COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF GREEN RIVER ELECTRIC CORPORATION AND HENDERSON UNION ELECTRIC COOPERATIVE CORPORATION FOR APPROVAL OF RATE DECREASE FOR KENERGY CORP., CONSOLIDATION SUCCESSOR	)	CASE NO. 99-162

O R D E R

Kenergy Corp. ("Kenergy") has applied for approval of a 4-percent reduction in the rates for its non-direct serve member-customers. By this Order, we grant the proposed reduction effective September 2, 1999.

PROCEDURE

On May 20, 1999, Green River Electric Corporation ("GREC") and Henderson Union Electric Cooperative Corporation ("HUECC") (collectively "the Cooperatives") jointly applied, pursuant to KRS 278.455, for approval of a 4-percent reduction in the rates for non-direct serve member-customers, to become effective upon the Cooperatives' consolidation as Kenergy. Finding that KRS 278.455 did not govern the application, the Commission rejected the application and directed the Cooperatives to conform their application to the requirements of either KRS 278.455 or Administrative Regulation 807 KAR 5:001, Section 10.

On August 16, 1999, Kenergy submitted an amended application in which it requested of a 4-percent reduction, effective September 1, 1999, in the rates of its non-direct serve member-customers. Kenergy further requested deviations from

Administrative Regulation 807 KAR 5:001, Section 10, to permit the acceptance of its application without, inter alia, the submission of a cost-of-service study.

On August 31, 1999, the Commission granted Kenergy's requested deviations and accepted its application for filing. We expressly reserved the right to require Kenergy to perform a cost-of-service study should we determine that such study was necessary. We further ordered that the proposed rate reduction be suspended for one day and then become effective, subject to change, for service rendered on and after September 2, 1999. After subsequently hearing additional arguments on the need for a cost-of-service study, the Commission determined that this proceeding should go forward without such study.

On December 14 1999, the Commission established a procedural schedule in this matter. After the parties[1] conducted discovery and submitted written testimony, the Commission held a public hearing on the proposed rate reduction on April 18, 2000.[2] In lieu of submitting written briefs in this matter, the parties on or about May 12, 2000, submitted written issue lists for the Commission's consideration.

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[1] Kentucky Industrial Utility Customers ("KIUC") was permitted to intervene in this matter on behalf of its members Alcan Aluminum Corporation ("Alcan"), Southwire Company, Commonwealth Aluminum Corporation ("Commonwealth"), and Kimberly Clark Corporation ("Kimberly Clark").

[2] The following persons testified at this hearing: Dean Stanley, Kenergy's President and Chief Executive Officer; Stephen J. Thompson, Kenergy's Vice President of Finance and Accounting; Jack D. Gaines, Vice President and Manager of Utility Rates Department, Southern Engineering Company; and, Russell L. Klepper, Founder and Principal, Energy Services Group, LLC.

STATEMENT OF THE CASE

Background

An understanding of the issues in this case requires a review of the efforts to consolidate Green River and Henderson Union. In 1993 a Commission-sponsored management audit of Green River and Henderson Union first raised the subject of consolidation. F.E. Jennings and Co. ("Jennings"), an independent management consulting firm retained to perform the audit, recommended in its report that further studies be performed to explore the feasibility of consolidating the entire Big Rivers Electric Corporation ("Big Rivers") system.[3] Although two members of the Big Rivers' system declined to participate, Green River and Henderson Union agreed to consolidation discussions and eventually procured a formal feasibility study.

The National Rural Electric Cooperative Association ("NRECA") and the National Rural Utilities Cooperative Finance Corporation performed a preliminary study. Based upon this study, they recommended further in-depth analysis of consolidation. This presentation became Phase I of a five-phase consolidation process. Eventually, Green River and Henderson Union engaged NRECA to perform a detailed study of the proposed consolidation.

The detailed NRECA Consolidation Study ("1996 Study"), completed in October 1996, reviewed virtually every element related to a consolidation of Green River and Henderson Union. Based upon the 1996 Study's extensive findings and recommendations, the two cooperatives entered into negotiations toward consolidation.

[3] At that time Big Rivers' system consisted of four distribution cooperatives: Green River; Henderson Union; Jackson Purchase Electric Cooperative Corporation; and Meade County Rural Electric Cooperative Corporation.

On March 11, 1997, they executed a Consolidation Agreement to merge and form a new entity to be known as Kenergy Corp. On May 27, 1997, this Commission approved the proposed consolidation.[4] A majority of Henderson Union members who subsequently voted on the proposed consolidation, however, failed to approve the proposal.[5]

In November 1998, Green River and Henderson Union formed a Consolidation Committee to renew exploration of consolidation. They retained Joseph Slatter, Jr., co-author of the 1996 Study, to revise and update that study. This revised study ("1999 Study") included three scenarios relating to the economic benefits of consolidation. Scenario 1 reflected the immediate impact of consolidation from year one to year 10 of the forecast period and would result in savings of $23.6 million. Scenario 2 reflected a phase-in period of 5 years to full realization and results in savings of $19.9 million. Scenario 3 reflected a phase-in period of 10 years to full realization and results in savings of $14.5 million.[6] The study recommended that the "savings be returned immediately to the Green River EC and Henderson Union EC members in the form of a 4% retail reduction to rural members."[7]

[4] Case No. 97-156, The Application of Green River Electric Corporation and Henderson Union Corporation for Approval of Consolidation (May 27, 1997).

[5] Case No. 99-136, The Application of Green River Electric Corporation and Henderson Union Corporation for Approval of Consolidation, Application at 3. By a vote of 478 to 170, Green River's members approved the proposed consolidation. Henderson Union's members, however, voted 230 against and 217 in favor.

[6] National Rural Electric Cooperative Association, Green River Electric Corporation and Henderson Union Electric Cooperative Consolidation Study (Jan. 1999) at 77 – 85.

[7] Id. at 82 (emphasis added).

On January 23, 1999, Green River and Henderson Union executed a Consolidation Agreement. This agreement provided that, subject to the Commission's approval, the two cooperatives would consolidate on July 1, 1999. It also addressed several critical issues involving the consolidated entity's operations, including Kenergy's principal place of business, the composition of Kenergy's board of directors, the naming of Kenergy's principal officers, the retention of all current employees, and the new cooperative's capital credits policy.

The Cooperatives specifically addressed the issue of rate reductions that would occur following consolidation in the Consolidation Agreement. Paragraph 15 provides:

> GREC and HUEC shall immediately apply to KPSC for a rate reduction to go into effect upon the effective date of consolidation or as soon thereafter as may be ordered by KPSC. The application shall seek a 4% reduction for five (5) years for all non-direct serve members, blended so there will be rate parity among all affected members of Kenergy Corp. If, for any reason, KPSC does not approve the requested rate reduction, all reasonable efforts will be made to effectuate a 4% reduction to the existing rates of said non-direct serve members, to be effective upon the effective date of consolidation or as soon thereafter as may be ordered by KPSC.
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> It shall be the objective of the Kenergy Corp. to provide rate parity for all of its members within a period of two (2) years from the effective date of the consolidation; provided, however, that Kenergy Corp. shall not make any reduction in rates which would violate or interfere with performance of any of the obligations of Kenergy Corp. to any of its lenders.[8]

Pursuant to KRS 279.170, the Cooperatives submitted the proposed consolidation to their members for approval. When placing the Consolidation

[8] Kenergy's Response to KIUC's First Set of Data Requests, Item 3.

Agreement before their members, the Cooperatives' management emphasized that the proposed rate reduction to their non-direct serve members was intended to "send a strong signal to the members that voting for consolidation . . . [meant] lower rates than otherwise achievable."[9] The Cooperatives, moreover, made clear that this reduction would not apply to direct serve customers.[10] A majority of members from each cooperative voting approved the proposed consolidation.[11]

After receiving the approval of their memberships, the Cooperatives then applied in Case No. 99-136[12] to the Commission for approval of the consolidation. KIUC intervened in that proceeding of behalf of its members Alcan, Commonwealth, and Kimberly Clark. No party or direct serve customer voiced any objection to the proposed consolidation or to the provisions of the Consolidation Agreement. On June 18, 1999, the Commission approved the proposed consolidation without modifications or conditions.

[9] Testimony of Dean Stanley at 2.

[10] See, e.g., Kenergy's Response to the Commission's Order of January 10, 2000, Attachment 3b(1).

[11] Case No. 99-136, Application at 7. Green River's members voted 11,346 to 1,283 in favor of the proposed consolidation. Henderson Union's vote was 4,478 to 3,182.

[12] Case No. 99-136, The Application of Green River Electric Corporation and Henderson Union Corporation for Approval of Consolidation.

Proposed Rate Reduction

Kenergy proposes a consolidation credit rider equal to 4 percent of the monthly billing amount will appear on all non-direct serve customer bills[13] for a five year period. It estimates that the credit rider will reduce annual utility revenues by $2,298,780.[14]

Kenergy chose the 4 percent rider for two reasons. First, it wanted to emphasize the benefits of the consolidation. Such emphasis would be lacking if the reduction were placed immediately into base rates.[15] Second, it viewed the flat rate rider as more consistent and predictable than a credit reflecting actual consolidation savings. Because the amount of savings from the consolidation is dependent in large measure upon employee reductions achieved through normal attrition and early retirement, Kenergy asserts, the time frame for realizing those savings is not known and measurable.[16]

Kenergy does not expect the proposed reduction to significantly affect its financial condition. It asserts that, at the time of consolidation, its predecessors had

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[13] Non-direct serve customers are those customers who receive electric service through Kenergy's distribution facilities. They are generally customers who receive electric service at voltages much lower than the transmission voltages of Big Rivers, Kenergy's electric supplier. In contrast, direct serve customers are served directly from Big Rivers' transmission system. They demand electric service at transmission voltage levels. There is, therefore, no need for Kenergy facilities to reduce the voltage prior to delivery. With direct serve customers, Kenergy supplies only the meter.

[14] Testimony of Steve Thompson at 2.

[15] After the proposed credit expires, Kenergy intends "to establish base rates reflecting most of the efficiencies gained from consolidation." Testimony of Dean Stanley at 2.

[16] Testimony of Steve Thompson at 2.

"very strong" financial positions.[17] These positions are enhanced by the Rural Utilities Service's reduction in Kenergy's minimum times interest earned ratio from 1.5 to 1.0 for the next 5 years and by the expected efficiencies and cost reductions achieved through the consolidation.

DISCUSSION

Kenergy's application presents the following issue: Is the application of the proposed credit to reflect consolidation savings only to non-direct serve customers reasonable?

Kenergy advances several arguments in support of its decision not to extend the credit rider to all customer classes. First, it contends that application of the credit rider to Alcan and Southwire Company ("the Smelters"), customers served under its smelter rate, would be contrary to the terms of their service contracts. It notes that both customers are currently served under contracts that establish Kenergy's adder at .1 mills per kilowatt hour ("kWH") through December 31, 2000. It further asserts that the language and intent of these contracts is that no change in that rate may occur until January 1, 2001.

Second, Kenergy asserts that application of the credit rider to direct serve customers would require the utility to provide electric service to these customers at a loss. In 1998, Kenergy's gross margin from sales to the Smelters was $514,000 out of $128 million in sales. If the credit rider were applied to these sales, Kenergy's revenues from the sales would decrease by $5.1 million annually. Similarly, Kenergy's gross margins from sales to the direct serve customers that Green River previously served

[17] Testimony of Dean Stanley at 2.

was approximately $565,000 out of $32.9 million in revenue. Application of the credit rider to these sales would decrease Kenergy's revenues by $1.316 million.

Third, Kenergy argues that direct serve customers have been treated more favorably than non-direct serve customers in recent rate proceedings. It notes that in the three of its last four rate proceedings, Green River increased rates beyond that necessary to flow through power costs to its non-direct serve customers while the rates of its direct serve customers were increased only by the amounts necessary to flow through power costs. In each of those cases, Green River's adders were not adjusted. Similarly, in Henderson Union's last rate proceeding, direct serve customer rates were reduced beyond the level necessary to flow through reductions in power costs at the expense of non-direct serve customers.

Responding to these arguments, KIUC first contends that in the absence of a cost-of-service study, no customer class should be excluded from the credit rider. It argues that Kenergy has failed to show that the merger savings will affect only those costs incurred for the benefit of non-direct serve customers and, therefore, any merger savings will be realized from all components of Kenergy's distribution costs.

KIUC further argues that Kenergy's reliance upon the results of earlier rate proceedings is misplaced. The earlier proceedings to which Kenergy refers involved only generation and transmission costs, KIUC contends, while the current proceedings involve only distribution costs. The allocation of any decrease in distribution costs among customers, it asserts, is independent of wholesale generation and transmission costs. Kenergy's proposed exclusion of direct serve customers, it further asserts, is nothing more than an exercise in retroactive rate-making.

KIUC disputes Kenergy's contention that existing contracts bar the Commission's consideration of any reduction in the adder assessed on sales to the Smelters. It notes that the contract specifies the adder's level but permits changes after December 31, 2000 upon either Kenergy or the Smelter's application to the Commission. Its witness argues that KIUC's intervention in this rate proceeding should be considered an application for such reduction.

Finally, KIUC argues that the existing adders are unreasonable and inequitable. It contends that the adders that Alcan, Southwire Company, Commonwealth, and Kimberly Clark are required to pay represent a disproportionate amount of distribution-related excess revenues.

In considering the reasonableness of the proposed credit rider, the Commission acknowledges the absence of any supporting cost-of-service study. The absence of such study is not fatal to the proposed rate. As we recognized in our Order of December 14, 1999, the unusual circumstances in this proceeding made the preparation of any cost-of-service study of limited value. Kenergy did not exist during the proposed test period. The merger savings upon which the proposed credit rider is based are prospective in nature and therefore would be difficult to quantify and allocate. The full extent of any savings will require a review of the consolidated entity's actual operations.

In addition, the Commission cannot accept KIUC's argument that, in the absence of a cost-of-service study, the reduction must be proportional to all customer classes. Given the significant and obvious differences in how Kenergy serves the direct serve and non-direct serve customers,[18] such assumption is not reasonable. Based upon the Consolidation Study, a significant portion of the merger savings is expected to result from distribution functions that are not provided to direct serve customers.

We furthermore are unconvinced by KIUC's arguments that the existing adders are unjust and unreasonable. It has presented no credible evidence to suggest that the adders result in an unreasonable allocation of costs. Moreover, KIUC's position is in direct conflict with its position in Cases No. 97-219[19] and No. 97-220.[20] In those proceedings, it did not object to the adders that Kenergy's predecessors proposed. It has failed to introduce any evidence to demonstrate that Kenergy's current situation differs significantly to render those adders unjust and unreasonable. Moreover, as the adders for the Smelters were negotiated within the past two years and as the parties to those service contracts agreed that they were to remain unchanged until 2001, we are reluctant to make any changes absent some credible evidence to support such changes.

In reviewing the record of this proceeding, we note that, since Green River and Henderson Union first proposed the consolidation in January 1999, the central premises of that proposed consolidation were that savings would result from that consolidation and that non-direct customers would be initial beneficiaries of those savings. The proponents of consolidation represented to the members of both Cooperatives that a

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[18] See text accompanying footnote 13.

[19] Case No. 97-219, Application of Green River Electric Corporation for a Decrease in Existing Rates and for Approval of Contracts.

[20] Case No. 97-220, Application of Henderson Union Electric Cooperative Corporation for a Decrease in Existing Rates and for Approval of Contracts.

reduction in non-direct serve rates would immediately result from consolidation. It was a key recommendation of the Consolidation Report. Equally important, consolidation proponents openly represented to the public and to this Commission that only non-direct serve customers would see an immediate reduction in rates. It is clear that approval of the consolidation and, therefore, any resulting consolidation savings were in large measure due to these representations.

The record of this proceeding and of Case No. 99-136, moreover, reveals that no objection to the proposed reduction was raised at any time while the proposed consolidation was before the Cooperatives' members or before this Commission. Although the proposed reduction was an integral provision of the Consolidation Agreement and of the Cooperatives' application for Commission approval of the proposed consolidation, no objection was raised to it. KIUC, though a party to Case No. 99-136, never raised the issue. We approved the proposed consolidation without modification or reservation.

Based upon the above, we find that the proposed credit rider is reasonable and will not result in an unreasonable preference or advantage and should be approved. We further find that the issues of the credit rider and adder for direct serve customers should be revisited at Kenergy's next rate adjustment proceeding. At that proceeding, Kenergy should support its proposed rates with a detailed cost-of-service study. This cost-of-service study should examine in detail the costs of serving direct serve customers and, if possible, identify any merger savings that are directly related to serving this customer class. The Commission expects that Kenergy will honor its stated intention to submit an application for rate adjustment in January 2001.[21]

SUMMARY

Having considered the evidence of record and being otherwise sufficiently advised, the Commission HEREBY ORDERS that:

1. Kenergy's proposed Consolidation Credit Rider is approved for service rendered on and after September 2, 1999 and until September 1, 2004, subject to the reservations described in Ordering Paragraph 3.

2. Kenergy shall file with the Commission no later than January 31, 2001 an application for rate adjustment that shall establish uniform rate schedules for customers within its Kenergy East (formerly Green River) and Kenergy West (formerly Henderson Union) Divisions. This application shall be accompanied by a complete and detailed cost-of-service study that covers Kenergy's consolidated operations.

3. The Commission reserves the right to adjust the Consolidation Credit Rider at such future rate proceedings upon review of the results of the detailed cost-of-service study.

4. Within 20 days of the date of this Order, Kenergy shall file revised tariff sheets that reflect the rate approved herein.

[21] Kenergy's Response to the Commission's Order of January 10, 2000, Item 5(b).

Done at Frankfort, Kentucky, this 14th day of June, 2000.

By the Commission

ATTEST:

Executive Director