mechanics of the flow through of the increased base rates on the rate design of the Member Cooperatives. EKPC has historically declined to roll its surcharge into base rates because its Member Cooperatives and their customers prefer the transparency of a separate line item for all environmental compliance costs. Moreover, modeling of a base rate roll-in showed that the surcharge and pass-through factors would become credits in some periods, further complicating any explanation to retail member customers.

After examining possible alternatives, EKPC is proposing to use a "flat rate" environmental surcharge factor that is calculated yearly by dividing the budgeted surcharge revenue requirement by budgeted revenues subject to the surcharge. The revenue requirement would be adjusted for the under- or over-recovery from the previous year. The factor would then remain fixed and be reset at the beginning of the next year. The monthly environmental surcharge filings would be submitted to calculate the over- or under-recovery and provide documentation for the six-month and two-year reviews of the reasonableness of the compliance costs for the period. EKPC modeled the Member Cooperatives' pass-through factors for the period January 2013 through September 2016 using the fixed rate surcharge from EKPC. The pass-through factors generally fluctuated in a 2 to 3 percentage point range as compared to 8 to 10 percentage points under the current methodology. Some Member Cooperatives' unique situations involving customer mixes and amortization of previously approved over- and under-recoveries reduced the smoothing effect of the flat rate surcharge; however, all Member Cooperatives' pass-through factors were less volatile under the flat rate approach.

EKPC stated that beginning to bill a flat rate surcharge for the March expense month would ease the transition because March is between the high energy use periods of winter and summer months. EKPC suggested that any over- or under-recovery from

¹ Case No. 2014-00051, *An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Period Ending December 31, 2013 and the Pass Through Mechanism for Its Sixteen Member Distribution Cooperatives* (Ky. PSC Oct. 12, 2015).

² Case No. 2015-00281, *An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Periods Ending June 30, 2014 and December 31, 2014, for the Two-Year Billing Period Ending June 30, 2015, and the Pass Through Mechanism for Its Sixteen Member Distribution Cooperatives* (Ky. PSC Apr. 8, 2016).

the month before the transition would be included in the adjustment when the flat rate was recalculated at the end of the year. Additionally, EKPC stated that all the Member Cooperatives have been informed of the proposal and that no objections have been made to date.

Finding that no party had any further questions, the conference was adjourned.

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE) CASE NO.
COMMISSION OF THE ENVIRONMENTAL) 2016-00335
SURCHARGE MECHANISM OF EAST KENTUCKY)
POWER COOPERATIVE, INC. FOR THE SIX-MONTH)
BILLING PERIOD ENDING JUNE 30, 2016, AND THE)
PASS THROUGH MECHANISM OF ITS SIXTEEN)
MEMBER DISTRIBUTION COOPERATIVES)

Informal Conference – November 9, 2016

Please sign in:

NAME	REPRESENTING
Molly Katen	PSC Legal
Mary Whitaker	PSC - FA
Ron Handziah	PSC - FA
Bob Russell	PSC - FA
Aaron Brunelle	PSC
Daryl Jenkins	PSC
Patrick Wood	ETPC
Mark Stallons	Owen
WILLIAM T. PRATHER	FARMERS RECC
Jennie Phelps	Farmers RECC
Ryan Henderson	Jackson Energy
Carol Wright	Jackson Energy

NAME

REPRESENTING

MARK R. KEENE

JACKSON ENERGY

JEFF WHEELER

SRBELL

Michelle Herrman

South Kentucky Rural Electric

Isaac Scott

EKPC

David S. Sanford

Goss Sanford-EKPC

Mike McWally

EKPC

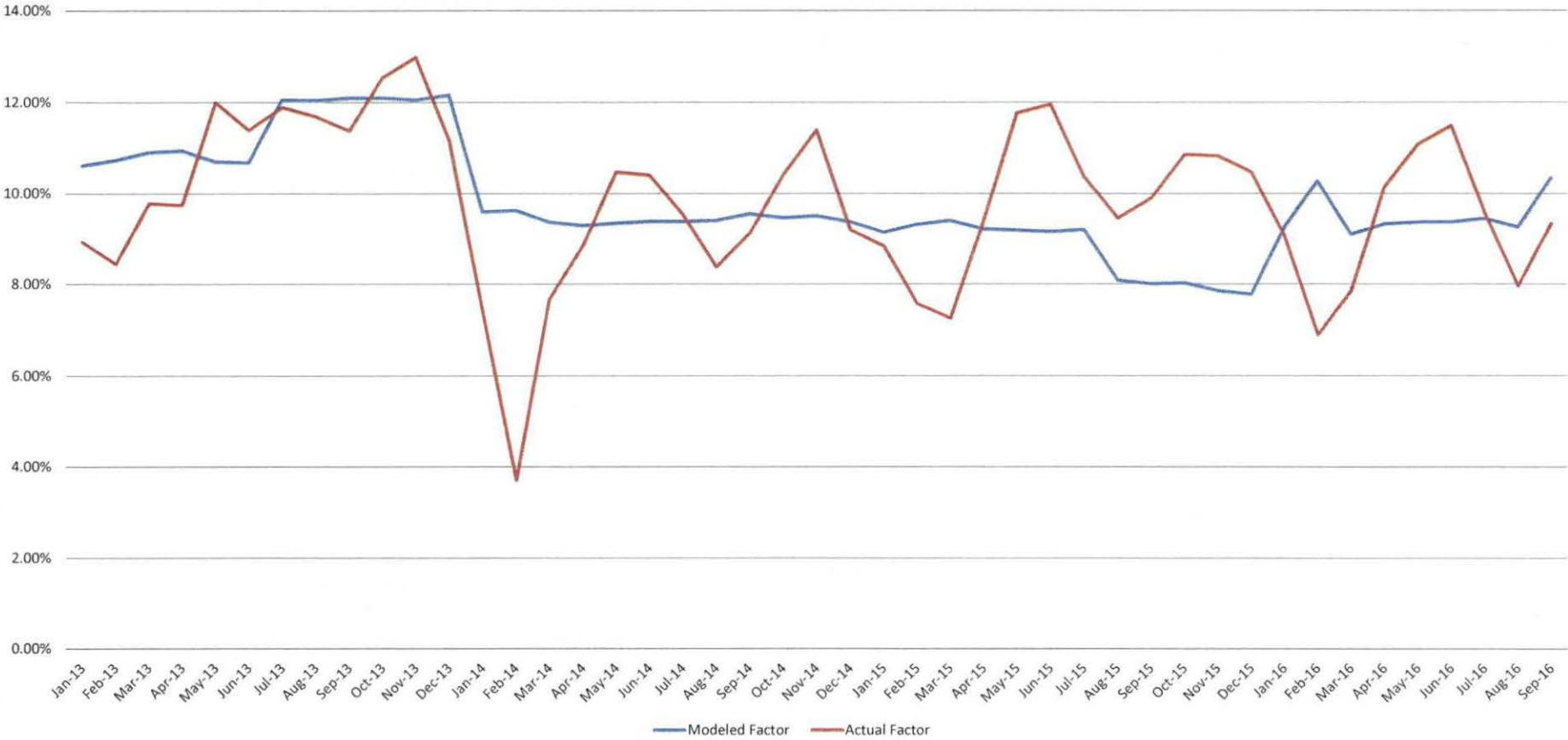
Big Sandy - Modeled versus Actual Pass Through Mechanism Factors



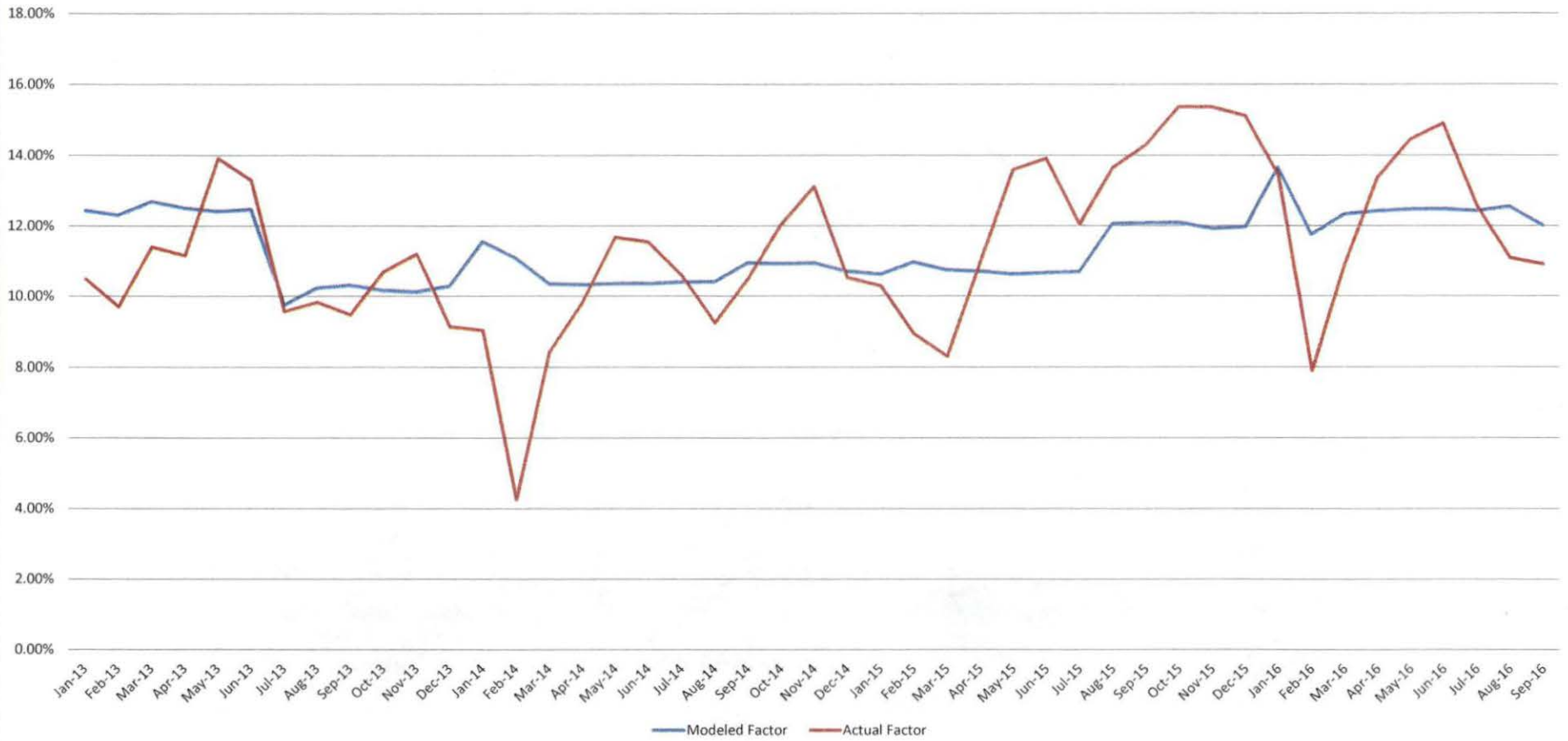
Blue Grass - Modeled versus Actual Pass Through Mechanism Factors



Clark - Modeled versus Actual Pass Through Mechanism Factors



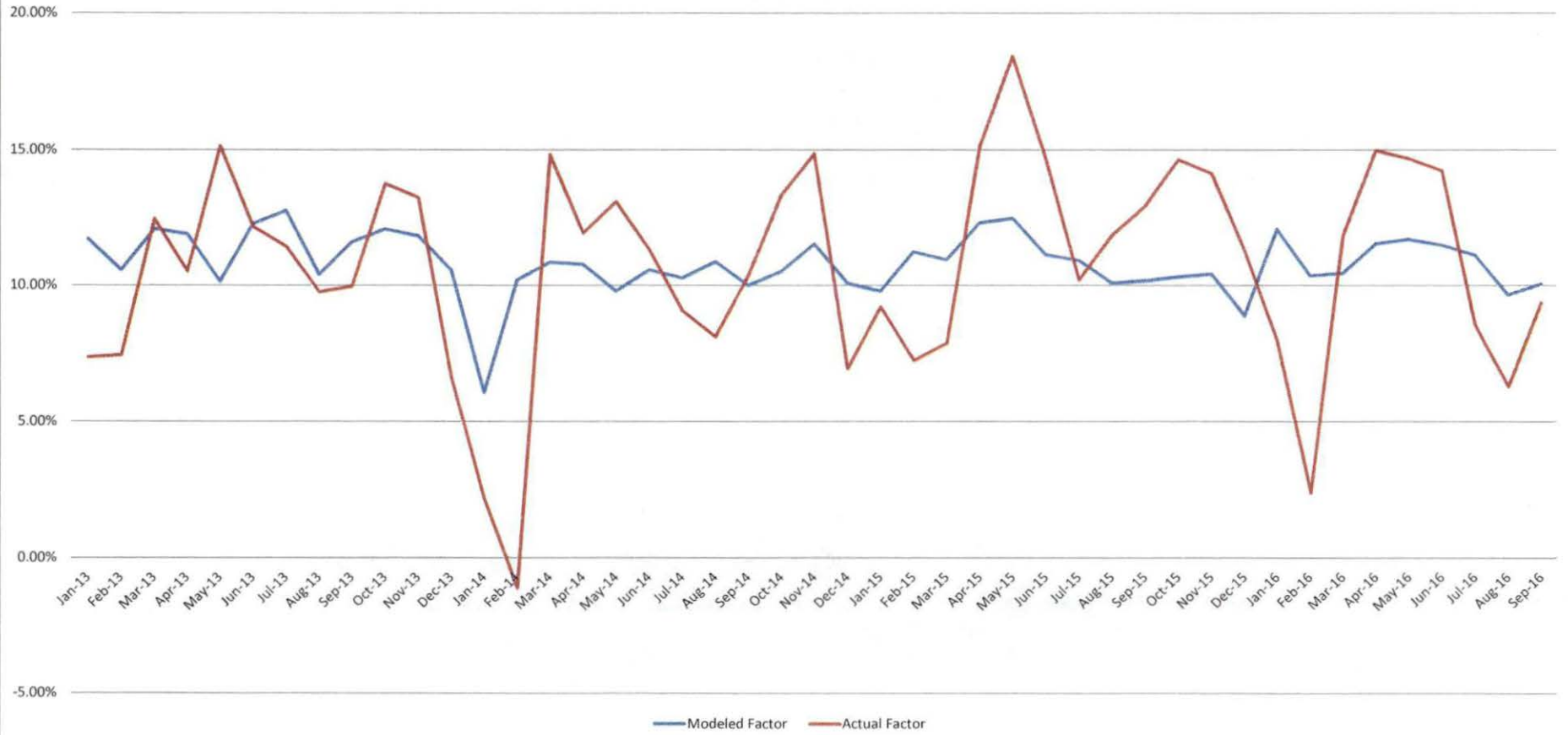
Cumberland Valley - Modeled versus Actual Pass Through Mechanism Factors



Farmers - Modeled versus Actual Pass Through Mechanism Factors



Fleming-Mason - Modeled versus Actual Pass Through Mechanism Factors



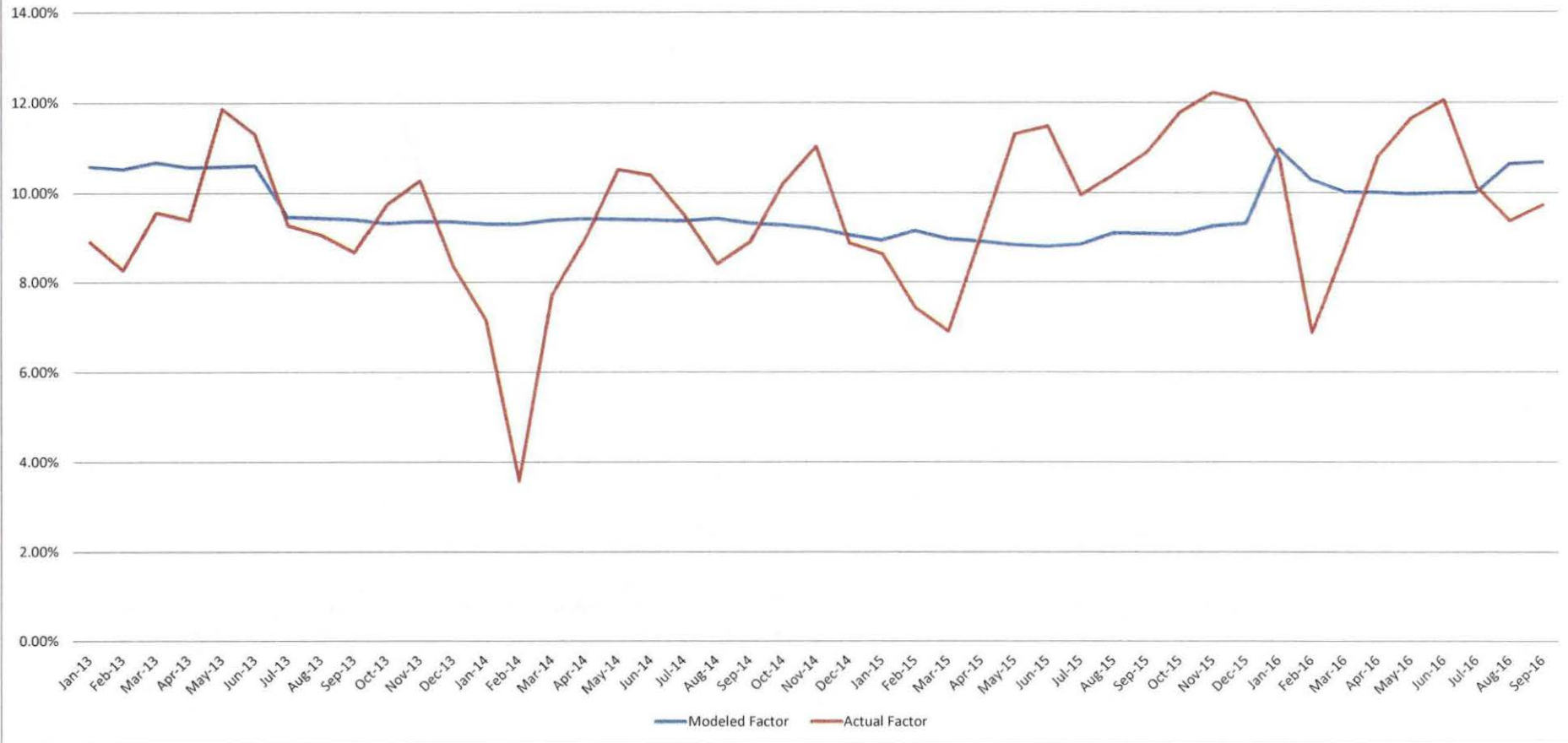
Grayson - Modeled versus Actual Pass Through Mechanism Factors



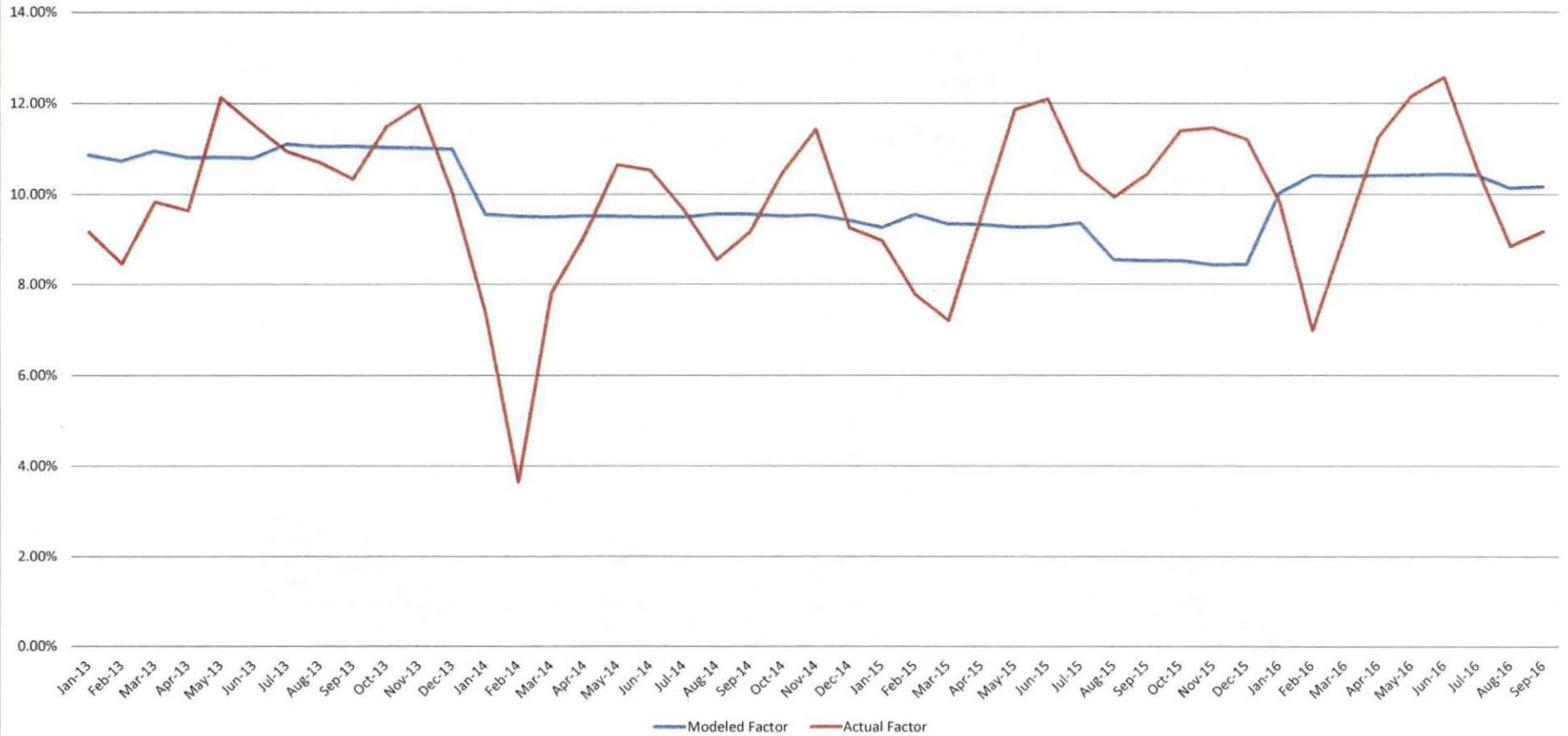
Inter-County - Modeled versus Actual Pass Through Mechanism Factors



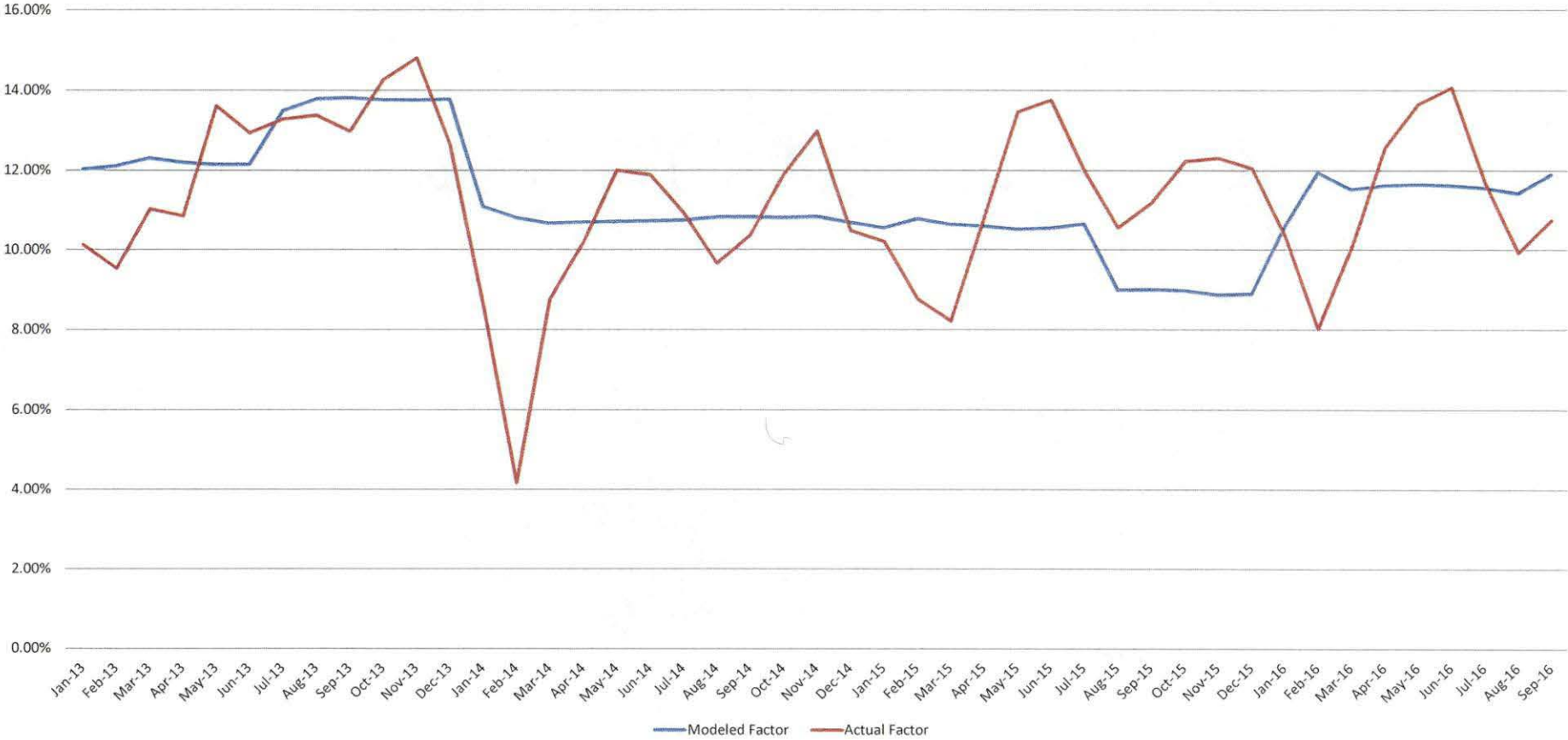
Jackson - Modeled versus Actual Pass Through Mechanism Factors



Licking Valley - Modeled versus Actual Pass Through Mechanism Factors



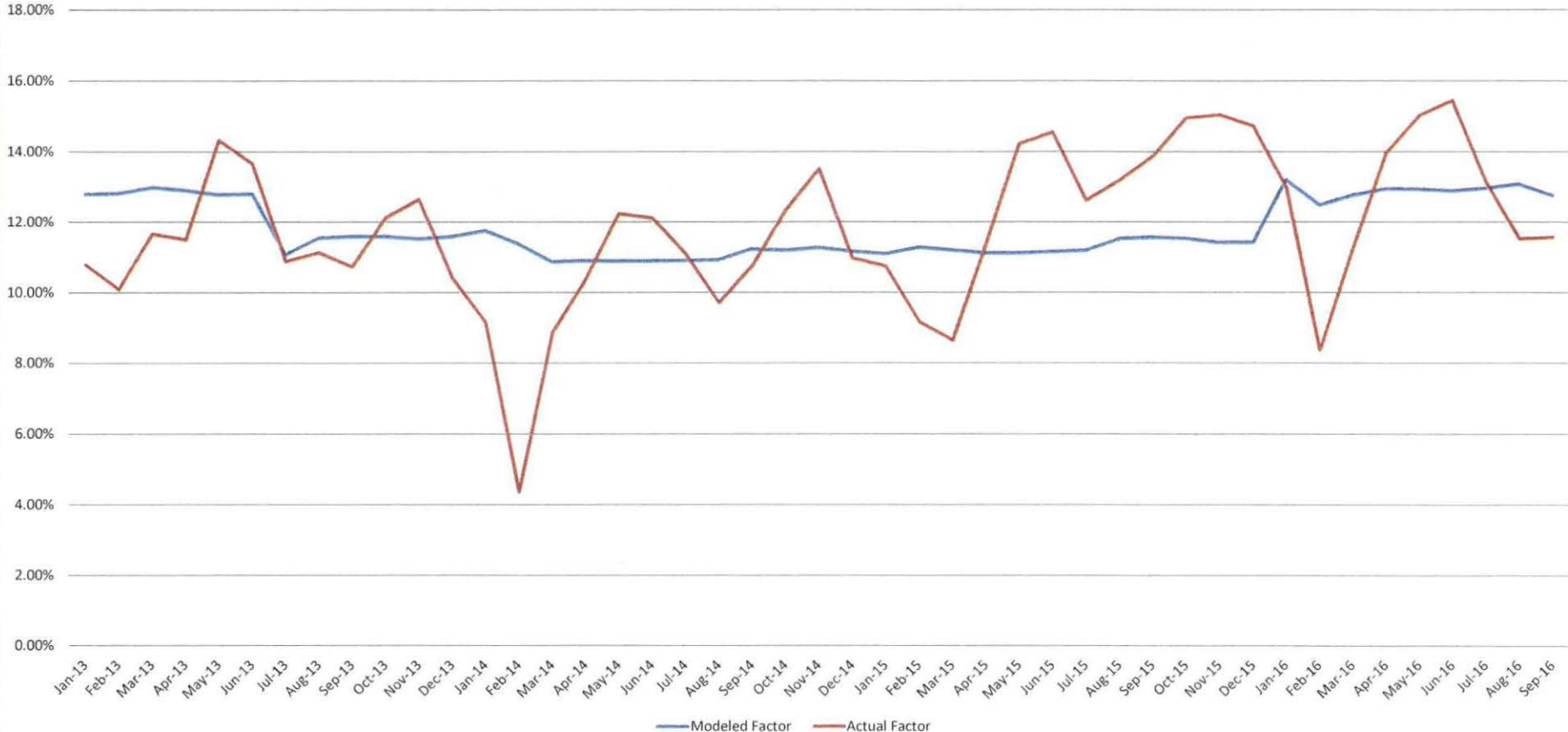
Nolin - Modeled versus Actual Pass Through Mechanism Factors



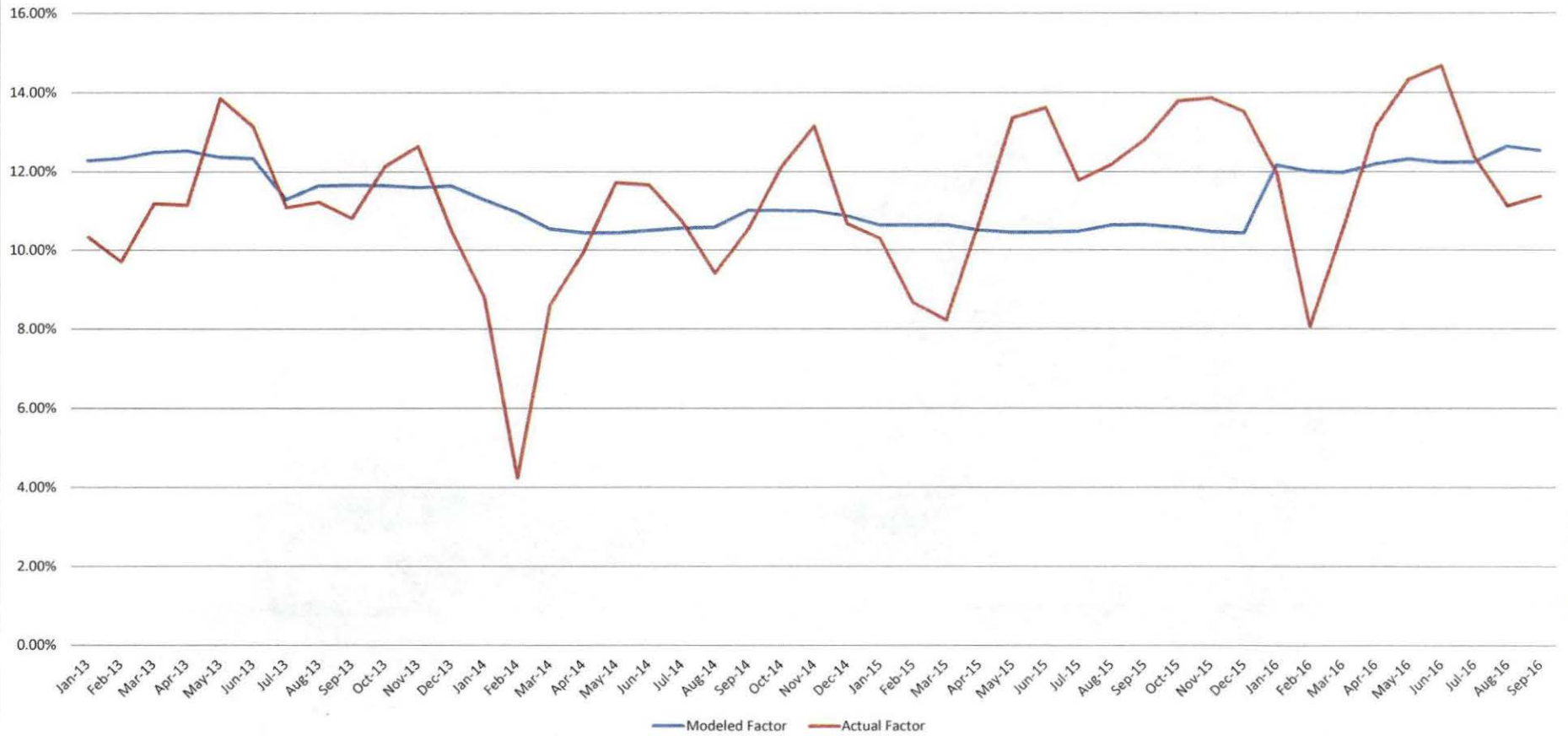
Owen - Modeled versus Actual Pass Through Mechanism Factors



Salt River - Modeled versus Actual Pass Through Mechanism Factors



Shelby - Modeled versus Actual Pass Through Mechanism Factors

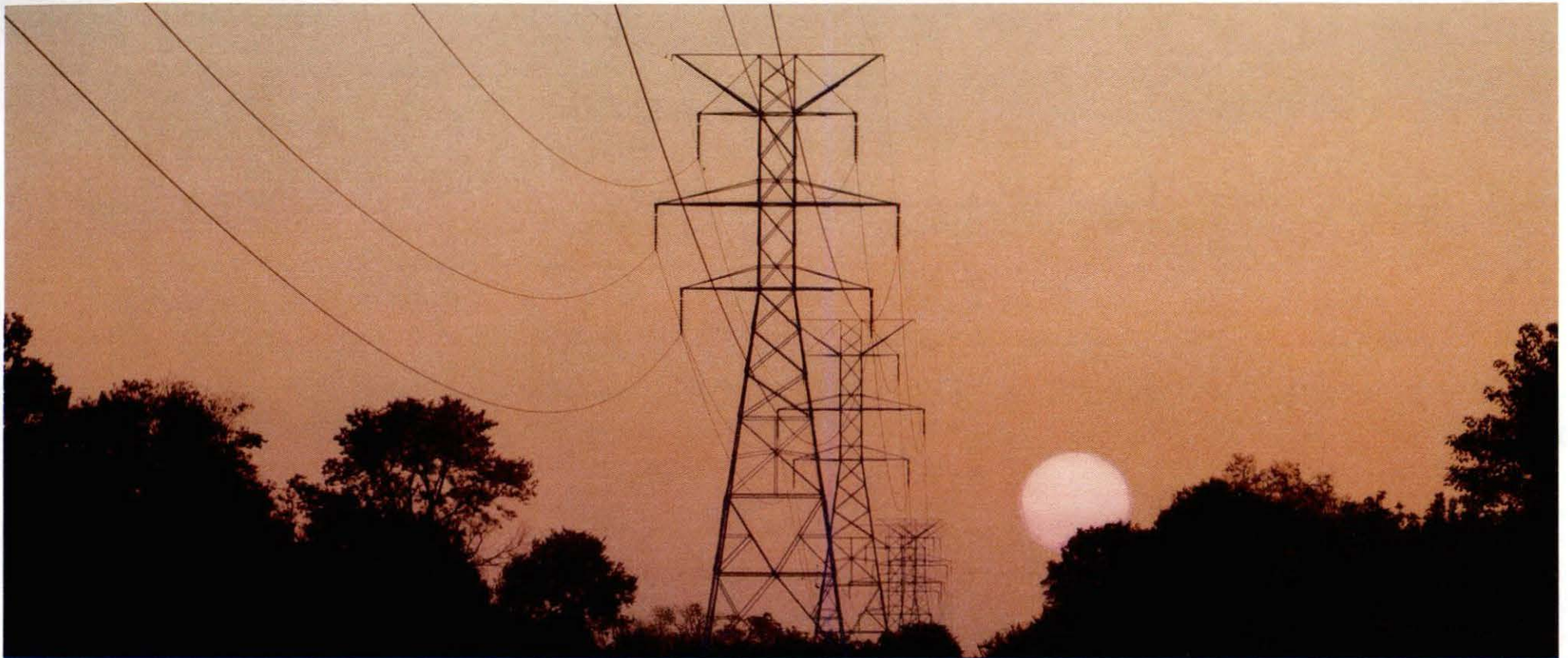


South Kentucky - Modeled versus Actual Pass Through Mechanism Factors



Taylor County - Modeled versus Actual Pass Through Mechanism Factors





EKPC Environmental Surcharge

Surcharge Factor Volatility and Possible Solution

Surcharge Factor Volatility - Background

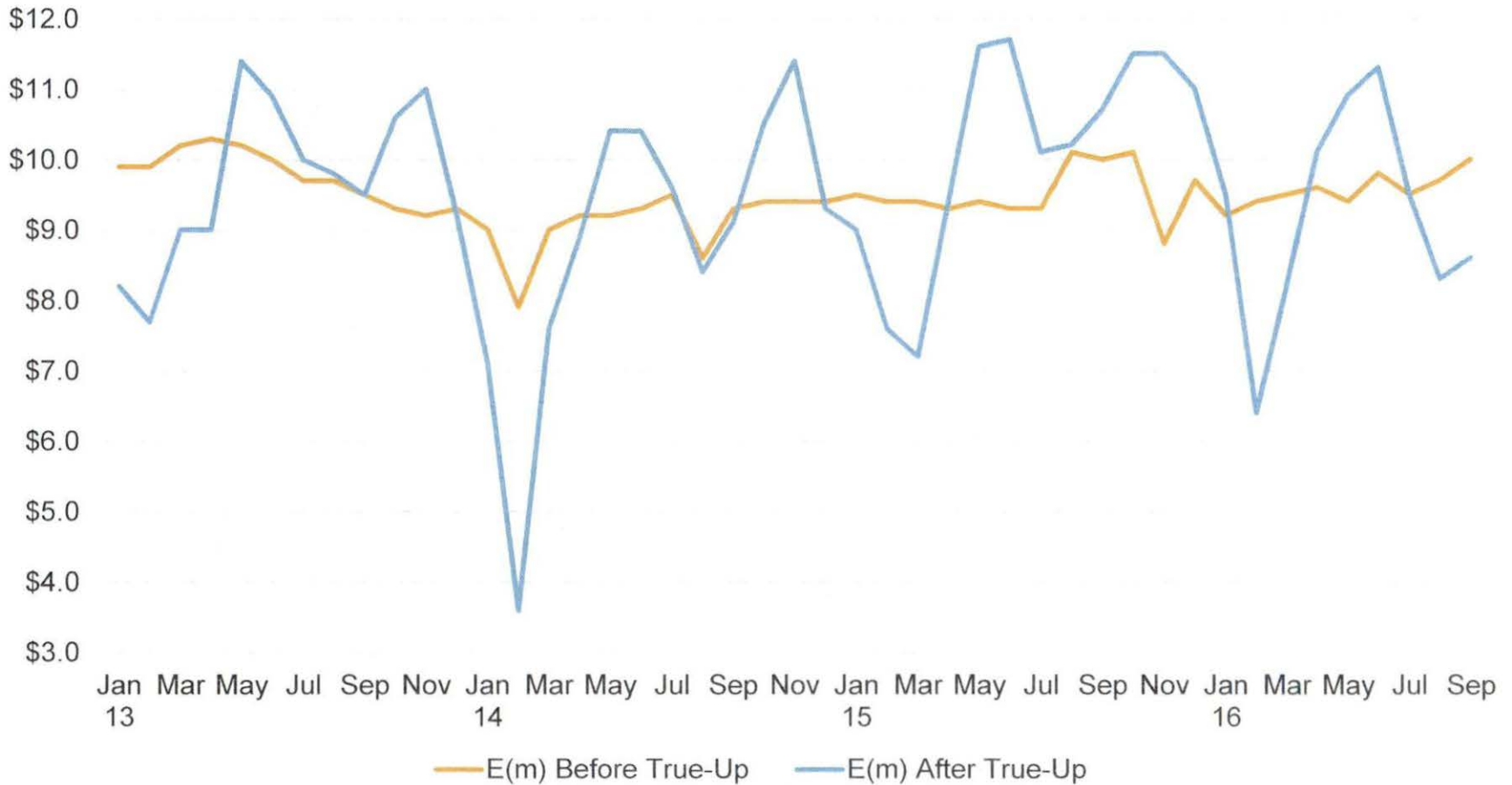
- Volatility in EKPC Surcharge Factor has been a concern of the Members for several years.
- Focused discussions between EKPC and Members have been on-going since 2014.
- Volatility issue was noted in Case No. 2014-00051 (Scott June 30, 2014 Supplemental Testimony) and Case No. 2015-00281 (Scott January 28, 2016 Supplemental Testimony); however, focus in both surcharge review cases was Member over/under recoveries rather than EKPC surcharge factor.

Surcharge Factor Volatility – What Is It?

- EKPC's surcharge factor reflects the monthly surcharge revenue requirement – $E(m)$ – and a true-up adjustment which allows for collection or refunding of the wholesale monthly over- or under-recovery of the surcharge.
- $E(m)$ has been relatively stable over the past few years.
- The true-up adjustment has fluctuated, sometimes significantly, over this same period.
- The result has been a volatile total monthly revenue requirement, which results in a monthly surcharge factor which can move several percentage points between months.

Surcharge Factor Volatility – What Is It? (continued)

E(m) Before and After True-Up Adjustment (millions of \$)



Surcharge Factor Volatility – What Is It? (continued)

- Volatility in the EKPC monthly surcharge factor translates into fluctuating pass-through surcharge factors for our Members.
- Generally, the magnitude of the volatility in the EKPC monthly surcharge factor is mirrored in the Members' pass-through surcharge factors.
- The Members naturally are concerned when their pass-through surcharge factors change by several percentage points between two months or over a period of a few months.
- The complexity of the calculations makes it difficult for the Members to explain to their retail customers' satisfaction why the surcharge can change so much over a short period of time.

Surcharge Factor Volatility – Options

- EKPC and its Members have reviewed several approaches to try and address the volatility of the EKPC surcharge factor.
 - Levelize the factor by averaging $E(m)$ or averaging calculated surcharge factors.
 - Determine surcharge factor using annual budgeted surcharge divided by previous calendar year's kWh sales or revenues, with an annual or six-month true-up adjustment for over- or under-recoveries.
- All approaches were modeled as if the approach had been in effect since January 2013. The modeling looked at the EKPC surcharge factor and the Members' corresponding pass-through factors.

Surcharge Factor Volatility – Options (continued)

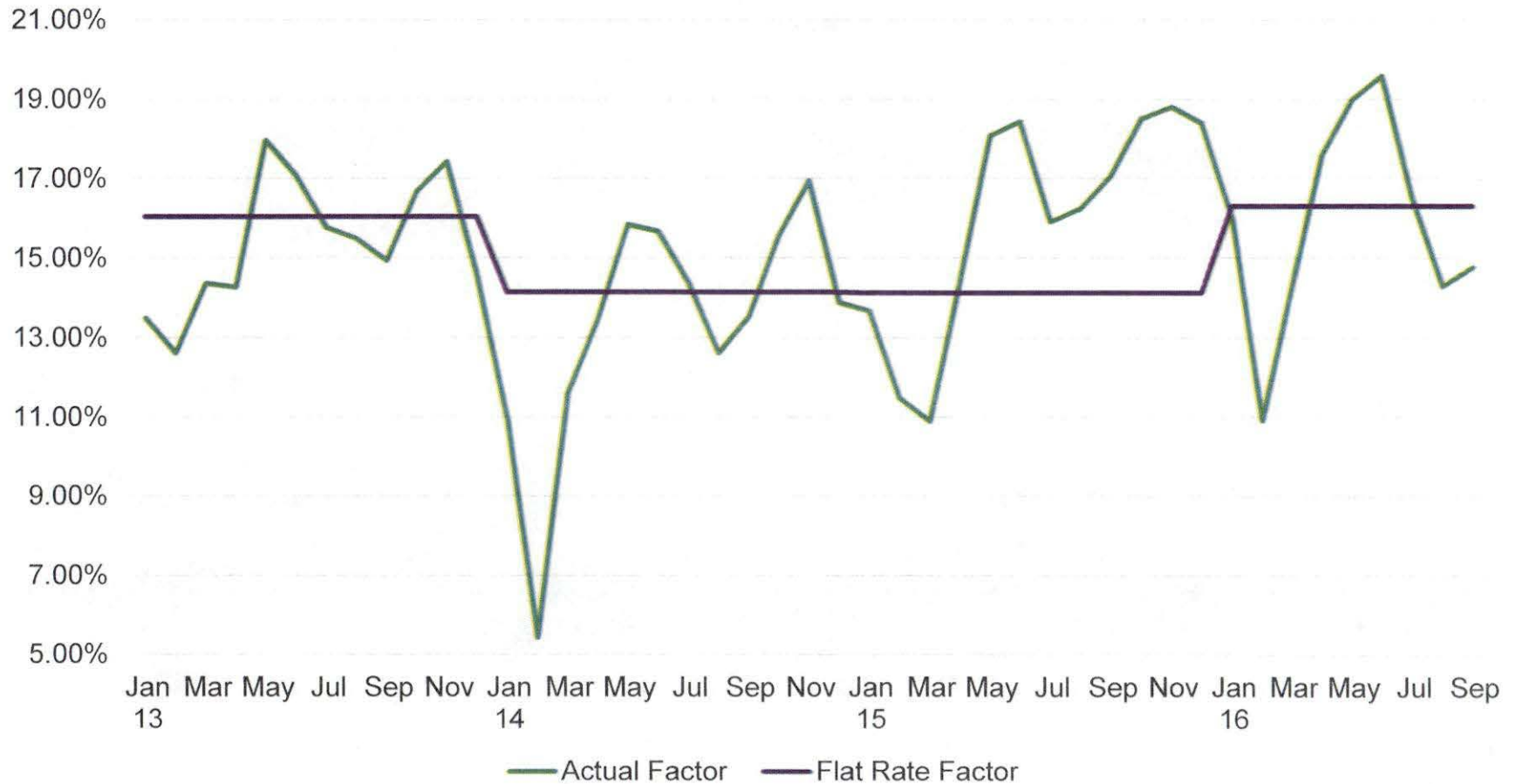
- Early in the discussions a surcharge roll-in to base rates was considered and modeled.
- The roll-in amount from Case No. 2013-00324 was used in the calculations – a roll-in of \$120.5 million.
- As a result of the roll-in, the modeling showed that EKPC's surcharge would essentially become a credit for the period; likewise the Members' pass-through factors would experience a similar shift to credit amounts, at slightly lower rates.
- Concerns over how base rates would be determined and the ability to readily identify surcharge costs resulted in the approach being rejected.

Surcharge Factor Volatility – Flat Rate Proposal

- EKPC and the Members concluded that a “Flat Rate” option would best address the volatility concerns.
- Under this approach, the EKPC monthly surcharge factor would be set at the first of each year and remain fixed.
- The Flat Rate is calculated by starting with the budgeted surcharge revenue requirement, $E(m)$, for the year and adding the actual annual surcharge over- or under-recovery from the previous year.
- The net $E(m)$ is then divided by the budgeted revenues subject to the surcharge for the same year.
- The actual monthly $E(m)$ would still be determined and be the basis for determining the annual over- or under-recovery.

Surcharge Factor Volatility – Flat Rate (continued)

EKPC Surcharge Factors – Actual versus Flat Rate Approach



Surcharge Factor Volatility – Flat Rate (continued)

- Member pass-through factors were also modeled using the Flat Rate.
- The mechanics of calculating the Member pass-through factors were not changed.
- Fluctuations in the pass-through factors reflected changes in Member revenue levels and amortization of over- or under-recoveries.
- Pass-through factors generally fluctuated between 2 and 3 percentage points using the Flat Rate approach, as compared with 8 to 10 percentage points under the current approach.
- Member Comments about Volatility.



Questions and Discussion

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