COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ADJUSTMENT OF RATES OF FLEMING-MASON ENERGY COOPERATIVE CORPORATION	))	CASE NO. 2001-00244

O R D E R

On November 29, 2001, Fleming-Mason Energy Cooperative Corporation (Fleming-Mason) applied for a $1,205,406 increase in retail electric service rates. The requested increase is 3.70 percent over normalized test-year operating revenues. Fleming-Mason stated that the proposed increase was required in order to maintain its financial integrity, cover operating costs, and maintain the minimum margins required by its mortgage agreement. By this Order, the Commission grants Fleming-Mason an increase of $432,003 or a 1.19 percent increase over normalized test-year operating revenues.

BACKGROUND

Fleming-Mason is a consumer-owned rural electric cooperative corporation, organized under KRS Chapter 279, engaged in the distribution and sale of electric energy to approximately 21,100 member-consumers in the Kentucky counties of Bath, Bracken, Fleming, Lewis, Mason, Nicholas, Robertson, and Rowan. Fleming-Mason has no electric generating facilities and purchases its total power requirements from East Kentucky Power Cooperative, Inc. (East Kentucky).

Fleming-Mason has a wholly owned subsidiary, Fleming-Mason Service Corporation (Service Corp.), which was organized for the purpose of providing

television and telecommunication services and related sales and services.[1] Service Corp. owns licenses that will allow it to offer wireless broadband Internet services through Local Multipoint Distribution Services (LMDS) technology.[2] Service Corp. has a wholly owned subsidiary, Kentucky Wireless Company LLC (Kentucky Wireless). At present, Service Corp. has not determined the service or function that Kentucky Wireless may perform.[3]

The Commission granted a motion to intervene filed by the Attorney General, by and through his Office for Rate Intervention (AG). Public hearings were conducted on April 16, 2002 and May 6, 2002.[4] All information requested during the hearings has been submitted.

TEST PERIOD

Fleming-Mason proposed and the Commission has accepted the 12-month period ending May 31, 2001 as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test year, the Commission has considered appropriate known and measurable changes.

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[1] Response to Information Requested at Public Hearing April 16, 2002, Item 5.

[2] Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 31.

[3] Transcript of Evidence (T.E.), April 16, 2002 at 62.

[4] During the public hearing on April 16, 2002 it was discovered that Fleming-Mason had failed to publish notice of the hearing as required by Administrative Regulation 807 KAR 5:011, Section 8(5), and KRS 424.300. Consequently, the April 16, 2002 hearing was adjourned and reconvened on May 6, 2002. See T.E., April 16, 2002 at 85-86.

VALUATION

Rate Base

Fleming-Mason proposes a net investment rate base of $38,902,642[5] based on the adjusted test-year-end value of plant in service, the test-year-end balances for materials and supplies and prepayments, and excluding the adjusted accumulated depreciation and the test-year-end level of customer advances for construction. Fleming-Mason also proposes to include working capital based on one-eighth of adjusted operating expenses, exclusive of purchased power, depreciation, taxes, and other deductions.

The AG contends that Fleming-Mason should have utilized the 13-month average balances for materials and supplies. The AG also argues that the 13-month average balance for prepayments should be utilized, and that Fleming-Mason s inclusion of dividend and rent receivables should be excluded from the determination of the 13-month average balance. The AG notes that Fleming-Mason has agreed to these modifications.[6]

Fleming-Mason s adjusted test-year-end value of plant in service includes an adjustment to the construction work in progress (CWIP) balance reflecting the capitalized portion of five proposed operating expense adjustments.[7] Fleming-Mason contends this adjustment is similar and consistent with a proposal accepted by the

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[5] Application Exhibit L, page 1 of 4.

[6] Post Hearing Brief of the AG at 12.

[7] Application Exhibit S, pages 1 and 3 of 4. Fleming-Mason included the capitalized portion of its adjustments to salaries, property taxes, depreciation expense, pension costs, and medical insurance as an adjustment to its CWIP balance.

Commission in Jackson Energy Cooperative Corporation s (Jackson Energy) recent rate case.[8] The Commission does not agree with Fleming-Mason s argument. In previous Commission decisions, the capitalized portion of operating expense adjustments have not been recognized in the determination of the distribution cooperative s rate base. The utility plant in service and CWIP used to determine Jackson Energy s rate base reflected significant revisions to the balances due to the write-off of plant and corrections to the amounts recorded in CWIP. The inclusion of capitalized expenses in the Jackson Energy case does not provide justification for a similar inclusion in this case. Fleming-Mason has not offered sufficient justification for this inclusion, and the Commission should not recognize the proposed adjustment to Fleming-Mason s CWIP balance.

The Commission has determined that Fleming-Mason s rate base should reflect the test-year-end value of plant in service and CWIP. The Commission agrees with the AG and will utilize the 13-month average balances for materials and supplies and prepayments. Dividend and rent receivables will be excluded from the prepayment balances. The Commission will exclude an adjusted level of accumulated depreciation that reflects the Commission s determination of the appropriate depreciation expense adjustment, which is discussed later in this Order. The Commission will also exclude the test-year-end level of customer advances for construction. Finally, the Commission agrees with Fleming-Mason s method of determining working capital, but will reflect the results of the adjustments to operating expenses discussed in this Order.

[8] Case No. 2000-00373, The Application of Jackson Energy Cooperative Corporation for an Adjustment of Rates.

Based on these adjustments, Fleming-Mason s net investment rate base for rate-making purposes is as follows:

Utility Plant in Service	$50,430,715
CWIP	474,970
Total Utility Plant	$50,905,685
ADD:	
Materials and Supplies	$ 349,741
Prepayments	138,880
Working Capital	589,116
Subtotal	$ 1,077,737
DEDUCT:	
Accumulated Depreciation	$12,936,951
Customer Advances for Construction	46,246
Subtotal	$12,983,197
NET INVESTMENT RATE BASE	$39,000,225

Capital Structure

The Commission finds that Fleming-Mason s capital structure at test-year-end for rate-making purposes was $36,185,372. This capital structure consisted of $11,689,554 in equity and $24,495,818 in long-term debt. The Commission has excluded generation and transmission capital credits (GTCCs) in the amount of $4,239,197.

REVENUES AND EXPENSES

Fleming-Mason proposes several adjustments to revenues and expenses to reflect current and expected operating conditions. The Commission finds that nine of the adjustments proposed by Fleming-Mason and not opposed by the AG are reasonable and will be accepted without change:

- the normalization of property taxes, an increase in expense of $22,398;

- the normalization of interest on long-term debt, an increase in expense of $189,482;

- the adjustment to reduce interest expense on short-term debt, a reduction in expense of $438,135;[9]

- the adjustment to annualize pension costs, an increase in expense of $24,822;

- the adjustment to remove donations made during the test year, a reduction in expense of $26,356;

- the adjustment to increase revenues from non-recurring charges, an increase in revenues of $61,960;

- the adjustment to remove test-year loss associated with Service Corp, an increase in income of $231,809;

- the normalization of purchase power expense, which includes the fuel adjustment clause (FAC) adjustment, a reduction in expense of $941,546; and

- the normalization of revenues, which includes the FAC adjustment, a reduction in revenues of $853,325.

The Commission makes the following modifications to the remaining proposed adjustments:

Customer Growth Adjustment - Revenue

Fleming-Mason proposed a customer growth adjustment for residential and commercial customers which increases revenues by $124,130, based on a 12-month customer average. The AG noted that the Commission generally uses a thirteen month period to calculate the average number of customers for the purpose of determining the test year end customer growth rather than the twelve month period

[9] Fleming-Mason had originally calculated a reduction in short-term interest expense of $302,789, but had incorporated a reduction of $475,288 in its determination of its adjusted test year. See Application Exhibit S, page 3 of 4 and Application Exhibit 6, page 2 of 2. Fleming-Mason later indicated the more accurate adjustment was a reduction in short-term interest expense of $438,135. See Response to the AG s Second Data Request dated January 30, 2002, Item 17 and T.E., May 6, 2002 at 39-40.

reflected in the filing.[10] Based on a test year 13-month customer average, the AG calculated a revenue increase of $152,137. The AG s adjustment was calculated by subtracting the 13-month average number of customers from the total number of customers, by rate class, for the last month of the test year and annualizing the resulting change in the number of customers. The annualized increase in customers for each customer class was then multiplied times the average rate for each class, resulting in the additional revenues. The Commission finds that the customer growth revenue adjustment proposed by the AG is consistent with adjustments approved in other recent rate cases, is reasonable, and should be approved.

Customer Growth Adjustment - Expenses

Fleming-Mason recognized a customer growth expense adjustment of $68,980 for increased wholesale power cost associated with the increase in sales in its customer growth adjustment. For his 13-month-based customer growth adjustment the AG proposed an expense adjustment of $84,581 to reflect increased wholesale power costs. Consistent with our acceptance of the AG s customer growth revenue adjustment, the Commission accepts the AG s proposed expense adjustment, modified to incorporate Fleming-Mason s test-year average line loss of 4.6 percent. This results in an increase in a customer growth expense adjustment of $88,733.

Customer Additions - Revenues

Fleming-Mason did not propose an adjustment to annualize the revenues generated from serving Family Dollar, which became a Fleming-Mason customer in the fifth month of the test year. The AG contends that it is appropriate and consistent with

[10] Post Hearing Brief of the AG at 5.

KPSC rate making policy to annualize this test year sales amount.[11] Annualizing the test-year sales to Family Dollar produces an increase in sales of 4,581,193 kWh, and using the average rate for an industrial customer of $.041 per kWh produces a corresponding increase in revenues of $187,829.[12] We find the AG s argument to be reasonable. However, we will adjust the AG s calculation by using the actual test-year average rate for industrial customers of $.04127 per kWh, which changes the increase in revenues to $189,068.

Fleming-Mason likewise proposed no adjustment to reflect the addition of Tennessee Gas, which did not become a customer until June 2001, the first month after the end of the test year. The AG proposed to annualize sales for Tennessee Gas based on December 2001 sales, which it argues are representative of the ongoing level of sales to Tennessee Gas.[13] Annualizing the December 2001 sales of 9,648,603 kWh and using the test-year average rate of $.041 per kWh would result in annual sales of 115,783,236 kWh and revenue of $4,747,113.

Given the magnitude of the sales to Tennessee Gas, the Commission finds that an adjustment to recognize the addition of such a customer is appropriate. We do not, however, agree with the AG s proposal to annualize sales based on only 1 month, which happens to be 7 months beyond the end of the test year as well as the highest volume sales month for Tennessee Gas in the record of this proceeding. Consistent with our previous rate-making treatment of post-test-year adjustments, the Commission will only

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[11] Id. at 2.

[12] Id.

[13] Id. at 4.

go 6 months beyond the end of the test year in making its adjustment. We recognize that the first 2 months Fleming-Mason served Tennessee Gas were start-up months, which are not representative of the ongoing level of sales to the customer. Therefore, these sales will be excluded from our calculation. We will calculate our adjustment based on the sales for the months of August 2001 through November 2001 which total 22,317,226 kWh, for a monthly average sales volume of 5,579,307 kWh. Using this monthly average results in adjusted annual sales to Tennessee Gas of 66,951,684 kWh. Based on the test-year average industrial rate of $.04127 per kWh, such an increase in sales results in additional revenues of $2,763,096.

Customer Additions - Expenses

Expenses for increased wholesale power costs related to serving Family Dollar and Tennessee Gas must be recognized along with the additional revenues realized from the increased sales to these two customers. The combined increase in sales reflected in the revenue adjustments for Family Dollar and Tennessee Gas equals 71,532,877 kWh. Using Fleming-Mason s test-year average line loss of 4.6 percent[14] as the line loss factor in calculating the increase in wholesale power costs incurred to serve Family Dollar and Tennessee Gas results in increased annual power purchases of 75,423,843 kWh. The resulting increase in purchased power costs is $2,412,055.

CATV Attachments

Fleming-Mason proposed to increase its charges for Cable Television (CATV) attachments based upon the current costs of providing these services. In calculating these costs, Fleming-Mason used a rate of return based upon net investment in poles,

[14] Fleming-Mason s Monthly Fuel Adjustment Clause Report, June 2001.

which reflects the same methodology approved by the Commission in recent cases involving cooperatives CATV attachment charges. Using the rate of return of 7.04 percent allowed in its previous rate case, Case No. 1990-00081,[15] adjusted by a net-to-gross plant ratio of 76 percent, Fleming-Mason calculated a net-to-gross return of 5.34 percent as its cost of money. Combined with an operation and maintenance expense carrying charge of 11.89 percent, Fleming-Mason calculated total annual carrying charges of 17.23 percent.

Fleming-Mason performed the calculations correctly; however, it should have based its proposed CATV charges on the rate of return it proposed in this proceeding. The Commission has calculated Fleming-Mason s new CATV attachment charges based on the rate of return of 6.52 percent allowed herein. The approved charges are included in Appendix A of this Order.

Labor and Labor-Related Costs

Fleming-Mason proposed adjustments to increase test-year operating expenses by $97,434 for labor and labor-related costs.[16] The adjustments consisted of increases to wages and salaries, payroll taxes, and health insurance premiums.

Wages and Salaries. Fleming-Mason proposes an adjustment of $81,377 to normalize total wages and salaries, of which $26,854 was capitalized and $54,523 was

[15] Case No. 1990-00081, Adjustment of Rates of the Fleming-Mason Rural Electric Cooperative Corporation, Flemingsburg, Kentucky, final Order dated November 6, 1990.

[16] The expense increase for wages and salaries was $54,523; the expense increase for payroll taxes was $10,617; and the revised expense increase for medical, dental, and life insurance premiums was $32,294. See Application Exhibits 1, 2, and 8 and the Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 25.

expensed. Full-time employees were assumed to work 2,080 hours. Part-time employees were assumed to work the number of hours actually worked during the test year. Test-year actual overtime hours were included at 1.5 times the test-year-end wage rates.[17]

The AG notes that Fleming-Mason s normalization included the salary for an operations superintendent who retired during the test year. Existing employees are covering the duties of this employee. The AG proposes that the retired employee s salary should be excluded from the wage and salary normalization. After applying the test-year capitalization rate, the AG reduced Fleming-Mason s proposed expense adjustment by $46,741.[18]

The Commission agrees with the AG that the retired employee s salary should not have been included in the wage and salary normalization and has recalculated the proposed adjustment excluding the retiree. After applying the test-year capitalization rate of 33 percent, the Commission finds that an adjustment to increase test-year operating expenses by $7,785 is reasonable.

Payroll Taxes. Fleming-Mason proposed to increase its payroll taxes by $15,566, based on the proposed normalization of wages and salaries and reflecting an increase in the Federal Insurance Contribution Act (FICA) base wage limit from

[17] Application Exhibit 1, pages 1 through 3 of 10.

[18] Post Hearing Brief of the AG at 7-8 and Exhibit AG-7.

$76,200 to $80,400. Of this amount, $4,949 was capitalized and $10,617 was expensed.[19]

The AG proposes to remove the payroll tax expense associated with the retired operations superintendent. Based on the AG s proposed reduction in salary expense of $46,741, the AG calculates that associated FICA and Medicare for the retiree should be $3,576. The AG proposes that Fleming-Mason s proposed expense adjustment be reduced by $3,576.[20]

As with the wage and salary normalization, the Commission agrees with the AG that the impact of the retired employee should be removed. The Commission has recalculated this adjustment, based on the level of normalized wages and salaries found reasonable and the FICA base wage limit of $80,400. This results in an increase in test-year payroll taxes of $10,477. After applying the test-year capitalization rate of 31.8 percent, the increase to test-year payroll tax expense would be $7,145.

Medical, Dental, and Life Insurance. Fleming-Mason proposes to normalize its medical and dental insurance premium costs to reflect the premiums effective December 2000. This normalization, plus the recognition of the cost of life insurance

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[19] Application Exhibit 2. Payroll taxes include FICA, Medicare, and Federal and State Unemployment.

[20] Post Hearing Brief of the AG, Exhibit AG-7.

coverage for Fleming-Mason s employees, results in an increase in costs of $47,352.[21] Of this amount, $15,058 would be capitalized and $32,294 would be expensed.

The AG proposes two adjustments related to Fleming-Mason s medical, dental, and life insurance coverage expense. First, the AG recommends that employee benefit expenses associated with the retired operations superintendent should be removed, which results in a reduction to Fleming-Mason s adjusted operating expenses of $14,239.[22] The AG determined this amount by calculating an average benefit expense per employee. Second, the AG recommends an increase to Fleming-Mason s adjusted operating expenses of $91, to correct errors the AG believes were present in Fleming-Mason s calculation of its medical, dental, and life insurance coverage expense.[23]

Fleming-Mason provides its employees with two times their annual salary of life insurance coverage, with the employee responsible for 20 percent of the premium cost. Fleming-Mason has not performed any analyses or surveyed other cooperatives in order to determine that this level is an appropriate level of life insurance coverage.

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[21] Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 25. Fleming-Mason had originally proposed an increase in costs of $60,155, with $19,129 capitalized and $41,026 expensed. See Application Exhibit 8. However, Fleming-Mason revised its proposed adjustment, noting that the original proposal had failed to recognize the portion of medical and dental premiums paid by employees and had not included the life insurance premiums in the determination of the overall increase.

[22] Post Hearing Brief of the AG, at 8 and Exhibit AG-7, line 5.

[23] Id. at 9-10 and Exhibit AG-8.

Fleming-Mason has provided this benefit to employees for many years, but its last wage and salary plan did not include any analysis that supports the practice.[24]

The Commission does not view the provision of life insurance coverage for a utility s employees unfavorably. However, as we have noted in previous electric distribution cooperative rate proceedings, the Commission is concerned about Fleming-Mason s current practice. Under current federal law, the cost for insurance coverage in excess of $50,000 constitutes wages subject to FICA taxes.[25] Once the $50,000 coverage level is reached, Fleming-Mason incurs additional employer-share FICA tax expense. To include the expenses associated with employee life insurance coverage in excess of $50,000, utilities must clearly demonstrate the need for this additional compensation. Fleming-Mason has not done so. Therefore, the Commission has limited test-year life insurance premium expense to the cost to provide each Fleming-Mason employee up to $50,000 of coverage.

Concerning the AG s proposed adjustments, while the Commission agrees that the impact of the retired employee should be excluded from cost normalizations, the AG s use of an average benefit calculation is not reasonable. The adjustment should be based on the actual impact the employee had on Fleming-Mason s costs. The Commission also rejects the AG s proposed adjustment to the medical, dental, and life insurance coverage. The AG s calculation of the adjustment has the effect of assuming

[24] Response to Information Requested at the Public Hearing May 6, 2002, Item 2. While Fleming-Mason has annually adjusted its pay rates, its last wage and salary plan study was performed in November 1989.

[25] 26 U.S.C § 79 (1992).

that Fleming-Mason had no test-year expense for life insurance coverage. The record does not support such an assumption.

Fleming-Mason s proposed adjustment normalized medical and dental insurance coverage based on premiums effective December 2000. Fleming-Mason provided its premium statements for medical, dental, and life insurance coverage as of June 1, 2001, the first day after test-year end. Using this information, the Commission has recalculated the adjustment for these insurance coverages. The Commission s calculations are only based on active employees, exclude coverage for Fleming-Mason s directors and attorney, and exclude the cost of life insurance coverage in excess of $50,000. After deducting the employee-share of the adjusted premiums, the Commission has determined that medical, dental, and life insurance premium costs should be increased $16,249. After applying the test-year capitalization rate of 31.8 percent, the increase to test-year medical, dental, and life insurance expense would be $11,082.

Post-Retirement Benefits. Fleming-Mason proposed no adjustment to its annual accrual for post-retirement benefits. Fleming-Mason accounts for its post-retirement benefits in accordance with the requirements of Statement of Financial Accounting Standards (FAS) No. 106, which it adopted in 1995.[26] Fleming-Mason s test-year accrual of $157,400 reflected the results of the FAS 106 analysis performed in 1995. Fleming-Mason included with its application an updated FAS 106 analysis as of January

[26] Fleming-Mason pays post-retirement benefits to employees that were employed prior to 1994. Employees hired after 1994 do not have post-retirement benefits. See T.E., May 6, 2002 at 57.

1, 2001.[27] The updated analysis indicates that the annual accrual should be $288,400, however, this amount reflects the accrual for both employees and directors. In previous electric distribution cooperative rate proceedings the Commission has found that ratepayers should not bear the cost of post-retirement benefits for directors. No evidence has been presented in this proceeding to cause the Commission to handle Fleming-Mason s costs differently. Based on information in the 2001 FAS 106 analysis, the Commission has determined that the annual accrual for employees should be $257,593.[28] This represents an increase in the annual accrual of $100,201.

The Commission finds that the recalculated annual accrual should be recognized as an adjustment to Fleming-Mason s operating expenses. After applying the test-year capitalization rate of 29.0 percent to the $100,201 increase, the Commission will include an adjustment to increase operating expenses by $71,143.

Directors Fees and Expenses

During the test year Fleming-Mason paid its seven directors fees and expenses totaling $66,156. Fleming-Mason proposes an adjustment to reduce this expense by

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[27] Application Exhibit 22.

[28] The accrual allocation is based on the total expected post-retirement benefit obligation. The employees component represents 89.318 percent of the combined obligation and the directors component is 10.682 percent. Applying the 89.318 percent to the total accrual of $288,400 results in the employee accrual of $257,593. See Application Exhibit 22, page 5 of 16.

$39,004, to exclude certain expenses for rate-making purposes.[29] The AG proposes to reduce these expenses an additional $278, which reflects the exclusion of meals for two directors spouses.[30] The AG notes that Fleming-Mason has agreed that this expense should be excluded.[31]

The Commission agrees with the exclusions identified by Fleming-Mason and the AG. The exclusion of these items is consistent with the Commission s decisions in previous electric distribution cooperative rate proceedings. In addition, the Commission has identified additional adjustments that should be made to the directors fees and expenses.

Fleming-Mason s board of directors is comprised of seven directors. During the test year, one director resigned and was replaced 2 months later. In December 2000, the directors increased the monthly per diem payment from $255 to $290 per meeting. Finally, the analysis of directors fees and expenses submitted by Fleming-Mason showed one director receiving 13 per diem payments during the test year. Fleming-Mason proposed no adjustments to normalize the per diem payments to reflect having a full board of directors complement at the higher monthly meeting per diem for 12 months. Fleming-Mason also did not normalize the mileage reimbursement for its

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[29] Application Exhibit 10. The $39,004 adjustment was comprised of per diems paid for meetings other than regular monthly directors meetings, health insurance premiums, directors Christmas gifts, and expenses associated with a director s attendance at the Congressional breakfast. In a data response, Fleming-Mason identified a $10 overstatement of the health insurance premiums; <u>See</u> Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 28(c).

[30] Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 28(f).

[31] Post Hearing Brief of the AG at 6.

directors to reflect the test-year-end composition of its board of directors. The Commission finds these normalizations are reasonable and should be included for rate-making purposes. The net impact of these normalizations is an increase in operating expenses of $1,433.

The individuals serving as Fleming-Mason s board of directors also serve as the board of directors for Service Corp.[32] Fleming-Mason states that approximately 10 to 15 minutes of its 3 to 4 hour monthly board meetings are devoted to Service Corp. matters.[33] While Fleming-Mason does allocate various expenses as appropriate to Service Corp., none of the directors fees and expenses are allocated to Service Corp. Fleming-Mason s failure to allocate <u>all</u> common or joint costs to its subsidiary raises concerns that the non-regulated business may be subsidized by the regulated cooperative. When several jurisdictional cooperatives became involved in the distribution and sale of satellite-delivered television programming services, the Commission addressed its concerns about potential cross-subsidization by stating:

> In order to minimize the possibility that utility ratepayers cross-subsidize the satellite-TV operations, all costs must be properly identified, allocated, and recorded. The principle applies irrespective of the materiality of the cost. Nonutility operating costs should not be recorded as utility operating costs.[34]

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[32] Response to the Commission Staff s Second Data Request dated December 21, 2002, Item 31(b).

[33] Response to the Commission Staff s Third Data Request dated January 30, 2002, Item 38.

[34] Administrative Case No. 326, An Investigation Into the Diversification of Rural Electric Cooperative Corporations Into the Satellite-Delivered Television Programming Services, final Order dated March 18, 1991, Appendix A at 2.

In addition, KRS 278.2201 addresses the concerns of cross-subsidization by stating, A utility shall not subsidize a nonregulated activity provided by an affiliate or by the utility itself. The Commission finds it reasonable to allocate a portion of the normalized per diems and mileage expense to Service Corp. using an allocation factor based on the relationship between the time spent on Service Corp. issues at the monthly board meetings to the total duration of those meetings.[35] This results in a reduction in operating expenses of $1,515.

One of Fleming-Mason s directors serves as its representative to the Kentucky Association of Electric Cooperatives (KAEC) meetings. During the test year, this director was unable to attend the KAEC annual meeting and two other directors attended the KAEC annual meeting on behalf of Fleming-Mason.[36] In previous cooperative rate cases, the Commission has found it to be excessive to include annual meeting expenses for directors who were not the designated delegate or alternate. No evidence has been presented in this case to persuade the Commission to treat Fleming-Mason differently. The Commission finds that the expenses for one of the two directors should be included for rate-making purposes, while the other director s meeting fees and mileage for attending the KAEC annual meeting should be excluded. This results in a reduction in operating expenses of $192.

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[35] The relationship between 10 to 15 minutes per meeting and the total monthly meeting time of 3 to 4 hours results in allocation factors of 4.2, 5.5, 6.25, and 8.3 percent. The Commission has used an allocation factor of 6.06 percent, which reflects the average of these individual results.

[36] Response to the AG s First Data Request dated December 19, 2001, Item 32.

Based on these findings, the Commission has reduced Fleming-Mason s operating expenses by $39,546.[37]

Depreciation Expense

Fleming-Mason undertook its first depreciation study in 2001, retaining Alan M. Zumstein to perform the study.[38] The study results included recommended annual depreciation accrual rates for Fleming-Mason as of December 31, 2000. The proposed depreciation rates were based on the remaining life methodology. The proposed depreciation rates reflect an increase in depreciation on distribution plant. Mr. Zumstein delivered the depreciation study results to Fleming-Mason in October 2001. As the proposed depreciation rates for distribution plant varied with those prescribed in the Rural Utilities Service (RUS) Bulletin 183-1, Fleming-Mason sought RUS approval of those rates. Fleming-Mason has not received any correspondence from RUS relating to the approval of the proposed depreciation rates.[39] Using Mr. Zumstein s study results, Fleming-Mason proposes an increase in depreciation expense of $521,398 with a corresponding increase in its transportation clearing account of $14,314.[40] After applying the test-year capitalization rate of 39.0 percent, the increase in the

[37] The total reflects Fleming-Mason s original reduction adjusted for the health insurance correction, the AG s additional reduction, and the Commission s three identified adjustments.

[38] Mr. Zumstein is Fleming-Mason s independent auditor and assisted in the preparation of adjustments other than those related to depreciation contained in the rate application.

[39] Response to the Commission Staff s Third Data Request dated January 30, 2002, Item 44(f). The responses to this data request were filed with the Commission on February 13, 2002.

[40] Application Exhibit 3, page 2 of 6.

transportation clearing account expense would be $8,732. Mr. Zumstein also recommends that Fleming-Mason review its depreciation every 5 years.[41]

The AG evaluated Mr. Zumstein s use of the simulated plant records balances approach to analyze plant lives. The AG notes this approach was used because Fleming-Mason does not maintain aged data on its plant accounts. The results of the AG s evaluation supported Mr. Zumstein s analysis, and the AG accepts the use of the service lives and the Iowa curves contained in Mr. Zumstein s study. The AG also accepts the use of the remaining life methodology, subject to certain conditions. The AG expressed no opinion on the proposed increase to the transportation clearing account. However, the AG opposes Mr. Zumstein s treatment of negative net salvage as incorporated into the distribution plant depreciation rates.

The AG states three conditions in conjunction with his acceptance of the remaining life methodology for Fleming-Mason. First, Fleming-Mason must maintain its book depreciation reserves at the starting points established in Mr. Zumstein s depreciation study. The December 31, 2000 depreciation reserves should be rolled forward by account and continually maintained by recording retirements, accruals, cost of removal, gross salvage, and other adjustments. Second, Fleming-Mason should adjust its book balances to agree with simulated plant survivors balances determined by Mr. Zumstein. The net adjustment is an increase in distribution plant of $3,226. Lastly, Fleming-Mason should be held responsible for maintaining and updating the simulated plant records database. By maintaining this database, Fleming-Mason

[41] Fleming-Mason s Service Life and Salvage Study and Recommended Depreciation Accrual Rates as of December 31, 2000, Section 1 Introduction.

should be able to demonstrate during its next depreciation study that its surviving balances start with the December 31, 2000 simulated plant records database by vintage year.[42]

The AG contends that Fleming-Mason s net salvage analysis results in an unreasonable depreciation expense increase. The AG argues that the majority of the overall distribution plant depreciation expense increase is a result of Mr. Zumstein s future negative salvage proposals.[43] The AG also believes the net salvage analysis was flawed because it was conducted at the functional level, but applied to individual plant accounts using a ratio.[44]

The AG proposes revised depreciation rates for distribution plant using the remaining life methodology and the service lives contained in Mr. Zumstein s study. In determining his proposed distribution plant depreciation rates, the AG removed the negative net salvage ratios. The AG proposes that the net salvage component normally included in depreciation rates be recovered using an average net salvage allowance approach, which is similar to the approach adopted for Jackson Energy.[45] Under the AG s proposal, an amount representing the 5-year average net salvage experience is added to the distribution plant remaining life depreciation expense in lieu of Fleming-

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[42] Majoros Direct Testimony at 9-10.

[43] Id. at 8-9. The AG claims that the change from a 3.03 percent composite depreciation rate to the proposed 4.07 percent rate is comprised of .11 percent related to a deficiency in the depreciation reserve and .93 percent related to future negative salvage proposals.

[44] Id. at 12.

[45] See Case No. 2000-00373, final Order dated May 21, 2001, at 32-34.

Mason s proposed net salvage ratios. This amount should be prorated to the accounts in proportion to actual net salvage experience. The AG recommends this approach for at least the next 5 years, at which time another depreciation study could be conducted.[46]

Fleming-Mason has not offered comments on nor expressed concerns about the AG s depreciation proposal.[47]

The Commission agrees with the AG. While the Commission agrees that net salvage is normally recovered as part of the depreciation rates, the arguments offered by the AG are persuasive reasons for supporting a departure in this case from the normal approach. The Commission finds that it is reasonable under the circumstances in this case to use the average net salvage allowance approach proposed by the AG. This approach should be utilized until Fleming-Mason undertakes a new depreciation study.[48] The Commission finds that the distribution plant depreciation rates proposed by the AG are reasonable and should be approved. The Commission also finds the depreciation rates proposed by Fleming-Mason for general plant are reasonable and should be approved. Fleming-Mason should seek RUS approval of the depreciation rates approved by the Commission as soon as possible. Finally, the Commission finds that the conditions expressed by the AG in conjunction with the acceptance of the remaining life methodology are reasonable and Fleming-Mason should make the adjustments to reflect the adoption of these conditions.

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[46] Majoros Direct Testimony at 12-13.

[47] T.E., May 6, 2002 at 43.

[48] The timing of a new depreciation study is discussed later in this Order.

Based on these findings, the Commission has determined that Fleming-Mason s depreciation expense should be increased by $307,323. This increase includes $229,800 for the average net salvage allowance. The Commission also finds that the transportation clearing account should be increased by $14,315. After applying the test-year capitalization rate of 39.0 percent, the increase in transportation clearing account expense would be $8,732.

Rate Case Expense

Fleming-Mason estimated its rate case expense at $33,000. It proposes to recover this expense through a 3-year amortization. This estimate did not include in-house labor. Throughout this proceeding, Fleming-Mason has been providing updates of the actual expenses incurred in presenting this rate case. As of the February 13, 2002 update, Fleming-Mason has expended $20,139 for this rate case. The Commission finds that a 3-year amortization of these expenses is reasonable and will allow an increase in operating expense of $6,713 to reflect the first year of the amortization for rate-making purposes.

Professional Services Expense

The AG proposes to reduce Fleming-Mason s professional services expenses by $12,754. The proposed adjustment is composed of a loan application filing fee, the cost of a consolidation study with another cooperative, and several expenses paid on behalf of Fleming-Mason s attorney.[49] The AG argues that the loan application filing fee and the consolidation study costs are non-recurring items and should be excluded for rate-

[49] The attorney expenses were the provision of health insurance coverage, a subscription to a legal reporting service, a Christmas gift, and the expense of attending the KAEC annual meeting.

making purposes. The AG also notes that Fleming-Mason agrees that the consolidation study costs, as well as the health insurance and Christmas gift for its attorney, should be excluded for rate-making purposes. The AG states that the expense for the legal reporting subscription and the KAEC annual meeting should be excluded for rate-making purposes. He states that this is consistent with the Commission s treatment of these items in previous cases.[50]

The Commission agrees with the AG and has reduced Fleming-Mason s operating expenses by $12,754.

Amortization of Mapping Project

Fleming-Mason digitized its existing maps during the 1999-2000 period, incurring a cost of $90,540.[51] Believing that it was not appropriate to record the entire mapping cost in 1 month, Fleming-Mason determined the cost should be amortized over a 3-year period.[52] As of test-year end, the unamortized balance of the deferred mapping cost was $57,941.[53] The total deferred cost should be fully amortized by the end of April 2003.

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[50] Post Hearing Brief of the AG at 6-7 and Exhibit AG-5.

[51] See Response to the AG s First Data Request dated December 19, 2001, Item 48(1). The annual amortization of $30,180 multiplied by a 3-year amortization yields the $90,540.

[52] Response to the Commission Staff s Third Data Request dated January 30, 2002, Item 5. Fleming-Mason did acknowledge that while it selected a 3-year period, it could not determine the number of years of future benefit from the mapping project.

[53] Response to the AG s Second Data Request dated January 30, 2002, Item 48(2).

Noting that the mapping cost should be fully amortized by April 2003, the AG argues that the unamortized deferred mapping cost balance should be amortized over an additional 3-year period. The AG notes this approach will prevent Fleming-Mason from substantially over-recovering the mapping costs. The AG states this rate-making treatment is consistent with the Commission s decision in Case No. 2001-00092.[54] Using the unamortized mapping cost balance as of April 30, 2002, the AG recommends that Fleming-Mason s operating expenses be reduced by $20,088.[55] In response to the AG s proposal, Fleming-Mason notes that while the initial setup cost is non-recurring, there would be continuing costs associated with the operation and maintenance of the mapping system.[56]

The Commission finds the AG s arguments to be persuasive and will extend the amortization of the mapping costs an additional 3 years. The Commission has recalculated the adjustment using the unamortized balance for the mapping costs as of July 31, 2002, and determined that operating expenses should be reduced by $22,603.[57]

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[54] Case No. 2001-00092, Adjustment of Gas Rates of The Union Light, Heat and Power Company, final Order dated January 31, 2002.

[55] Post Hearing Brief of the AG, Exhibit AG-6. The AG used the unamortized balance as of April 30, 2002 because it assumed the rate case would be finalized by the end of April.

[56] T.E., May 6, 2002 at 47-48.

[57] The unamortized balance at April 30, 2002 was $30,276. The monthly amortization expense is $2,515. Deducting 3 additional months of amortization expense from the unamortized balance produces a balance of $22,731. Dividing this amount by 3 years results in an annual amortization expense of $7,577. Deducting $7,577 from the current amortization expense of $30,180 results in the reduction of $22,603.

Miscellaneous Expenses

Fleming-Mason proposes to reduce operating expenses by $14,288 to remove certain miscellaneous expenses not normally included for rate-making purposes.[58] The AG proposes an additional reduction of $1,667, based on his review of expenses recorded in the miscellaneous expense accounts.[59] Fleming-Mason has agreed that the additional items identified by the AG should not be included for rate-making purposes.[60]

The Commission agrees with the reductions proposed by Fleming-Mason and the AG. Based on a review of Fleming-Mason s miscellaneous expense accounts, the Commission has identified additional adjustments that should be made to these accounts. First, Fleming-Mason has indicated that $2,271 in expenses for employee picnics, service awards, and holiday dinners should not have been included for rate-making purposes.[61] Second, Fleming-Mason twice included in the test year the annual subscription to a human resources publication. The Commission finds it appropriate to only include the subscription once for rate-making purposes, resulting in an expense

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[58] These expenses include general advertising, scholarships, costs associated with a golf outing, various gifts, Fleming-Mason s contribution to the CFC Integrity Fund, membership dues, and sponsorship of a little league team. See Application Exhibit 11.

[59] Post Hearing Brief of the AG at 6 and Exhibit AG-4. The AG s proposal calls for the removal of annual meeting gifts, expenses for a home and garden show, and meal expenses associated with the Washington Youth Tour. The AG s brief also excluded $278 in expenses associated with meals for directors spouses; however, that adjustment has been addressed previously in this Order in conjunction with Directors Fees and Expenses.

[60] See Response to the AG s Second Data Request dated January 30, 2002, Item 24 and Response to the Commission Staff s Second Data Request dated December 21, 2001, Items 29(c) and 29(d).

[61] Response to the AG s First Data Request dated December 19, 2001, Item 52.

reduction of $299.[62] Third, the Commission identified an additional $124 in meals associated with the Washington Youth Tour, which Fleming-Mason agreed should not be included for rate-making purposes.[63] Finally, Fleming-Mason s test-year expenses reflect 4 months of costs associated with its Internet Website. The Commission believes it is reasonable to include a full 12 months of this cost for rate-making purposes. This results in an increase in expense of $280.

Based on these findings, the Commission has reduced miscellaneous expenses by $18,369.

PSC Assessment

Fleming-Mason did not propose an adjustment to its PSC Assessment to reflect the effects of its normalization of revenues and purchase power expense or the impact of its proposed revenue increase. Likewise, the AG did not propose an adjustment to the PSC Assessment to reflect the impact of its proposed adjustments or proposed revenue reduction.

The Commission has calculated an adjustment to the PSC Assessment that reflects the normalization of revenue and purchase power found reasonable in this Order and applied the current PSC Assessment rate. This calculation results in an increase in the PSC Assessment of $8,382. The Commission has also determined the

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[62] Id. The subscription appears on pages 4 and 7 of 8.

[63] Application Exhibit 11, page 3 of 6. Fleming-Mason agreed that expenses on page 5 of 6 of this exhibit labeled as annual meeting meals were actually associated with the Washington Youth Tour. An entry on page 3 of 6 identified as annual meeting meals has the same transaction date, document reference number, and payee as the entry on page 5 of 6. Thus, it is concluded that both entries relate to expenses associated with the Washington Youth Tour.

impact of the revenue increase granted herein and provided for an additional PSC Assessment expense of $820.

Pro Forma Adjustments Summary

The effect of the pro forma adjustments on Fleming-Mason s net income is as follows:

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$34,081,497	$ 2,316,600	$36,398,097
Operating Expenses	32,346,805	1,941,495	34,288,300
Net Operating Income	1,734,692	375,105	2,109,797
Interest on Long-Term Debt	1,075,600	189,482	1,265,082
Other Income and (Deductions) Net	(707,117)	696,300	(10,817)
NET INCOME	$ (48,025)	$ 881,923	$ 833,898

REVENUE REQUIREMENTS

Revenue Increase

The actual rate of return earned on Fleming-Mason s net investment rate base established for the test year was 2.61 percent. Fleming-Mason requests rates that would result in a Times Interest Earned Ratio (TIER) excluding GTCCs of 2.00X and a rate of return of 6.50 percent on its proposed rate base of $38,902,642. Fleming-Mason proposes an increase in revenues of $1,205,406 to achieve the 2.00X TIER excluding GTCCs.

The AG proposes that Fleming-Mason s revenues should be reduced by $203,535. The AG s proposal was not determined using the TIER approach. Rather, the AG started with Fleming-Mason s proposed increase of $1,205,406 and reflected

the effects of eight adjustments on the proposed increase, which results in the AG s proposed reduction of $203,535.[64]

Fleming-Mason s actual TIER excluding GTCCs for the test period was 0.96X. For the calendar years 1999 and 2000, it was 1.57X and 0.87X, respectively. After taking into consideration pro forma adjustments, Fleming-Mason would achieve a 1.66X TIER excluding GTCCs without an increase in revenues. Fleming-Mason s equity to total capitalization ratio is 32.31 percent based on the approved capital structure.

Revenue requirements calculated to produce a TIER excluding GTCCs of 2.00X should be approved. To achieve the 2.00X TIER, Fleming-Mason should be allowed to increase its annual revenues by $432,003. This increase includes an additional $820 to reflect the associated increase in Fleming-Mason s PSC Assessment. This additional revenue should produce net income of $1,265,081, which should be sufficient for Fleming-Mason to meet its mortgage requirements and service its mortgage debts.

PRICING AND TARIFF ISSUES

Cost of Service and Revenue Allocation

Fleming-Mason filed a cost-of-service study (COSS) for the purpose of determining the cost to serve and related revenue requirements for each rate class. The results of the COSS showed that Fleming-Mason s industrial classes were generating sufficient revenues while its other customer classes were not. Having reviewed the COSS proposed by Fleming-Mason, the Commission finds it acceptable to be used as a guide in allocating the revenue increase awarded herein.

[64] Post Hearing Brief of the AG, Exhibit AG-1.

Fleming-Mason proposed a base-rate revenue increase of $1,205,406 or 3.7 percent, with class revenue increases of 7.8 percent for residential and small power (RSP), 4.6 percent for electric thermal storage (ETS), and 7.7 percent for outdoor lighting service (OLS) and all-electric schools (AES). Fleming-Mason proposed no increase in rates for industrial customers. Following the allocation approach proposed by Fleming-Mason, the base-rate revenue increase of $432,003, or 1.17 percent, awarded herein results in class increases of 3.8 percent for RSP, 3.0 percent for OLS and 2.9 percent for AES. In its data response to the AG, Fleming-Mason acknowledged that the ETS customers shown on Exhibit 17 of its application were actually seasonal customers, not ETS customers, which results in a zero percent revenue increase for the ETS class.[65]

Rate Design

Generally, within its various customer classes, Fleming-Mason proposed to assign larger percentage increases to customer charges than energy charges. Based on Fleming-Mason s COSS and in order to promote revenue stability, the Commission will increase customer charges and energy charges in the manner proposed by Fleming-Mason, adjusted downward, proportionately, to generate the revenue increase approved herein. The ETS energy charge will be set at 60 percent of the energy charge for the RSP customer class. The rate changes approved for customer classes RSP, ETS, OLS and AES are shown in Appendix A of this Order.

[65] Response to the AG s Second Data Request dated January 30, 2002, Item 1.

OTHER ISSUES

Discontinuance of Required Capital Credit Rotation

Under the terms of the 1990 Settlement Agreement reached in Fleming-Mason s last general rate case, Case No. 1990-00081, all total margins in excess of a 2.00X TIER are to be used to retire capital credits to Fleming-Mason s members. The revenue requirements established in that Settlement Agreement were based on a 2.50X TIER.

Fleming-Mason now requests that this provision of the Settlement Agreement be eliminated because it finds the provision to be contrary to its intent to refund capital credits to its members. This is due to the constraints within its mortgage agreement with the RUS that require Fleming-Mason to have a Current Ratio above 1.0 before capital credits are refunded. The Current Ratio is the ratio of current assets to current liabilities. Fleming-Mason also notes that the margins earned in future years will be needed to restore its financial stability, after years of declining margins. The continuation of the required rotation would not permit Fleming-Mason to devote future years margins to the restoration of its financial stability. The AG has not expressed an opinion on the discontinuation of the required capital credit rotation.

Fleming-Mason s financial performance over the past 3 calendar years has been deteriorating. The net margins, rate of return on rate base, achieved TIER, and debt service coverage ratio have all been declining.[66] The Commission finds that, under the current circumstances, it is reasonable to eliminate the requirement that all margins in excess of a 2.00X TIER be used to retire capital credits to members. In this proceeding Fleming-Mason has requested, and the Commission is authorizing, a TIER of 2.00X.

[66] Application Exhibit K.

The revenue requirement approved in this Order is not designed to generate revenues in excess of a 2.00X TIER.

By eliminating this provision of the Settlement Agreement, the Commission reminds Fleming-Mason that it still has the obligation to retire capital credits to its members as it is financially able to do so. Addressing this obligation should be an integral part of Fleming-Mason s comprehensive equity management plan, which is discussed later in this Order.

Future Depreciation Study

Both Fleming-Mason s and the AG s depreciation experts acknowledge that continued review and periodic revisions are normally required to maintain continued use of appropriate annual depreciation accrual rates. Both experts also indicate that new depreciation studies should be performed approximately every 5 years. In addition, it is hoped that Fleming-Mason s net salvage data will be more complete by that time, and that any study would be able to incorporate a net salvage component into the depreciation rates recommended. The Commission finds that Fleming-Mason should undertake a new depreciation study that should be completed no later than July 2007.

Accumulated Depreciation Accounting Records

Fleming-Mason maintains its accumulated depreciation accounts using two approaches. Distribution plant accumulated depreciation is maintained at the functional level of detail, while general plant accumulated depreciation is maintained at the account level of detail. The lack of account level detail for the distribution plant accumulated depreciation contributed to some of the concerns raised by the AG relating to Fleming-Mason s depreciation study. Fleming-Mason has agreed that maintaining

the distribution plant accumulated depreciation at the account level would provide more accurate information and noted that it would not be difficult to keep the accumulated depreciation at the account level.[67]

The majority of Fleming-Mason s accumulated depreciation account balance is related to distribution plant. The RUS Uniform System of Accounts only requires accounting records be maintained at the functional level, but does not prohibit a cooperative from keeping more detailed information. In addition, under the approach utilized in the calculation of CATV Attachment rates, it is necessary to have the accumulated depreciation available for specific distribution plant accounts.

The Commission finds that Fleming-Mason should adjust its accounting system and should begin maintaining the accumulated depreciation balances at the account level. The Commission realizes that conversion from the functional level to the account level will require some effort on the part of Fleming-Mason. However, the Commission believes it is reasonable to maintain this important accounting information at this level of detail. The Commission also finds that Fleming-Mason should submit a report showing its conversion of the distribution plant accumulated depreciation balances from the functional level to the account level. The report should include all assumptions and rationale used to develop the account level balances. This report should be submitted to the Commission within 6 months of the date of this Order.

[67] Response to the Commission Staff s Third Data Request dated January 30, 2002, Item 27 and T.E., May 6, 2002 at 42-43.

As the Commission stressed in Jackson Energy s last rate case Order,[68] Fleming-Mason is not being singled out for this requirement. The Commission believes that all cooperatives under its jurisdiction should keep accumulated depreciation balances at the account level. The Commission does not believe this to be an unreasonable requirement given the level of computerization available to the cooperatives. This level of detail will be necessary for any cooperative planning to revise its CATV Attachment rates.

Equity Management Plan

Fleming-Mason adopted a revised equity management plan on March 7, 2002.[69] Fleming-Mason s previous equity management plan had not been reviewed since June 6, 1985. However, the previous equity management plan focused exclusively on the retirement of capital credits to members and to deceased members estates.[70] It did not address appropriate equity levels, targeted earnings levels, or the overall management of Fleming-Mason s equity.[71] The revised equity management plan, Policy No. 52, does address these subjects as well as the development of a flexible capital credit rotation program. While the revised equity management plan is an improvement over the previous version, the Commission notes that the revised plan:

a) Does not state when Fleming-Mason should have its long-range financial plan and goals established;

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[68] See Case No. 2000-00373, May 21, 2001 Order at 49-50.

[69] Response to Information Requested at Public Hearing May 6, 2002, Item 3.

[70] Application Exhibit 21, Operating Policy Nos. 27 and 28.

[71] Response to the Commission Staff s Second Data Request dated December 21, 2001, Item 33.

b) Does not provide for the long-range financial plan and goals to be updated periodically;

c) Does not state when Fleming-Mason should have the flexible capital credit rotation program in place; and

d) Does not provide for an annual financial study and review of the equity and capital management performance.

The Commission believes these deficiencies in Fleming-Mason s revised equity management plan should be addressed as soon as possible. While the Commission realizes that the development and implementation of a comprehensive equity management plan is not accomplished overnight, prompt action on the equity management plan should promote the financial stability of Fleming-Mason. Therefore, the Commission finds that Fleming-Mason should address the four deficiencies noted in the March 7, 2002 equity management plan within 3 years of the date of this Order or by the filing of its next rate case, whichever occurs first. Within 10 days of adoption, Fleming-Mason should file a copy of the modified Policy No. 52 and the capital credit rotation program. In addition, the Commission finds that Fleming-Mason should include with its annual financial report filed with the Commission a status report addressing its compliance with Policy No. 52. This status report should indicate the completion date of its most recent long-range financial plan, its most recent long-range financial goals, and the results of its most recent annual financial study and review of the equity and capital management performance. This status report should be filed along with the annual reports for calendar years 2003, 2004, and 2005.

Industrial Park Debt Service Loans

Since 1996, Fleming-Mason has operated a program where it pays the debt service on loans for several industrial parks in its service territory.[72] Under this program, Fleming-Mason agrees to pay the debt service for the industrial park site up to $400,000 for a 3-year period or until the site is sold. At the time of sale or expiration of the 3 years, Fleming-Mason is to be reimbursed for the amount of debt service payments made on behalf of the industrial parks. East Kentucky participated in this program with Fleming-Mason by sharing in the funding of the debt service, but discontinued its participation in 2002.[73] The debt service loans are evidenced by a letter from Fleming-Mason to the industrial park authority or other appropriate entity, outlining the general terms of the loan and the uses of the debt service coverage funding. While the program is to provide debt service coverage for only 3 years, Fleming-Mason has on occasion extended the term of the program, usually in 1-year increments. Through April 2002, Fleming-Mason has debt service loan payments totaling $82,273 and has received $28,508 in reimbursements from East Kentucky.[74]

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[72] Fleming-Mason has industrial park debt service loans outstanding with the Flemingsburg Fleming County Industrial Park III, the Flemingsburg Fleming County Industrial Park Speculative Industrial Building, the Maysville Mason County Industrial Park III, and the Lewis County Industrial Park.

[73] The first industrial park debt service loan was made to Morehead/Rowan County Economic Development Council in August 1996. East Kentucky provided 60 percent of the funding and Fleming-Mason provided 40 percent. See Response to Information Requested at Public Hearing April 16, 2002, Item 2, page 2 of 5. For subsequent loans, East Kentucky provided 50 percent of the funding and Fleming-Mason 50 percent. However, East Kentucky ended its assistance with the debt service loans in calendar year 2002. See T.E., April 16, 2002 at 18-20.

[74] See Application Exhibit 9, page 6 of 6 and Response to Information Requested at Public Hearing April 16, 2002, Item 4.

Generally, the Commission is supportive of economic development programs like the debt service loan program administered by Fleming-Mason. These programs not only encourage the economic development efforts in the cooperative s service territory, but also allow the cooperative to develop a wider diversification of its membership and improvement of its load factor. Programs like the debt service loan program allow Fleming-Mason to partner with other entities working for the overall improvement of the economy in its service territory.

However, the Commission has two problems with the current debt service loan program as administered by Fleming-Mason. First, the documentation of the debt service loans does not appear to adequately protect the interests of Fleming-Mason and its members. The documentation of the debt service loans is a letter signed only by the President and Chief Executive Officer of Fleming-Mason. There are no signatures on behalf of the industrial authority or of any other entity guaranteeing the repayment of the loans. While the debt service loan letter discusses the terms of the loan in general terms, it lacks specific details. For example, the letter does not discuss whether the loan can be extended beyond the initial 3-year period, exactly how and when repayment is to be made, or what legal recourse exists for Fleming-Mason if the industrial park does not make the required repayment within the scheduled time frame.

Second, through its debt service loan program, Fleming-Mason is assuming the debt service obligations of the industrial park authorities. KRS 278.300(1) states, No utility shall issue any securities or evidences of indebtedness, or assume any obligation or liability in respect to the securities or evidences of indebtedness of any other person until it has been authorized so to do by order of the commission. Fleming-Mason has

neither sought nor been granted the authority to issue these industrial park debt service loans.

While being supportive of economic development efforts by cooperatives, the Commission cannot ignore the fact that Fleming-Mason did not seek Commission approval of the debt service loan program or the fact that Fleming-Mason and its members do not appear to be adequately protected. The Commission finds that Fleming-Mason s current debt service loan program must be suspended. The Commission understands that Fleming-Mason is obligated under some current loans and must continue those loan payments until their expiration. However, effective on the date of this Order, Fleming-Mason should not extend or renew any existing debt service loans, nor commit to any new debt service loans.[75] Within 30 days from the date of this Order, Fleming-Mason should provide the Commission with a schedule of the outstanding debt service loans, identifying the industrial park authority, listing the total amount advanced to the industrial park authority, and stating the expiration date of each debt service loan. If Fleming-Mason has extended or renewed an existing debt service loan or authorized a new debt service loan since April 2002, it should provide copies of all documentation associated with that debt service loan, including copies of the board of directors minutes authorizing the action.

[75] Based on information provided by Fleming-Mason, the existing debt service loans as currently authorized expire on the following dates: Flemingsburg Fleming County Industrial Park III expired December 2001; Flemingsburg Fleming County Industrial Park Speculative Industrial Building expired in July 2002; Maysville Mason County Industrial Park III should expire in November 2002; and Lewis County Industrial Park expired January 2002.

If Fleming-Mason desires to resume this program, it must file an application seeking approval of the debt service loan program with the Commission. If such an application is filed, Fleming-Mason must address the concerns the Commission has expressed about the documentation of the loans.

Service Corp. Activities

Fleming-Mason formed Service Corp. in November 1997 with the intention of providing wireless broadband Internet services (wireless broadband). In January 1998, Service Corp. established a $375,000 secured line of credit from the National Cooperative Services Corporation (NCSC). This line of credit was increased to $750,000 in July 1999.[76] Fleming-Mason has executed documents that guaranteed this secured line of credit between Service Corp. and NCSC. In 1998 and 1999, Service Corp. purchased LMDS Licenses from the Federal Communications Commission at a cost of $312,227. The LMDS Licenses are being amortized for accounting purposes over a 15-year period. Service Corp. has developed a business plan, and it is anticipated that Service Corp. will begin deploying wireless broadband in the second quarter of 2002.[77]

Service Corp. s business plan includes an analysis of the wireless broadband product, the applicable market, market risks associated with wireless broadband, capital requirements, and an exit strategy. The business plan indicates that Service Corp.

[76] The initial NCSC line of credit had a term of 12 months. In January 1999, the term of the line of credit was increased to 60 months.

[77] Response to Information Requested at Public Hearing April 16, 2002, Item 10, page 4 of 14. Although the business plan is not dated, references contained in the plan establish that it was written in 2002. These references include the notation that Fleming-Mason, established in 1938, was celebrating its 64th anniversary.

intends to target existing Fleming-Mason customers for wireless broadband in order to capitalize on customer loyalty and name recognition. The business plan notes that the expansion and adaptation of Service Corp. s infrastructure will require substantial capital expenditures and numerous resources. The business plan acknowledges different strategies available if Service Corp. determines it needs to exit wireless broadband. The business plan notes that Service Corp. has substantial financial resources available to undertake the deployment of wireless broadband in the Fleming-Mason service territory.[78]

Service Corp. has not earned any revenue since its inception and, through December 31, 2001, had cumulative losses of $552,382.[79] Fleming-Mason accounts for its investment in Service Corp. using the equity method of accounting. Thus, the annual losses have been recognized on Fleming-Mason s income statements and appear on its balance sheet as a negative investment. Service Corp. owes $743,041 on its line of credit with NCSC.[80] In addition, through March 2002, Fleming-Mason has loaned Service Corp. $81,500 through a line of credit arrangement.[81]

Fleming-Mason did not survey its members to determine there was a need for it to provide Internet access or wireless broadband. Fleming-Mason did not notify its members that it was proposing to create Service Corp. In annual reports to its members for calendar years 1999 and 2000, Fleming-Mason did not inform its members

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[78] Id., Item 10, pages 4 through 7 of 14.

[79] Response to the AG s Second Data Request dated January 30, 2002, Item 6.

[80] Id., Item 7.

[81] Response to Information Requested at Public Hearing April 16, 2002, Item 12.

of the existence of Service Corp. or the fact that Service Corp. had incurred losses each year of its existence. Fleming-Mason noted that RUS had been encouraging electric cooperatives to provide this service to rural communities. Fleming-Mason simply determined that there was a need for wireless broadband.[82]

The AG argues that Fleming-Mason is subsidizing the non-regulated activities of Service Corp. through the guarantee of the NCSC line of credit and the funds advanced by Fleming-Mason directly to Service Corp, which he views as a violation of KRS 278.2201 and the guidelines the Commission issued in Administrative Case No. 326. The AG notes the cumulative losses incurred by Service Corp. and that those losses, coupled with the cost of the LMDS Licenses, exceed the proceeds from the NCSC line of credit. The AG concludes that under this situation, the losses are being covered by cash advances from Fleming-Mason s general operating funds. The AG also notes that Fleming-Mason has no shareholders to bear these losses and that Commission approval of the NCSC line of credit guarantee or the advances from Fleming-Mason was not sought. The AG recommends that the Commission order Fleming-Mason to divest itself of Service Corp. immediately.[83]

The Commission has numerous concerns relating to Service Corp. and the possible effects it could have on Fleming-Mason. Fleming-Mason has guaranteed Service Corp. s line of credit with NCSC. As was noted with the industrial park debt service loans, KRS 278.300(1) requires the Commission s authorization to execute such

[82] T.E., April 16, 2002 at 35-36, 38-41, and 58-59.

[83] Post Hearing Brief of the AG at 13.

a guarantee. Fleming-Mason has neither sought nor been granted the authority to be the guarantor of the NCSC line of credit.[84]

Fleming-Mason is owned by and operated for the benefit of its members. Before entering into a venture like wireless broadband, Fleming-Mason should understand how its members view the venture and ensure that the membership supports the venture being considered. It is apparent from the documentation provided in this record that Fleming-Mason made little or no attempt to ascertain what its members thought about the cooperative providing wireless broadband through a non-regulated subsidiary. After deciding to enter the wireless broadband market, Fleming-Mason s directors and management had the responsibility to keep members informed of the status of the business, even if it was in a prolonged development phase. The members of Fleming-Mason could not be expected to make informed decisions about these activities if they were not provided the information. Fleming-Mason has acknowledged that it has not kept the members informed of what was happening with Service Corp.

Diversifying cooperatives need to have a good business plan which accurately and honestly evaluates all the resources that the non-regulated business will have available. Service Corp. s business plan concludes that it has substantial financial resources. This statement does not accurately reflect the financial condition of Service Corp., which 1) has yet to earn any revenues, 2) has reached the maximum limit of borrowing on its NCSC line of credit, and 3) has borrowed funds from its parent, Fleming-Mason. It appears that the business plan is relying on the financial strength of

[84] On July 29, 2002, Fleming-Mason submitted its application to the Commission seeking approval of its guarantee of the NCSC line of credit.

Fleming-Mason when it concludes that substantial financial resources exist. KRS 278.2201 prohibits Fleming-Mason from subsidizing its non-regulated businesses.

Diversifying cooperatives need to have an exit strategy that establishes exactly what determines the success or failure of the non-regulated business and provides specific and clearly measurable benchmarks for evaluation. The exit strategy included in Service Corp. s business plan only addresses the options available if a decision is made to abandon the wireless broadband business. Fleming-Mason has not provided any evidence that it has established what constitutes success or failure for the wireless broadband venture. It also has not developed any evaluation techniques that will assist in a decision to employ one of the identified exit strategy options.

While the Commission understands the points raised by the AG, we will not adopt the AG s recommendation and order Fleming-Mason to divest itself of Service Corp. The Commission has concerns about the ability of Service Corp. to continue as a going concern and the impact a possible failure of the non-regulated business will have on Fleming-Mason s financial condition. However, those concerns do not persuade us that at this time the Commission should be ordering divestiture.

The Commission does believe that it is imperative that Fleming-Mason s member-consumers should be made aware of the situation concerning Service Corp.[85] Therefore, the Commission finds that Fleming-Mason should undertake the following actions. First, within 60 days of the date of this Order, Fleming-Mason should publish in

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[85] As noted previously in this Order, the services and functions to be provided by Kentucky Wireless have yet to be identified. However, as Kentucky Wireless is a wholly-owned subsidiary of Service Corp., the requirements discussed in this Order are equally applicable to both subsidiaries.

its monthly insert in the Kentucky Living magazine a full disclosure to its membership of its involvement in Service Corp. and Kentucky Wireless. This disclosure should be placed in a prominent location in the monthly insert and must include the following information:

- A description of the nature of Service Corp. and Kentucky Wireless;

- The amount of losses Fleming-Mason has recorded to date as a result of its investment in Service Corp. and Kentucky Wireless;

- The outstanding balance to date on the NCSC line of credit, or other lines of credit, that have been guaranteed by Fleming-Mason for Service Corp. and Kentucky Wireless; and

- The outstanding balance to date of any loans, lines of credit, or other financial advances made and extended to Service Corp. or Kentucky Wireless by Fleming-Mason.

Within 5 days of publication, Fleming-Mason should provide copies of the insert to the Commission.

Second, in subsequent annual reports to its membership, Fleming-Mason should be required to report on the status and financial condition of Service Corp. and Kentucky Wireless. This report should include:

- A discussion of Service Corp. s and Kentucky Wireless s activities since the previous report;

- The outstanding balance on any line of credit owed by Service Corp. and Kentucky Wireless that has been guaranteed by Fleming-Mason;

- The amounts owed by Service Corp. and Kentucky Wireless to Fleming-Mason; and

- The amount of any net income or net loss from Service Corp. and Kentucky Wireless recorded on Fleming-Mason s books.

In addition, beginning with the 2002 annual report filed with the Commission, Fleming-Mason should include a supplemental report that includes all the information

required to be supplied to Fleming-Mason s membership as well as the balance sheets and income statements for the subsidiaries for that reporting period.

It is the Commission s hope that an informed membership can then indicate to Fleming-Mason s board of directors and management whether it should proceed with the wireless broadband venture, as they are the ones to bear the risks of the success or failure of the venture. The Commission also expects Fleming-Mason to continue to monitor the situation concerning Service Corp. and, if conditions warrant, Fleming-Mason should consider divestiture of its wireless broadband service.

The Commission stresses that Fleming-Mason is not being singled out concerning membership disclosure. All electric cooperatives under the jurisdiction of this Commission are placed on notice that they are expected to disclose to their members the full details of any diversification into businesses that are not part of the provision of electric service. These non-regulated businesses may be established within the cooperative itself or a non-regulated subsidiary. Any cooperative undertaking such diversification has a greater responsibility to provide information to its members about these business ventures.

SUMMARY

The Commission, after consideration of the evidence of record and being otherwise sufficiently advised, finds that:

1. The rates set forth in Appendix A are the fair, just, and reasonable rates for Fleming-Mason to charge for service rendered on and after the date of this Order.

2. The rate of return and TIER granted herein are fair, just, and reasonable and will provide for Fleming-Mason s financial obligations.

3. The rates proposed by Fleming-Mason would produce revenue in excess of that found reasonable herein and should be denied.

IT IS THEREFORE ORDERED that:

1. The rates in Appendix A are approved for service rendered by Fleming-Mason on and after the date of this Order.

2. The rates proposed by Fleming-Mason are denied.

3. Fleming-Mason shall file, within 30 days of the date of this Order, its revised tariff sheets setting out the rates approved herein.

4. The depreciation rates proposed by Fleming-Mason are denied.

5. The depreciation rates proposed by the AG are approved. Fleming-Mason shall begin using these rates as of the date of this Order.

6. The conditions expressed by the AG in conjunction with the acceptance of the remaining life methodology, as discussed in this Order, are reasonable and Fleming-Mason shall make the necessary adjustments to its records to reflect the adoption of these conditions.

7. Fleming-Mason shall undertake and complete a new depreciation study no later than July 2007.

8. Within 6 months of the date of this Order, Fleming-Mason shall submit a report showing its conversion of the distribution plant accumulated depreciation balances from the functional level to the account level. The report shall include all assumptions and rationale used to develop the account level balances.

9. Fleming-Mason s request to eliminate the requirement in the Settlement Agreement adopted in Case No. 1990-00081 to use all margins in excess of 2.00X TIER to retire capital credits to members is approved.

10. Within 3 years from the date of this Order, or the filing of Fleming-Mason s next rate case, whichever occurs first, Fleming-Mason shall address the four deficiencies, as discussed in this Order, identified in its March 7, 2002 equity management plan.

11. Within 10 days of its adoption, Fleming-Mason shall file a copy of the modified Policy No. 52 and its capital credit rotation program.

12. As a supplement to its Annual Reports for 2003, 2004, and 2005, Fleming-Mason shall file a status report addressing its compliance with Policy No. 52. The status reports shall be prepared as described in this Order.

13. Fleming-Mason shall not extend or renew any existing debt service loans nor commit to any new debt service loans without prior approval by the Commission.

14. Within 30 days of the date of this Order, Fleming-Mason shall file with the Commission a schedule of its outstanding industrial park debt service loans. The schedule shall be prepared as described in this Order.

15. Within 60 days of the date of this Order, Fleming-Mason shall publish in its monthly insert in the Kentucky Living magazine a full disclosure to its membership of its involvement in Service Corp. and Kentucky Wireless. This disclosure shall be placed in a prominent location in the monthly insert and include the information discussed in this Order. In addition, within 5 days of its publication, Fleming-Mason shall provide copies of the insert to the Commission.

16. In subsequent annual reports to its membership, Fleming-Mason shall report on the status and financial condition of Service Corp. and Kentucky Wireless. The report shall be prepared as described in this Order.

17. Beginning with its 2002 Annual Report, Fleming-Mason shall include a supplemental report that contains balance sheets and income statements for Service Corp. and Kentucky Wireless for that calendar year, as well as the information required to be supplied to Fleming-Mason s membership on an annual basis.

Done at Frankfort, Kentucky, this 7th day of August, 2002.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2001-00244 DATED AUGUST 7, 2002

The following rates and charges are prescribed for the customers in the area served by Fleming-Mason Energy Corporation. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order.

SCHEDULE RSP
RESIDENTIAL AND SMALL POWER

Monthly Rate:

Customer Charge	$6.26/meter
Energy Charge	5.371c/kwh

SCHEDULE RSP-ETS
ELECTRIC THERMAL STORAGE

Monthly Rate:

Energy Charge	3.223c/kwh

SCHEDULE AES
ALL ELECTRIC SCHOOL

Monthly Rate:

Customer Charge	$56.77
Energy Charge	4.967c/kwh

SCHEDULE OLS

OUTDOOR LIGHTING SERVICE

Monthly Rate:

Mercury Vapor	
7,000 Lumens-Standard	$ 5.82
7,000 Lumens-Ornamental	$14.47
20,000 Lumens-Standard	$10.94
20,000 Lumens-Ornamental	$18.45
High Pressure Sodium	
9,500 Lumens-Standard	$ 6.08
9,500 Lumens-Ornamental	$13.56
9,500 Lumens-Directional	$ 6.16
22,000 Lumens-Standard	$ 8.26
22,000 Lumens-Ornamental	$15.76
22,000 Lumens-Directional	$ 8.08
50,000 Lumens-Standard	$11.88
50,000 Lumens-Ornamental	$18.98
50,000 Lumens-Directional	$11.58

NON-RECURRING CHARGES

Return Check	$15.00
Meter Reading	$25.00
Collection	$25.00
Installation and reconnect	$25.00
Overtime	$65.00
Meter Tests	$25.00

CATV ATTACHMENTS

Two-Party Pole Attachments	$4.23/yr.
Three-Party Pole Attachments	$3.68/yr.
Two-Party Anchor	$6.38/yr.
Three-Party Anchor	$4.21/yr.
Two-Party Anchor	$0.26/yr.
Three-Party Anchor	$0.16/yr.