

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF SOUTH KENTUCKY RURAL)	
ELECTRIC COOPERATIVE CORPORATION)	
FOR A CERTIFICATE OF CONVENIENCE AND)	CASE NO.
NECESSITY TO CONSTRUCT A NEW)	2008-00371
HEADQUARTERS FACILITY IN SOMERSET,)	
KENTUCKY)	

O R D E R

South Kentucky Rural Electric Cooperative Corporation (“South Kentucky”) has applied for a Certificate of Convenience and Necessity (“CPCN”) to construct a new headquarters facility in Somerset, Kentucky at an estimated cost of \$18.1 million. The new facility would replace its existing headquarters facility also located in Somerset. Finding that the proposed facility would result in an excessive investment, the Commission denies the application without prejudice.

STATEMENT OF THE CASE

South Kentucky is a consumer-owned rural electric cooperative organized pursuant to KRS Chapter 279 and engaged in the distribution and sale of electric energy to customers in 11 counties in Kentucky and in two counties in Tennessee.¹ Within the last several years, South Kentucky has constructed new district office buildings in the cities of Albany, Russell Springs and Whitley City, replacing existing

¹ Those counties are Adair, Casey, Clinton, Cumberland, Laurel, Lincoln, McCreary, Pulaski, Rockcastle, Russell, and Wayne in Kentucky and Pickett and Scott in Tennessee.

offices at those locations. On February 20, 2007, South Kentucky notified the Commission that construction of the new Whitley City facility had been substantially completed at a total cost of \$2.05 million.²

Seventeen months after notifying the Commission that the construction of the Whitley City district office had been substantially completed, South Kentucky notified the Commission that the construction of the Albany and Russell Springs district offices had been substantially completed at total costs of \$2.33 million and \$2.34 million, respectively.³

In addition to these construction projects, on December 31, 2008, South Kentucky acquired the fixed assets of the Monticello Electric Plant Board (“MEPB”) for \$4.686 million.⁴ The fixed assets of MEPB included, among other things, an office building in the city of Monticello. In justifying the purchase price for MEPB as being fair, just and reasonable, South Kentucky asserted that the acquisition of MEPB would enable it to forego plans to construct a district office in Monticello to serve its existing

² See, South Kentucky letter to Commission dated February 20, 2007 in Case No. 2005-00261, Application of South Kentucky Rural Electric Cooperative Corporation for a Certificate of Convenience and Necessity to Construct a District Office and Service Facility in Whitley City, Kentucky (Ky. PSC Nov. 14, 2005).

³ See, South Kentucky report filed on July 24, 2008 in Case No. 2006-00402, Application of South Kentucky Rural Electric Cooperative Corporation for a Certificate of Convenience and Necessity to Construct a District Office and Service Facility in Russell Springs, Kentucky and a District Office and Service Facility in Albany, Kentucky (Ky. PSC Feb. 28, 2007).

⁴ South Kentucky issued the city of Monticello a note payable in 30 annual installments at an interest rate of 4.75 percent. See, Case No. 2007-00374, Application of South Kentucky Rural Electric Cooperative Corporation for Approval to Purchase the Fixed Assets of the Monticello Electric Plant Board, Monticello, Kentucky (Ky. PSC Dec. 18, 2007).

customers because it could utilize MEPB's existing office building as its new Monticello district office. South Kentucky advised that the cost of building a new district office in Monticello would have been approximately \$2.2 million.

In sum, over the past three years, South Kentucky's capital construction projects solely related to the building of new district offices have totaled \$6.72 million, not including the cost to acquire the MEPB office. In the final Order in Case No. 2006-00402, we expressed concerns regarding South Kentucky's plans to spend significant funds on non-revenue generating and non-reliability related capital construction projects. Accordingly, South Kentucky was placed on notice that, in its next application for a CPCN to construct an office facility, should its financial forecasts continue to reflect the need for a rate increase in the near future, it would be required to justify the immediate need for the proposed construction and show that the construction would not significantly harm its customers.

PROPOSED HEADQUARTERS FACILITY

According to the architectural blueprint provided by South Kentucky, the size of the proposed headquarters facility would total 134,112 square feet. The headquarters would comprised of an office building (46,060 square feet), a warehouse (62,662 square feet), and a covered fleet parking building (25,390 square feet). Initially, South Kentucky indicated in its application that the project would cost approximately \$19.3 million. As this matter progressed, South Kentucky revised the cost estimate downward to \$18.1 million, citing a decrease in labor and material costs due to the severe downturn in the national, state and local economies. South Kentucky will finance the

construction with a loan through the United States Department of Agriculture's Rural Development Electric Program.

DISCUSSION

Legal Standard

KRS 278.020(1) provides that no utility may construct any facility to be used in providing utility service to the public until it has obtained a CPCN from this Commission. A determination of public convenience and necessity requires both a finding of the need for a new facility from the standpoint of service requirements and an absence of wasteful duplication resulting from the construction of the facility.⁵

Kentucky's highest court has held that "need" requires:

a showing of a substantial inadequacy of existing service, involving a consumer market sufficiently large to make it economically feasible for the new system or facility to be constructed and operated.

. . . [T]he inadequacy must be due either to a substantial deficiency of service facilities, beyond what could be supplied by normal improvements in the ordinary course of business; or to indifference, poor management or disregard of the rights of consumers, persisting over such a period of time as to establish an inability or unwillingness to render adequate service.⁶

"Wasteful duplication" is defined as "an excess of capacity over need" and "an excessive investment in relation to productivity or efficiency, and an unnecessary multiplicity of physical properties."⁷ To demonstrate that a proposed facility does not

⁵ *Kentucky Utilities Co. v. Pub. Serv. Comm'n*, 252 S.W.2d 885, 890 (Ky. 1952).

⁶ *Id.* at 890.

⁷ *Id.*

result in wasteful duplication, we have held that the applicant must demonstrate that a thorough review of all reasonable alternatives has been performed.⁸ However, selection of a proposal that ultimately costs more than an alternative does not necessarily result in wasteful duplication.⁹

Need for Proposed Headquarters Facility

South Kentucky testified that it retained a consultant, Roy Cowan of the National Rural Electric Cooperative Association, in 2002 to assist it in analyzing its need for the Somerset headquarters location as well as new district offices (“2002 Facilities Analysis”). South Kentucky elected to proceed to construct new district offices and again in 2008 retained Mr. Cowan to update the facilities requirement for the Somerset headquarters location (“2008 Somerset Analysis”). According to both studies, South Kentucky’s headquarters facility is inadequate for its needs and those of its customers. The existing headquarters complex was constructed in 1952 and has been renovated or expanded a dozen times over the last 57 years. South Kentucky maintains that it would be neither feasible nor possible for it to further renovate the existing headquarters to address its current and future needs.¹⁰

⁸ Case No. 2005-00142, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for a Certificate of Public Convenience and Necessity for the Construction of Transmission Facilities in Jefferson, Bullitt, Meade, and Hardin Counties, Kentucky (Ky. PSC Sept. 8, 2005).

⁹ See *Kentucky Utilities Co. v. Pub. Serv. Comm’n*, 390 S.W.2d 168, 175 (Ky. 1965). See also Case No. 2005-00089, Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity for the Construction of a 138 kV Transmission Line in Rowan County, Kentucky (Ky. PSC Aug. 19, 2005).

¹⁰ South Kentucky’s current headquarters facilities include a 21,704 square-foot office building and a 29,580 square-foot warehouse.

South Kentucky notes the following issues associated with its current headquarters facility:

1. Offices, warehousing, shops, and storage areas have far exceeded their useful lives with no room for expansion;

2. Access and egress to and from the current location present safety issues for members and employees;

3. Fire regulations do not allow for renovation or expansion;

4. Current facilities are located in a flood plain;

5. Current facilities do not meet certain requirements of the Americans with Disabilities Act;

6. Customer parking is restrictive;

7. Restroom facilities are not adequate;

8. Hallways are too narrow and facilities contain too many stairways due to building modifications creating potential hazards in emergencies and inefficient working conditions; and

9. Space needed for private matters pertaining to members or employees where confidentiality is an important consideration is minimal.

Based on this evidence, the Commission finds that South Kentucky has demonstrated that its existing headquarters facility is inadequate and a new headquarters facility is needed. Due to the age of the current facility and the impracticality and physical limitations of renovating the existing facility, renovation is neither cost-effective nor feasible.

Duplication of Facilities

1. Lack of Reasonable Alternative Proposals

Having determined that a new headquarters facility is needed, the Commission now addresses whether the proposed facility will result in wasteful duplication of facilities. The Commission will first examine whether South Kentucky considered all reasonable alternatives to its headquarters facility needs and selected a reasonable, economically feasible and cost-effective option. Other than the proposed design contained in the application, South Kentucky failed to consider all reasonable alternatives prior to resolving its headquarters facility needs.¹¹ Given the magnitude of the scope of the proposed headquarters project in terms of size and cost,¹² it would have been appropriate for South Kentucky to thoroughly investigate and examine reasonable alternative designs. The Commission recognizes that South Kentucky's proposed facility is designed not only to meet its current needs but also to accommodate its future needs. Thus, a possible alternative that South Kentucky could, and perhaps should, have examined and studied is the feasibility of a design which would address its near-term needs with the potential for future expansion when needed to meet longer-term needs. Such an alternative would undoubtedly lessen any

¹¹ See, South Kentucky's Response to Commission Staff's Second Data Requests, Item No. 2e.

¹² According to South Kentucky's 2008 Annual Report, which is on file with the Commission, the company's total electric plant in service was \$181,695,203. South Kentucky's initial cost estimate of \$19.3 million for the headquarters project amounts to a capital investment of almost 11 percent of its total electric plant in service. Factoring the \$6.72 million already expended by South Kentucky in constructing three new district office buildings would increase this percentage to 14 percent.

immediate financial impact to South Kentucky's customers while also spreading the ultimate cost over a greater period of time.

Similarly, the 2002 Facilities Analysis was prepared utilizing a one-story building layout and use of a prefabricated steel structure to contain cost. An alternative study examining the feasibility and reasonableness of these recommendations along with, perhaps, a turnkey approach, as opposed to a design build concept, would have provided a critical element in determining whether the proposed design is a reasonable, economically feasible, and cost-effective option.

2. South Kentucky's Inconsistent Proposal

South Kentucky's justification for the size of the proposed Somerset facility is based upon the 2008 Somerset Analysis, which updated the 2002 Facilities Analysis. A review of South Kentucky's design proposal reveals significant internal inconsistencies. From a size requirement standpoint, the 2002 Facilities Analysis projected the following size recommendations for a Somerset headquarters facility: (1) office building – 35,750 square feet; (2) garage, warehouse and shops – 57,000 square feet; (3) cold storage/parking – 10,000 square feet; and (4) community room – 4,000 square feet. The total size recommended amounted to 106,750 square feet.

According to the 2002 Facilities Analysis, South Kentucky had approximately 25,823 customers in the Somerset service area being served by 110 employees. Based on South Kentucky's 15-year load forecast, the study projected that South Kentucky will grow to approximately 37,269 customers in the Somerset service area by 2018. The study also projected South Kentucky's Somerset workforce to be approximately 143 employees by 2018. The 2002 Facilities Analysis then arrived at the

approximate space requirements for the Somerset headquarters facility based upon the forecasted number of employees.

According to the 2008 Somerset Analysis, South Kentucky had approximately 44,000 customers in the Somerset service area being served by 122 employees at the end of 2007. Based on South Kentucky's 15-year load forecast, the study anticipated that South Kentucky's Somerset service area will increase to approximately 56,500 customers by 2022. The 2008 study also projected South Kentucky's Somerset workforce to be approximately 164 employees by 2022.

Based on the projected level of South Kentucky's Somerset workforce, the 2008 Somerset Analysis projected the following size recommendations for a Somerset headquarters facility: (1) office building – 49,200 square feet; (2) garage, warehouse and shops – 67,800 square feet; and (3) community room – 4,900 square feet. As recommended, the size of the headquarters facility totaled 121,900 square feet.

Although South Kentucky stated that the size of the proposed Somerset facility was based upon the 2008 Somerset Analysis, South Kentucky's proposed design totaled 134,112 square feet, which is 10 percent more than the total size recommended in the 2008 study and almost 26 percent more than the size recommended in the 2002 study. South Kentucky noted that its architect conducted an intensive and extensive programming process in arriving at the necessary space requirements for South Kentucky to accommodate its current and future needs. Other than a six-year difference between the two facilities studies, South Kentucky failed to provide any explanation for the significant increase in the recommended size proposed by the 2008 Somerset Analysis as compared with the 2002 Facilities Analysis. More importantly,

South Kentucky has failed to provide any justification for proposing a headquarters design that is greater than what was recommended in the 2008 Somerset Analysis.

3. South Kentucky's Proposed Facilities Compared to Those of Similarly Sized Cooperatives.

South Kentucky did not consider any alternative designs for its proposed headquarters building. Due to the absence of any alternative designs, the Commission will look at other comparable distribution cooperatives to determine the reasonableness of South Kentucky's proposed facilities. As a result of the 2002 Facilities Analysis, South Kentucky established an internal Building Committee, which was tasked with establishing a process to complete the construction of the various district offices and the Somerset headquarters. The Building Committee, comprised of three members of South Kentucky's Board of Directors and several employees, visited and reviewed the designs of new office facilities of Nolin Rural Electric Cooperative Corporation, Blue Grass Energy Cooperative, Owen Electric Cooperative ("Owen"), and Jackson Energy Cooperative. The Commission will focus on Owen, since that utility's customer base and employee level are similar to those of South Kentucky.¹³

In Case No. 2002-00175,¹⁴ the Commission granted Owen a CPCN to construct a new headquarters facility. Owen had proposed a headquarters facility consisting of a 31,900 square-foot office building and a 27,900 square-foot service facility – for a total

¹³ According to Owen's 2008 Annual Report, Owen had 56,959 customers and 145 full-time employees. South Kentucky's 2008 Annual Report indicated that the company had 66,249 customers and 163 full-time employees.

¹⁴ Application of Owen Electric Cooperative, Inc. for an Order Issuing a Certificate of Public Convenience and Necessity (Ky. PSC Aug. 1, 2002).

size of 59,800 square feet. The total projected cost to construct and furnish the proposed facilities was \$8.19 million.

When compared to Owen's headquarters facility, South Kentucky's proposed facility is significantly larger. South Kentucky's proposed headquarters is nearly 125 percent greater than Owen's current facility. South Kentucky's proposed office building and service facilities are 25 percent and 125 percent larger, respectively, than Owen's. By any reasonable measure, the sheer size of South Kentucky's proposed headquarters facilities dwarfs that of Owen, even though the two utilities are similar in size based upon customer and employee levels. The Commission is cognizant of the fact that Owen's headquarters was constructed seven years ago at a time when Owen's customer base and number of employees were lower than its present levels. This distinction, however, does not take away from the apparent fact that the size of Owen's headquarters facility is adequately meeting the needs of its current employee and customer levels. Based upon this relevant comparison, combined with the lack of alternative designs and inconsistency in South Kentucky's own study, the Commission finds that South Kentucky's proposed headquarters facility is unreasonable and would result in excessive investment in relation to productivity or efficiency.

Financial Impact of Proposed Facility

When it filed the instant application, South Kentucky was under notice that it would have to establish that the construction project would not significantly harm its customers. In its post-hearing brief, South Kentucky asserts that the headquarters project's financial impact on customers would be minimal. South Kentucky points out

that the proposed headquarters' revised operation and maintenance ("O&M") cost¹⁵ is estimated to be \$1.25 million per year. Spreading this cost over its customer base,¹⁶ South Kentucky states that the project will cost its members \$18.66 per year individually, or \$1.56 per month.

The Commission is not persuaded by South Kentucky's arguments. South Kentucky overlooks the fact that, at the time the application was filed, the estimated annual cost to operate the new headquarters was \$2,086,601. The unexpected decrease in the annual O&M costs reflect (1) a decrease in the overall cost of the project and (2) a decrease in debt expense due to more favorable interest rates. Both of these factors stem directly from the severe downturn in the economy, not from any affirmative cost-cutting action on behalf of South Kentucky.

Likewise, at the time the application was filed, South Kentucky estimated the cost of the project to be \$19.3 million. South Kentucky provided a 10-year financial forecast utilizing two different scenarios. The first scenario was the development of a financial forecast which excluded the construction of the new headquarters. The second scenario was the development of a financial forecast which included the proposed facilities. Without the new headquarters, South Kentucky projected a revenue shortfall of \$7,228,554 and a need to seek an increase in rates by 2012. The impact of the new headquarters would increase the revenue shortfall to \$9,569,586 and the need to seek a rate increase in 2011. Thus, the new headquarters would increase the revenue

¹⁵ South Kentucky included depreciation and interest expense as part of the proposed headquarters' O&M costs.

¹⁶ South Kentucky used a customer base figure of 67,000.

shortfall by \$2,341,032 and require South Kentucky to seek a rate increase one year sooner than projected.

South Kentucky revised the project's initial cost estimates downward to \$18.1 million largely due to unanticipated decreases in labor and material costs as a result of the severe economic recession. South Kentucky also revised its financial forecast to reflect the change in the cost of the proposed facility. Under both scenarios, South Kentucky projected a need for an increase in electric base rates by 2012. South Kentucky now projects that the impact of constructing a new headquarters would increase its revenue shortfall from \$7,228,554 to \$8,618,091, an increase of \$1,389,548 due solely to the new headquarters building. The headquarters project's overall impact on rates would thus be slightly higher than just looking at the proposed headquarters' estimated O&M costs.

The Commission is of the opinion that South Kentucky should have been more sensitive to the cost of the headquarters project, particularly given the fact that it had already expended \$6.72 million in constructing three new district office buildings within the last three years. The costs for the district offices will have a cascading effect on South Kentucky's financial status. Because the construction expenditures for the district offices are not reflected in South Kentucky's base rates, those expenses will have an impact on South Kentucky's finances in addition to any impact the new headquarters may have. Knowing this and having been placed on notice by the Commission, South Kentucky should have been more diligent and cognizant of the magnitude of the size and costs of a new headquarters facility.

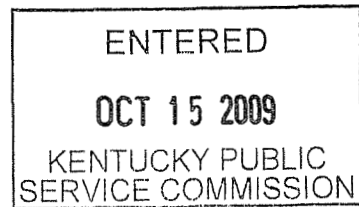
IT IS THEREFORE ORDERED that:

1. South Kentucky's request for a CPCN to construct a new headquarters facility in Somerset, Kentucky is denied without prejudice.


2. South Kentucky, if it elects to do so, shall file a notice with the Commission of its intent to file a revised application within 20 days of the date of this Order.

3. If South Kentucky does not file a notice of intent to revise the application within 20 days of the date of this Order, this matter shall be deemed closed and removed from the Commission's docket.

By the Commission



ATTEST:



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