COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE APPLICATION OF THE FUEL ADJUSTMENT CLAUSE OF BIG RIVERS ELECTRIC CORPORATION FROM NOVEMBER 1, 1991 TO APRIL 30, 1992)	CASE NO. 90-360-C

O R D E R

The Commission initiated this proceeding on July 7, 1992 to review the operation of the fuel adjustment clause ("FAC") of Big Rivers Electric Corporation ("Big Rivers") for the period from November 1, 1991 to April 30, 1992. Citing the level of Big Rivers' fuel costs and the disclosure of potential conflicts of interest between former Big Rivers' employees and one of Big Rivers' coal suppliers, the Commission subsequently determined that a more in-depth investigation of Big Rivers' fuel procurement practices was required and that an independent consultant should be retained to investigate and report on the appropriateness of Big Rivers' fuel procurement strategies and practices and on opportunities for improvement in the management and operation of Big Rivers' fuel procurement function.

While this proceeding was pending, two additional dockets were opened to review the operation of Big Rivers' FAC for other time

periods.[1] These were later consolidated with this proceeding so that the period under review in this case spans from November 1, 1990 to April 30, 1993.

In January 1993, the Commission retained Overland Consulting, Inc. ("Overland") to perform a focused management audit of Big Rivers' fuel procurement practices. In May 1993, Overland issued its report ("Overland Report") in which it concluded that Big Rivers had incurred unreasonable fuel costs of approximately $6 million under contracts with Green River Coal Company ("GRCC") and E & M Coal, Inc. ("E & M") during the period from November 1, 1990 through December 31, 1992.[2] Overland also made numerous recommendations for prospective improvements in Big Rivers' fuel procurement practices.

The three aluminum companies that comprise over two-thirds of Big Rivers' load, NSA, Inc.; Alcan Aluminum Corporation; and Commonwealth Aluminum, intervened individually and jointly as Kentucky Industrial Utility Customers ("KIUC"). The Attorney General's Office, Utility and Rate Intervention Division ("AG"),

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[1] Case No. 92-490, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1990 to October 31, 1992 (July 14, 1993); Case No. 92-490-A, An Examination by the Public Service Commission of the Application of the Fuel Adjustment Clause of Big Rivers Electric Corporation from November 1, 1992 to April 30, 1993 (July 14, 1993).

[2] Subsequent to the issuance of the Overland Report the period subject to review was extended through April 30, 1993. Overland revised its calculation of unreasonable costs accordingly to approximately $6.7 million.

and Willamette Industries, Inc. also intervened. Hearings were held at the Commission's offices from October 27 through 30, 1993, and from November 3 through 5, 1993.

SUMMARY OF DECISION

The Commission finds that Big Rivers acted unreasonably in administering GRCC Contract 527 and, as a result, incurred unreasonable fuel costs of approximately $12.4 million. Big Rivers also acted unreasonably in entering Contract 905 with E & M, resulting in $846,000 in unreasonable fuel costs. On a jurisdictional basis, the amount of unreasonable fuel costs is $10.8 million which should be amortized and credited to Big Rivers' customers over one year. Big Rivers, beginning August 1994, shall reduce the price paid under Contract 527 for purposes of calculating the fuel costs included in its monthly FAC calculation. The amount of fuel cost included in Big Rivers' non-smelter base rates will be reduced from 13.3 mills to 12.9 mills per KWH. In addition, Big Rivers shall submit a proposed mechanism for distributing to its customers amounts collected as fines or damages.

SCOPE OF THIS PROCEEDING

The issues are numerous and complex. This case is governed by KRS 278.255 and 807 KAR 5:056. Thus, this proceeding focuses on the operation and management of Big Rivers' fuel procurement function and whether that operation and management resulted in any unreasonable fuel costs being passed through the FAC during the period under review.

This Order does not specifically address all issues set forth in the Overland Report or raised by the intervenors. Overland made 38 recommendations for improvements in Big Rivers' fuel procurement practices.[3] The Commission finds merit in all of Overland's recommendations and strongly encourages Big Rivers to implement them.

KIUC and the AG raised several issues that are beyond this proceeding's scope and the Commission's authority. These issues concern events which occurred outside the review period or which required a determination of whether violations of federal and state criminal laws have occurred.

The Commission has addressed the following issues: (1) was the level of fuel costs incurred by Big Rivers during the review period reasonable? (2) were the fuel costs incurred during the review period affected by improper fuel procurement practices? and (3) what portion, if any, of the fuel costs incurred during the period in question was unreasonable? The Commission has also addressed the ability of Big Rivers' management to operate the cooperative in a competent, effective manner that is responsive to the needs of its customers and in the public interest generally.

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[3] Overland Report at 1-7.

ISSUES[4]

1. Big Rivers' Decision to Enter Contract 527 with GRCC for the Coal Supply at the Wilson Generating Station ("Wilson"): Did Big Rivers follow its written fuel procurement policies and procedures? Were the contracted quantities reasonable and consistent with the recommendations of Big Rivers' fuel consultant? Did awarding the contract to GRCC result in unreasonable costs?

2. Big Rivers' Administration of Contract 527 with GRCC: Were unreasonable fuel costs incurred as a result of Big Rivers' failure to exploit the Rural Electrification Administration's ("REA") rejection of the contract? Were unreasonable fuel costs incurred as a result of entering Amendment No. 1? Were unreasonable fuel costs incurred as a result of entering the Substitution Agreement?

3. Big Rivers' Decision to Enter Contract 865 with Jim Smith for a Portion of Wilson Coal Supply: Was it reasonable for Big Rivers to contract for additional quantities above those included in Contract 527? Was the contract price reasonable? Were the contract quantities reasonable? Did Big Rivers incur any unreasonable fuel costs as a result of entering the contract?

4. Big Rivers' Decision to Enter Contract 905 with E & M Coal: Did Big Rivers act reasonably when agreeing to a premium price for two and one-half years in exchange for an opportunity to

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[4] Issues such as the amount of fuel cost to be included in Big Rivers' base rates are addressed in the section of the Order entitled *Other Issues*.

purchase at a market discount for five and one-half years? Was Big Rivers' decision based on adequate market price information? Did Big Rivers properly consider the weakened financial condition of E & M Coal and its sister company?

5. Big Rivers' Decisions to Enter Contract 814 with Jim Smith and Contract 882 with E & M Coal: Was it reasonable for Big Rivers to negotiate these contracts rather than obtain competitive bids? Should Big Rivers have used contemporaneous contracts or offers to negotiate lower prices under these contracts?

6. Big Rivers' 1992 Write-down of the Coal Inventory at the Green Plant: Was the amount of the inventory write-down excessive? Did the write-down result in unreasonable fuel costs?

7. Retiki Mine Closing Costs Charged to Big Rivers by Webster County Coal Corporation: Has Big Rivers incurred unreasonable fuel costs related to the scheduled closing of the Retiki mine? Has Big Rivers taken corrective action to ensure that it does not incur unreasonable costs under the Retiki contract? Should the Commission rule on this matter when the contract is presently in litigation?

8. Illegal, Improper and Questionable Payments by Big Rivers' Coal Suppliers: Have such payments resulted in increased fuel costs? Are such payments fuel costs that can be passed through the FAC? Should money that Big Rivers recovers from these suppliers in criminal and civil proceedings be returned to ratepayers through the FAC or, possibly, through a separate non-fuel mechanism?

9. The Ongoing Impact of Contract 527: To what extent is the contract price currently above market prices? What is the reasonable adjusted price of the contract? By what means, if any, can the Commission ensure that the excess costs are not borne by ratepayers in the future?

10. Big Rivers' Conduct in Prior FAC Cases: Did Big Rivers deceive or mislead the Commission in prior FAC cases about its use of negotiation in fuel procurement?

11. The Inclusion of Interest in the Amount Which the Commission Finds as Unreasonable Fuel Costs: What level of interest, if any, should be included in the amounts Big Rivers returns to ratepayers?

12. The Jurisdictional Amount Which Big Rivers Should Return to Ratepayers and the Time Period over Which the Return Should Occur: How should the jurisdictional portion of any unreasonable costs be determined? Over what period should these amounts be returned to ratepayers? Should Big Rivers' financial condition affect the period over which these amounts are returned?

DISCUSSION

1. THE 1982 DECISION TO ENTER CONTRACT 527 WITH GRCC

Overland's Position

A 1980 report prepared for Big Rivers by Theodore Barry & Associates ("Theodore Barry") entitled "Big Rivers Electric Corporation, Fuel Strategy Study" recommended that Big Rivers enter long-term contracts for its Wilson and Green units. REA required Big Rivers to enter long-term contracts for Wilson. In light of

these factors and the potential affects on the coal market of the synfuels projects planned for Western Kentucky, Big Rivers' decision to rely on long-term contracts as the primary method to supply Wilson was reasonable.

GRCC was selected as the coal supplier for Wilson after an informal bidding and negotiation process that began with a November 1978 solicitation and concluded with an Agreement of Intent in August 1981. The contract was entered May 5, 1982 and provided for deliveries from July 1984 through December 2004, a 20-year period.

The selection of GRCC for Contract 527 was not reasonable given GRCC's limited financial resources. Further, the favorable consideration given GRCC, coupled with questions about sales commissions paid by GRCC to two persons acquainted with Big Rivers' former general manager, raised concerns of favoritism and collusion. However, GRCC's price was competitive with those offered by other suppliers and was reasonable when compared to bid proposals received by Big Rivers in response to a 1981 solicitation for similar quality coal for the Green plant. There is no evidence that the initial decision to select GRCC produced higher costs than would have otherwise been incurred.

<u>KIUC and AG's Position</u>

Big Rivers did not follow its own written fuel procurement policies and procedures when it entered coal contracts based on negotiation rather than sealed, competitive bids. The quantities under Contract 527 were excessive when compared to the quantities recommended in the Theodore Barry report. The process by which

GRCC was awarded the contract was tainted by fraud--fraud that enabled GRCC to submit a "second" final proposal three days after the deadline for proposals had passed. This fraud rendered the quantities to be delivered under the contract no more secure than if purchased on the spot market. Therefore, unreasonable costs incurred under Contract 527 should be based on the difference between the contract prices and the spot market prices over the same time period.

Big Rivers' Position

Big Rivers' coal procurement policies and procedures contemplated several procurement techniques, including competitive bid, proposal, and negotiation. Negotiating contracts with or without bids conformed with its written policies and procedures filed with the Commission in previous cases.

The guidelines and policies recommended by Theodore Barry were followed in contracting for the Wilson coal supply. Subsequent to the Theodore Barry report and based on its analyses of updated coal market data, Big Rivers decided to operate Wilson as a base load unit rather than a cycling, or mid-range unit, as envisioned in the report. This change necessitated purchasing quantities of coal greater than those recommended by the Theodore Barry report but the report's methodology for determining quantities to be purchased was used in the changed circumstances.

The intervenors presented no evidence that a long-term contract with another supplier would have been less costly. Comparison of spot market prices to the price under Contract 527 is

inappropriate given the need for a long-term coal supply. Regardless of the procedures by which GRCC was chosen, KIUC and the AG have not shown that any unreasonable fuel costs were incurred because of that choice.

Findings and Conclusion

While the conditions surrounding the selection of GRCC certainly cause concern, the record supports Overland's findings that it was reasonable for Big Rivers to employ long-term contracts as the primary source of fuel for Wilson. The GRCC price was competitive with other suppliers' prices during that time period and there is no evidence that Big Rivers incurred excessive or unreasonable costs by awarding Contract 527 to GRCC.

The record further shows that Big Rivers' written policies and procedures allowed for proposal and negotiation as procurement techniques. It also shows that Big Rivers, while responding to changing market conditions in choosing the quantities for Contract 527, did adhere to the guidelines in the Theodore Barry report.

The intervenors have failed to demonstrate that Big Rivers could have obtained a lower long-term price from another supplier. They have not shown that any unreasonable costs have been incurred by Big Rivers due to the initial award of Contract 527. Hence, the Commission finds that awarding Contract 527 to GRCC did not cause Big Rivers to incur unreasonable costs.

2. BIG RIVERS' ADMINISTRATION OF CONTRACT 527 WITH GRCC

(a) The REA Rejection of Contract 527

In June 1986 REA declined to approve Contract 527 because the price was substantially above then existing market prices. Big Rivers responded that, while the price was above market, both parties had been performing under the contract for four years since it was entered. Big Rivers resubmitted the contract to REA without seeking modifications. In November 1986 REA approved Contract 527 with GRCC.

Overland found that Big Rivers' decision to resubmit the contract to REA was not supported by adequate legal advice. Big Rivers' Outside Counsel-Fuels was not notified or consulted about the REA rejection letter. Big Rivers did not request, nor did its Outside Corporate Counsel provide, a formal legal opinion on the matter. Overland opined that Big Rivers should have attempted to use the REA rejection to obtain price concessions and that the issue should have been addressed in a formal legal opinion based on legal research. KIUC and the AG concur.

Overland concluded that, although Big Rivers missed an opportunity, there was no clear evidence as to the amount of reduction, if any, that could have been negotiated. The intervenors relied on their spot market calculations to support their calculation of all unreasonable costs incurred under the contract during the review period.

Big Rivers asserts that GRCC would have had a strong legal basis to challenge any rejection of the contract occurring years

after performance had begun. It was attempting to reduce its coal costs and renegotiate most of its contracts, including Contract 527, during 1986 but was unable to obtain concessions from GRCC.

Findings and Conclusion

The Commission adopts Overland's findings that Big Rivers' resubmission of the contract to REA was not supported by adequate legal advice and that Big Rivers missed an opportunity to negotiate a price reduction with GRCC. However, the evidence fails to show with any degree of certainty that, had Big Rivers assumed an aggressive negotiating stance, any reduction in cost would have resulted. Big Rivers' legal position in this instance was that the law did not favor such a stance.

(b) Amendment No. 1 to Contract 527

In early 1988, Big Rivers and GRCC entered Amendment No. 1 to Contract 527 which fixed the contract's productivity factor for 1988 at 2.19 tons per manhour and limited changes in future years to .06 tons per manhour. The index was 1.46 when the contract was entered and would have been 2.78 for 1988 if not for the amendment. The amendment was agreed to after GRCC disputed the continued use of the agreed productivity factor.

Overland found that Big Rivers' decision to enter the amendment was not reasonable. The productivity factor was used to adjust costs in direct proportion to changes in a government index of productivity for underground mines in Western Kentucky. It was not intended to track actual productivity at GRCC's mine and GRCC's argument to that effect was not supported by the contract language.

Amendment No. 1 caused an immediate price increase of $2.10 per ton. Overland calculated the impact of the amendment during the review period of this case at $5.85 million.[5]

KIUC and the AG agree that entering Amendment No. 1 was unreasonable and contend that Big Rivers failed to consider a substantial amount of readily available information on underground coal mine productivity when it negotiated the amendment.[6]

Big Rivers characterizes these arguments as hindsight. It contends that Amendment No. 1 was a reasonable attempt to avoid an unfavorable arbitration result and to limit the volatility of the productivity index. Big Rivers further argues that GRCC had a strong case that the substantial increase in Western Kentucky underground mine productivity during the contract period was a "supervening circumstance or event" entitling GRCC relief from the contract terms.

Findings and Conclusion

The evidence shows that underground mine productivity generally increased at a greater rate than GRCC's productivity and that this increase caused the productivity factor to work in Big Rivers' favor. This was exactly what was supposed to occur under the contract. When the contract was executed, both parties knew that GRCC's base productivity was greater than that of Western

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[5] Overland originally calculated $5.2 million for the period November 1, 1990, through December 31, 1992. After the review period was expanded, Overland revised its calculation to reflect $5.85 million.

[6] Watkins Rebuttal Testimony, pages 9-11.

Kentucky mines generally and were aware of the historical productivity changes of underground mining in Western Kentucky. The entry of new and more productive mines into the base while the contract was in effect should have been no surprise to either Big Rivers or GRCC.

In mining, as in most industries, newer and more efficient technologies periodically replace older, less efficient technologies. Changes in technologies and general increases in productivity are not "supervening events or circumstances" that would have nullified the contract's provisions for computing price revisions. Given the nature of these changes, the immediate price impact of Amendment No. 1, and the fact that 16 years remained under the contract, it was not reasonable for Big Rivers to agree to the amendment. The unreasonable fuel costs incurred during the 30-month review period as a result of this action are $5.85 million.

(c) The Andalex Substitution Agreement

In 1991, Big Rivers and GRCC entered an agreement ("substitution agreement") which permitted GRCC to substitute coal from Andalex Resources' ("Andalex") surface mine for coal from GRCC's underground mine. The coal supply agreement between GRCC and Andalex includes a base price of $20.25 per ton. Under the terms of the substitution agreement, GRCC resells the Andalex coal to Big Rivers for $31.40 per ton.

Overland found that Big Rivers missed an opportunity to obtain further price reductions when it accepted the substitution of coal from Andalex. Under Contract 527, Big Rivers was entitled to 50 percent of any savings resulting from a "major change in mining method." Under the substitution agreement, Big Rivers waived this right. Overland determined that the amount of cost increases due to the substitution agreement depended on the strength of legal claims that are difficult to evaluate and concluded that there was no clear evidence of the price reduction that could have been negotiated.

KIUC and the AG contend that Big Rivers had an exceptionally strong bargaining position to demand 50 percent of the savings as it was the sole arbiter of coal suitability under the substitution provision of Contract 527. Citing the $11.15 differential between the Andalex and GRCC prices, they calculate an annual difference of $11,373,000 and claim that Big Rivers and its customers are entitled to one-half of that amount.

Big Rivers argues that substitution of Andalex coal did not constitute a change in mining method under the contract and that, even if it did, GRCC could have avoided the issue by substituting coal from another underground mine. Therefore it had no reasonable basis to reject the Andalex coal. Nor does it accept the intervenors' argument that GRCC's cost of furnishing coal to Big Rivers equals the price GRCC pays Andalex, pointing to GRCC documentation showing that GRCC's costs were higher under the substitution agreement than when GRCC mined the coal itself.

Findings and Conclusion

By executing the Andalex substitution agreement, Big Rivers missed a golden opportunity to negotiate a price reduction under Contract 527. Given the language of the substitution agreement, the change in mining method provision of the contract, the circumstances that precipitated the substitution agreement, the extent to which the Contract 527 price was above market, and the fact that there were 13 years remaining on the contract, Big Rivers' passive acquiescence is appalling.

GRCC could have argued that the savings produced by purchasing coal from Andalex should be offset by the costs of closing its mine and paying off its bank debt. However, GRCC would have continued to own the mine and would have been free to market the mine's output to other potential buyers. GRCC's cost of retiring the bank debt on its mine was not a cost of furnishing coal mined from a different mine. It is not reasonable to base Big Rivers' price under the contract on the market for the output of a mine from which it did not receive coal.

Given the contract terms and the circumstances surrounding the need for a substitute supply, the Commission finds the difference between the Andalex price and the price which Big Rivers pays GRCC to be the appropriate measure of unreasonable fuel costs. However, the level of unreasonable fuel costs must be calculated in conjunction with the effect of Amendment No. 1 to Contract 527. Accordingly, the GRCC price should be reduced by $2.11 per ton to $29.29 per ton before calculating unreasonable costs under the

substitution agreement.[7] Using this figure for the tonnage purchased from December 1991, when the substitution agreement took effect, through the end of the review period, results in a savings of $13.1 million.[8] One-half of this, or $6.55 million, is the amount Big Rivers could claim under the change in mining method provision and is, therefore, the amount of unreasonable cost incurred by Big Rivers under the substitution agreement.

3. THE DECISION TO ENTER CONTRACT 865 WITH JIM SMITH

In 1983 Big Rivers entered Contract 865 with Jim Smith for a 20-year supply of coal for the Wilson plant. The contract called for Big Rivers to purchase an annual minimum of 240,000 tons and an annual maximum of 600,000 tons. By purchasing the minimum quantities under Contracts 527 and 865, Big Rivers would acquire enough coal annually to operate the unit at a capacity factor of approximately 75 percent.

Overland's Position

The initial price under Contract 865 compared favorably to spot prices during 1983. However, quantities above the contract minimum were not reasonable because Big Rivers was required to purchase all coal for Wilson not obtained under Contract 527 from Jim Smith under Contract 865 (up to 600,000 tons). The apparent intent of the 600,000 ton annual requirement was to guarantee a

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[7] $2.11 per ton is the average price impact of Amendment No. 1 for the portion of the review period during which the substitution agreement was in effect. See Appendix B.

[8] 1,451,349 tons x ($29.29-$20.25) = $13,120,195.

price for coal if amounts available under Contract 527 were reduced. As the tonnage requirements of Contract 527 have not been reduced to date, no unreasonable costs had been incurred due to the quantity provisions of Contract 865.

KIUC and AG's Position

The entire contract was unnecessary and the quantity requirements were unreasonable. Unreasonable costs should be calculated by comparing the contract price with spot market prices paid by other utilities at the same time. Big Rivers violated its written fuel procurement procedures when it entered the contract without following some type of bidding procedure. Unreasonable costs incurred under Contract 865 for the review period, including interest, are $2.9 million.

Big Rivers' Position

The analyses affirming that Wilson would operate as a base load unit support its decision to seek a second coal supply for the unit. The quantities under Contract 865 were reasonable and conformed to the Theodore Barry guidelines. It was reasonable to assume that Wilson would operate consistently at a 75 percent capacity factor and would require the combined minimums under Contracts 527 and 865. The flexibility of its fuel procurement procedures permitted awarding Contract 865 without soliciting proposals and the price was reasonable considering then-current spot prices.

Findings and Conclusion

Big Rivers did not violate the Theodore Barry guidelines or its own written fuel procurement procedures by entering Contract 865. Given Big Rivers' operating history, it was not unreasonable to expect that Wilson, as a base load unit, would operate in the 75 percent capacity factor range. At that level, it was not unreasonable for Big Rivers to acquire a second coal supply for Wilson. The record shows that the price under Contract 865 was reasonable compared to spot prices.

The requirement that Big Rivers purchase all quantities, up to 600,000 tons, above deliveries under Contract 527 from Jim Smith is not reasonable. Considering the length of both contracts and the possibility that the quantities under Contract 527 might be reduced, the inflexible quantity requirement of Contract 865 more than offsets the benefits of locking in a price for the additional tonnage. However, as deliveries under Contract 865 have not exceeded the minimum, Big Rivers incurred no unreasonable fuel costs during the period under review.

4. THE DECISION TO ENTER CONTRACT 905 WITH E & M

In 1985, Big Rivers entered Contract No. 882 with E & M for medium sulfur coal for the Coleman plant. At various times in the late 1980s and early 1990s, E & M and Big Rivers discussed a possible extension or revision of the contract.[9] In 1989, these discussions began to center on the acid rain legislation pending

[9] Contract 882 was amended four times. The final amendment extended the term of the contract through December 31, 1991.

before Congress and its impact on Big Rivers. As a result, Contract 905 was executed in November 1991. It was initially for the same quality medium sulfur coal as Contract 882 but allowed Big Rivers to require lower sulfur coal to comply with the Phase I requirements of the Clean Air Act Amendments that become effective in 1995.

Overland's Position

Under Contract 905, Big Rivers agreed to pay a price above market for medium sulfur coal through mid-1994 in exchange for the opportunity to buy lower sulfur coal at what it believed would be a price below market after mid-1994. Big Rivers lacked adequate price information and did not use its available information when entering the contract. It performed no study or analysis of the economics of a two-phase contract over a period of several years. It was learned by April 1991 that E & M's sister company, BFC Coal Company, the intended producer under Contract 905, was experiencing severe financial difficulty. With such financial problems, there was little assurance that E & M could deliver coal at below market prices for a period of approximately five years. Entering Contract 905 was unreasonable and Big Rivers incurred $846,000 in unreasonable costs before the contract was terminated due, in part, to the producer's financial weaknesses.

KIUC and AG's Position

They agree with Overland's assessment of the decision to execute Contract 905. They also accept Overland's calculation of

unreasonable costs and contend that interest of $102,000 should be added.

Big Rivers' Position

Overland's analysis of Contract 905 is based on hindsight. Overland relied on prices from a January 1992 solicitation for low sulfur coal when considering Big Rivers' assessment of prices in 1991 when Contract 905 was executed. The April 1992 financial collapse of E & M could not have been anticipated. Despite the known financial weaknesses of E & M and related companies, the risk of dealing with it was small. E & M had done business with Big Rivers for a number of years and had an established track record. Big Rivers' economic analysis of Contract 905 prepared for this case demonstrates potential savings sufficiently substantial to justify accepting significant risk under the contract.

Findings and Conclusion

When considering the contract, Big Rivers had several indications that market prices for medium sulfur coal were significantly below the Contract 905 price.[10] It performed no solicitation to determine market prices for low sulfur coal for the second phase of the contract. Given its lack of knowledge on prices, it is not surprising that Big Rivers did no economic analysis of the costs and benefits expected under Contract 905. Given the financial weaknesses of E & M and its sister companies, of which Big Rivers was aware, only a substantial economic benefit,

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[10] The Overland Report at 14-22 and 14-23.

determined at that time, could possibly justify such a significant risk.

In failing to evaluate market prices for both medium and low sulfur coal properly, and to perform any economic analysis of the costs and benefits of the contract, Big Rivers acted unreasonably in entering Contract 905. Given E & M's financial condition, Big Rivers' decision to enter such a contract without attempting to quantify its economic value is incomprehensible. As a result of its unreasonable actions, Big Rivers incurred unreasonable fuel costs during the review period of $846,000 based upon the premium it paid over market prices.

5. THE DECISIONS TO ENTER CONTRACTS 814 AND 882

KIUC and the AG contend that Big Rivers incurred unreasonable costs of approximately $1.8 million, including interest, under Contracts 814 and 882 with Jim Smith and E & M during the review period, citing that both contracts were negotiated. They also point to the questionable business dealings between the principals of both Jim Smith and E & M and the former general manager of Big Rivers. For each contract, they claim Big Rivers failed to obtain the best price because it did not use a contemporaneous offer, or contract price, from another supplier to negotiate a lower price.[11]

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[11] The intervenors cite the price of an existing contract that was 3.2 percent less than the Contract 814 price as the basis for that contract's price comparison. They cite an unsolicited offer with a 2.2 percent lower price, submitted one month after Big Rivers entered Contract 882, as the basis for that contract's price comparison.

Findings and Conclusion

While there are legitimate concerns about the business dealings of Big Rivers' former general manager with the principals of Jim Smith and E & M, the evidence fails to establish that these dealings resulted in unreasonable fuel costs under these contracts. The comparisons which the intervenors make between Contracts 814 and 882 and other offers and contracts demonstrate that the prices under Contracts 814 and 882 were neither the lowest prices nor the highest prices. The fact that the contracts were the result of negotiation rather than competitive bids forms no basis, in and of itself, for finding them unreasonable. Overland noted the absence of competitive bidding on both contracts but did not find that it resulted in any unreasonable costs.[12] The evidence fails to demonstrate that the contract prices were unreasonable. Therefore, no unreasonable fuel costs were incurred under Contracts 814 and 882 during the period under review.

6. THE INVENTORY WRITE-DOWN AT THE GREEN PLANT

KIUC and the AG contend that Big Rivers incurred unreasonable costs of $1.9 million due to the write-down of the coal inventory at the Green plant for the 12-month period ending August 31,

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[12] Compared to a group of 22 coal plants located within 100 miles of Henderson, Kentucky, Overland found that the prices under Contracts 814 and 882 were less than the average delivered cost of spot coal.

1992.[13] The number of tons was reduced but the dollar value of the inventory was not, resulting in a higher cost per ton of coal. The intervenors speculate that the discrepancy between the physical inventory and the book inventory could have occurred because some of the coal was diverted by the transporter, Rose Brothers Trucking, or because the supplier, MAPCO, billed Big Rivers for more coal than was actually mined and loaded.

Findings and Conclusion

There is no evidence of diversion or overbilling, nor is there any history of inventory shortages at Green. The lack of a write-down in 1991 may explain the magnitude of the 1992 write-down. Given the smallness of the total system inventory adjustment, 0.4 percent, the Green write-down was apparently an isolated event that happened to fall within the period of Overland's audit. There is insufficient evidence on this point to support any finding of unreasonable fuel cost.

7. RETIKI MINE CLOSING COSTS

Although KIUC and the AG asserted that $835,000 in unreasonable mine closure costs had been incurred at the Retiki Mine, they and Big Rivers agree that this issue is not ripe for decision. The Commission concurs.

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[13] Overland noted in its report that inventory shortages at Green involving material amounts of coal were not investigated. Overland made no related finding of unreasonable costs.

8. ILLEGAL, IMPROPER AND QUESTIONABLE PAYMENTS

KIUC and the AG argue that Big Rivers incurred unreasonable costs of $1.4 million, including interest, caused by illegal, improper, and questionable payments made by Big Rivers' coal suppliers during the period under review. They claim that these payments are included in the prices charged by the coal suppliers which, in turn, are charged to ratepayers. They argue that these costs should be disallowed to discourage similar activities in the future.

Big Rivers argues that the Commission's jurisdiction is limited to determining whether improper expenses were passed on to ratepayers and that the courts are the proper forum to resolve any claim against Big Rivers' coal suppliers and that this matter should be deferred pending the outcome of litigation. Big Rivers opines that once the court sets the amount of damages, the Commission can then determine the amounts and method for the distribution. KIUC agreed with Big Rivers that this matter should be deferred until judicial proceedings are resolved.

Findings and Conclusion

The evidence does not demonstrate that these payments caused Big Rivers to incur unreasonable fuel costs. However, the issues of damages and distribution thereof are still to be resolved. As suggested by the parties, a final determination on this matter will be deferred until pending litigation is resolved.

The parties should note that damages awarded by the courts, while fuel related, are not fuel costs as defined in the FAC

regulation. Therefore, a separate distribution mechanism will be required to pass these amounts on to ratepayers. Big Rivers should develop such a mechanism and submit it for Commission review within 90 days from the date of this Order. The filing should also address the potential damages, or awards, that should be distributed via the mechanism.[14]

9. THE CONTINUING, ONGOING IMPACT OF CONTRACT 527

KIUC and the AG seek a ruling that unreasonable fuel costs under Contract 527 may not be charged to ratepayers in the future. As the price paid GRCC under the substitution agreement is $11.15 per ton higher than GRCC pays Andalex, the intervenors argue that the contract price is $11.15 above current market prices. Based on the annual minimum contract tonnage of 1,020,000, the intervenors contend that Big Rivers incurs "excessive" costs of $11,373,000 per year.

The mere fact that the contract price is above market does not mean that the difference between the two prices represents unreasonable fuel costs. However, the Commission has determined that unreasonable costs incurred under Amendment No. 1 and the substitution agreement should be disallowed. The cumulative effect

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[14] The Commission takes administrative notice of the fact that a United States District Court has ordered Shirley Bethel Pritchett to pay $1,000,000 in restitution to Big Rivers. U.S. v. Shirley Bethel Pritchett, Criminal Nos. 93-00022-01-O and 93-00023-01-O (W.D.Ky. Apr. 12, 1994). It further takes administrative notice of the fact that Eddie Brown has agreed to pay $900,000 restitution to Big Rivers to settle civil actions brought by the utility. Big Rivers v. Thorpe, Civil No. 93-0110-O(CS) (W.D.Ky. filed Aug. 30, 1993).

of the disallowances is a price $6.63 less than the actual contract price[15] which is used to determine the unreasonable fuel costs incurred under Contract 527 in this case. Because of the variability of the productivity factor, future determination of the exact amount of unreasonable fuel cost incurred per ton under Contract 527 for Case No. 92-490-B[16] and subsequent cases will be necessary so long as the contract remains in effect in its present form. Reductions that reflect the current impact of the disallowances stemming from Amendment No. 1 and the Substitution Agreement should be reflected immediately for coal purchased from GRCC and included in fuel costs beginning with the month of August 1994. Based on the minimum tonnages under the contract, this will decrease fuel charges to Big Rivers' customers by more than $6 million annually for so long as Big Rivers honors the terms of Amendment No. 1 and the Substitution Agreement.

10. BIG RIVERS' CONDUCT IN PRIOR FAC PROCEEDINGS

KIUC and the AG allege that Big Rivers has misled the Commission in past FAC cases regarding its fuel procurement practices. They suggest that Big Rivers' evidence in past cases led the Commission to believe that all long-term contracts were based on sealed, competitive bids when that was not the case. The

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[15] GRCC base price of $31.40 per ton less the adjusted reasonable price of $24.77 per ton equals $6.63 per ton. This reflects the impacts of Amendment No. 1 and the substitution agreement. See Appendix C.

[16] Case No. 92-490-B, An Examination by the Public Service Commission of the Fuel Adjustment Clause of Big Rivers Electric Corporation from May 1, 1993 to October 31, 1993.

intervenors argue that this evidence induced the Commission to approve Big Rivers' fuel procurement practices and fuel charges, which the Commission would not have done unless it had been misled. In essence, they allege that Big Rivers committed fraud against the Commission and that such fraud permits the Commission to investigate Big Rivers' fuel costs for the periods prior to those reviewed in this case.

Big Rivers has submitted evidence before the Commission on numerous occasions regarding contracts that were entered through negotiation. It has filed its written fuel procurement procedures with the Commission several times and those procedures included negotiation as a procurement technique. The Commission had notice that Big Rivers did not exclusively rely on sealed bids as a means of fuel procurement.

11. THE INCLUSION OF INTEREST IN THE AMOUNT OF UNREASONABLE FUEL COSTS INCURRED BY BIG RIVERS

KIUC and the AG argue that any amounts due ratepayers based on unreasonable costs should include interest to compensate them properly for the damage caused by Big Rivers' fuel procurement actions. They suggest using 12 percent, the Kentucky statutory post-judgment rate as a conservative carrying charge given Big Rivers' heavily industrial customer base.

Big Rivers concedes that the decisions to award interest and its rate are both within the Commission's discretion.[17] However, Big Rivers maintains that there is no evidence to support use of

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[17] Big Rivers' Prehearing Memorandum at 82-83.

the statutory rate and that the damages claimed are not similar to liquidated post-judgment claims. Big Rivers suggests that, if interest is awarded, the appropriate rate would be the statutory rate of 6 percent applied to utility customer deposits.

The Commission finds that Big Rivers should include interest at the average of the Three-Month Commercial Paper Rate as reported in the Federal Reserve Bulletin and the Federal Reserve Statistical Release for the period November 1, 1990 to April 30, 1993. Big Rivers should calculate interest as if the unreasonable costs were incurred in level monthly amounts over the 30-month review period. Interest should be calculated up to the date of this Order on the jurisdictional portion of unreasonable costs and on the remaining balance thereof until the full amount of unreasonable costs has been returned to ratepayers.

12. DETERMINATION OF JURISDICTIONAL AMOUNTS AND PERIOD OF AMORTIZATION AND RETURN TO RATEPAYERS

Calculations under the FAC require a utility to determine the portions of total fuel costs incurred for jurisdictional and non-jurisdictional sales. The amounts of unreasonable costs found thus far reflect total fuel costs. The percentage of total fuel costs charged to jurisdictional sales during the review period should be used to calculate the percentage of unreasonable costs that are returned to Big Rivers' jurisdictional customers. For the period, Big Rivers incurred total fuel costs of $333,158,721 and 81.9 percent, or $272,770,421, of this amount was attributable to

jurisdictional customers.[18] 81.9 percent of $13.2 million, the total amount of unreasonable costs, equals $10.8 million, the jurisdictional portion of those unreasonable costs.

Big Rivers' financial condition is not a factor in the determination of unreasonable fuel costs and has not been considered. The $10.8 million in jurisdictional unreasonable costs should be returned to ratepayers in as short a time as is reasonable. Big Rivers should amortize and charge off this amount over one year via a monthly credit to its jurisdictional fuel cost in the amount of $900,000 plus one-twelfth of the total interest. The credit should begin with Big Rivers' FAC report filed for the month of August 1994 which determines the FAC charges to be applied to bills rendered on and after October 1, 1994.

OTHER ISSUES

Big Rivers' Management

Some of the most disturbing aspects of this proceeding have been the attitude and actions of Big Rivers' management. Particularly unsettling is the behavior of the Executive Committee of the Board of Directors ("EC") with respect to the consulting activities of Big Rivers' former general manager, William Thorpe, who entered a $500,000 consulting agreement with Jim Smith.

When the EC first learned of the agreement in March 1991, it viewed the Smith consulting agreement as a public relations problem

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[18] See Big Rivers' Response to Commission's September 17, 1993 Order, Item 1(c), and also Big Rivers' Response to Hearing Request of Commission Staff.

that should not be disclosed to the full board or the general public. Despite the obvious breach of the standard of conduct expected of utility executives, Big Rivers' legal counsel advised that the $500,000 payment did not constitute a conflict of interest and also advised against any action against Thorpe or disclosure to the Big Rivers' Board of Directors.[19] The EC took no action to investigate Mr. Thorpe's consulting agreement or his relationship with Jim Smith. Only after learning in May 1992 that Mr. Thorpe was a target in an ongoing FBI investigation, did the EC inform the full board of the agreement. By that time, the EC also knew that Mr. Thorpe's daughter was on the payroll of Eddie Brown, the principal owner of E & M. In June 1992, the Board permitted Mr. Thorpe to resign as general manager.

Once the full board learned of the activities and investigation of Mr. Thorpe, it continued to consider the matter as primarily a public relations problem which should be concealed. Not until the issuance of the Overland Report did the Commission and the general public learn the full extent of the problems that led to Mr. Thorpe's resignation. The EC and the full board were apparently concerned that disclosure might have negative impacts on their relationships with creditors, customers, and the Commission.

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[19] Overland concluded that "The consulting agreement between Jim Smith Contracting and Mr. Thorpe conflicted with Big Rivers' interests and was a serious violation of the standard of conduct expected of utility executives." Overland Report at page 16-1.

At its best, the EC's action represents a cavalier attitude toward its fiduciary duties as board members. At its worst, it is a rejection of the spirit and principles of the rural electric cooperative movement. The early leaders of the cooperative movement saw rural electric cooperatives as a means of promoting economic democracy and public power. Democracy can only flourish where there is an informed electorate. By concealing material information from cooperative members and their representatives, the EC members and Big Rivers' counsel displayed contempt for these democratic ideals and the ability of the cooperatives' members to deal with this issue.

The management of Big Rivers works for the benefit of its customers. As appointees of the ratepayers, either directly or indirectly, they should adhere faithfully to high standards of professional and ethical conduct. They are expected to conduct themselves in a manner which will inspire the confidence, trust, and respect of the entire cooperative membership.

Moreover, principles of ethical behavior are based on the belief that policy and decisions must be made through established procedures, carefully abiding by them and avoiding any appearance of impropriety or conflict of interest. To say that the board and management lacked proper sensitivity to these ethical standards is an understatement of huge proportions.

The Commission is also concerned with the Board's obvious lack of interest in fuel procurement matters. Prior to this proceeding, the Fuel Committee was dormant and few members challenged or

questioned fuel procurement decisions. Board members were all too willing to acquiesce to management's decisions and explanations about their cooperative's operation. In this regard, Big Rivers' treatment of the Overland Report is most revealing. Although the report was an extensive review of Big Rivers' fuel procurement operations and the first since allegations of criminal misconduct had arisen, the corporate management had not provided any Board member with a complete copy of the report. Only one of the five Board members appearing before the Commission had bothered to read the complete report.[20] Several members admitted that they had not reviewed it.

Overland made 38 recommendations for prospective improvements by Big Rivers. KIUC also made recommendations to improve Big Rivers' management of its fuel procurement function[21] which in many respects either mirror those of Overland or are compatible with steps Big Rivers has already taken.

Many customers on the Big Rivers' system have contacted the Commission during the course of this proceeding voicing their concerns about the management of Big Rivers and, certainly, the Commission has its own concerns about Big Rivers' management.[22]

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[20] That member, Mrs. Sandra Wood, had to request a full copy of the report from management which otherwise provided the board members with only a summary of the report.

[21] Initial Brief of KIUC, pages 155-156.

[22] Since the initiation of this proceeding, Big Rivers has made its bid opening process open to the general public.

Big Rivers is strongly encouraged to seek input from individuals and groups outside its management circle on major fuel decisions.

The Commission urges customers to take an active role in the management of their local distribution cooperatives through the election of cooperative directors who, in turn, elect and serve on Big Rivers' board. While a slow and imperfect process, the election of board members is the long-established means by which owners, who in this case are members as well, effect changes in the operation and management of the organization. The owners and members of the distribution cooperatives, in fact, have rights and prerogatives which allow them to take far broader actions concerning management than are available to the Commission. These rights and prerogatives carry the reciprocal responsibility to act. For, if cooperative members acquiesce to passive board management, refuse to elect qualified, capable, and intelligent persons to board management positions, and fail to demand aggressive and effective management on their behalf, they certainly run the risk of further activities such as those that have been exposed in this case.

Big Rivers should be able to glean from this discussion that the Commission is concerned not only about the competence and responsiveness of Big Rivers' management but also about its attitude toward this Commission. Failure of a utility to disclose material events affecting its operations to the state regulatory commission until after the events have become public knowledge

through the news media is unlikely to engender a trusting and cooperative relationship. Such behavior is more consistent with a climate where decision-makers are inordinately afraid that their decisions and activities, when held up to public scrutiny, will be found wanting.

Amount of Fuel Costs in Base Rates

Big Rivers has proposed to reduce the fuel cost component in its base rates for service provided at non-smelter delivery points from 13.3 mills to 12.9 mills per KWH.[23] It proposed that the month of August 1992 be used as the base period in arriving at the base fuel cost and the KWH components of its FAC.

Review of the supporting data provided by Big Rivers in its initial filing shows that the month of August 1992 is a representative generation month. A review of its monthly FAC filings shows that its fuel cost for the two-year period in question ranged from 12.16 mills per KWH in October 1992 to 13.98 mills per KWH in May 1992 with an average cost for the period of 13.24 mills per KWH. Based on the record, Big Rivers' proposed base fuel cost of 12.9 mills per KWH for non-smelter delivery points should be effective for service rendered on and after August 1, 1994, to be reflected in bills rendered on and after September 1, 1994. The rates and charges in Appendix A are designed to reflect the transfer (roll-in) to base rates of the

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[23] See Footnote No. 1. The base fuel cost included in rates for service provided at smelter delivery points was set at 12.95 mills per KWH in the settlement of Case No. 89-376, to remain at that level until September 1, 1997.

differential between the old base fuel cost of 13.3 mills and the new base fuel cost of 12.9 mills per KWH.

ORDERS

Based on the evidence of record, and the findings set forth herein, the Commission HEREBY ORDERS that:

1. The total amount of unreasonable costs incurred by Big Rivers during the period under review applicable to jurisdictional sales is $10.8 million. Beginning with the month of August 1994 and continuing each month thereafter for the following 11 months, Big Rivers shall credit $900,000 plus interest to the jurisdictional fuel cost included in its FAC report as filed with the Commission.

2. The price being paid by Big Rivers for coal purchased from GRCC under Contract 527 is unreasonable because of Amendment No. 1 to the contract and the "Andalex Substitution Agreement." For purposes of calculating Big Rivers' fuel cost for recovery through its FAC, the price for all coal purchased from GRCC shall be reduced in the manner set forth in Appendix C to reflect the current impact of the disallowances for both the amendment and the Substitution Agreement beginning in August 1994.

3. The base fuel cost included in rates for Big Rivers' non-smelter delivery points shall be reduced to 12.9 mills per KWH effective for service rendered on and after August 1, 1994.

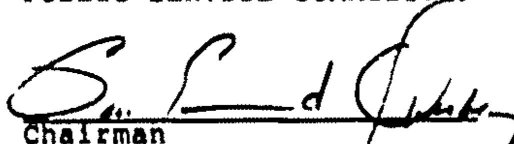
4. The rates and charges in Appendix A are fair, just, and reasonable and are approved for service rendered on and after August 1, 1994.

5. Within 30 days of the date of this Order, Big Rivers shall file with this Commission its revised tariffs setting out the rates approved herein.

6. Big Rivers shall develop a mechanism to distribute to customers amounts received by it as damages or awards in the various judicial proceedings involving its coal contracts and fuel procurement practices. Big Rivers shall submit its proposed mechanism for Commission review within 90 days from the date of this Order.

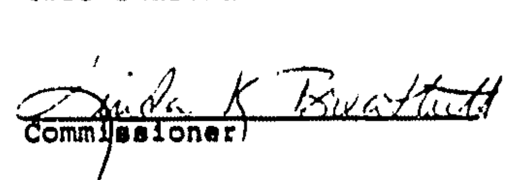
Done at Frankfort, Kentucky, this 21st day of July, 1994.

PUBLIC SERVICE COMMISSION



Chairman

Vice Chairman



Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 90-360-C DATED JULY 21, 1994.

The following rates and charges are prescribed for Big Rivers Electric Corporation. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under the authority of this Commission prior to the effective date of this Order.

RATES:

For all non-smelter delivery points:

(2) An Energy Charge of:

All KWH per month at $.0181006

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 90-360-C DATED JULY 21, 1994.

CALCULATION OF AVERAGE PRICE IMPACT OF AMENDMENT NO. 1 TO BIG RIVERS' COAL CONTRACT 527 FROM DECEMBER 1991 THROUGH APRIL 1993

Time Period	Tons Purchased	Difference Dollars per Ton[1]	Difference Total Dollars
12/91	85,000	(2.637)	$ (224,145)
1/92-12/92	1,020,414	(2.130)	(2,173,561)
1/93-4/93	345,935	(1.936)	(669,545)
Total	1,451,349		$ (3,067,251)

Average Difference (Price Impact) per Ton:

$(3,067,251) ÷ 1,451,349 tons = $(2.11) per ton

[1] Differences taken from Exhibit 15.3 of the Overland Report and response to Commission Staff's hearing data request.

APPENDIX C

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 90-360-C DATED JULY 21, 1994.

CALCULATION OF ADJUSTED PRICE OF CONTRACT 527 WHICH REFLECTS IMPACTS OF AMENDMENT NO. 1 AND THE ANDALEX SUBSTITUTION AGREEMENT

GRCC base price	$31.40			
Less:				
Impact of Amendment No. 1	2.11			
Adjusted Price	$29.29			
Adjusted Price per Amendment No.1		$29.29		
Less:				
Andalex Price to GRCC		20.25		
Potential savings per change-in-mining method provision of Contract 527		$ 9.04		
50% allocable to Big Rivers		4.52		
Adjusted Price per Amendment No.1			$29.29	
Less:				
Big Rivers' share of savings per change-in-mining method provision of Contract 527			4.52	
Adjusted Reasonable Price per Amendment No.1 and Substitution Agreement			$24.77	
GRCC Base Price				$31.40
Less:				
Adjusted Reasonable Price per Amendment No.1 and Substitution Agreement				24.77
Difference				$ 6.63