COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

GENERAL ADJUSTMENT OF ELECTRIC RATES OF EAST KENTUCKY POWER COOPERATIVE, INC.	)))	CASE NO. 2006-00472

O R D E R

East Kentucky Power Cooperative, Inc. ("EKPC") is a cooperative corporation organized under the provisions of KRS Chapter 279 and generates and transmits electric energy for sale at wholesale to 16 rural electric cooperative corporations ("RECC") that are principally engaged in the distribution of electric energy. The 16 distribution cooperatives ("16 member systems") are the sole members of EKPC and, as such, have an ownership interest in EKPC.[1] The 16 member systems purchase their power requirements from EKPC and distribute the power to approximately 502,000 retail customers in 89 counties in central and eastern Kentucky.

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[1] The 16 member systems are Big Sandy RECC, Blue Grass Energy Cooperative, Clark Energy Cooperative, Cumberland Valley Electric, Farmers RECC, Fleming-Mason Energy Cooperative, Grayson RECC, Inter-County Energy Cooperative, Jackson Energy Cooperative, Licking Valley RECC, Nolin RECC, Owen Electric Cooperative, Salt River Electric Cooperative, Shelby Energy Cooperative, South Kentucky RECC, and Taylor County RECC.

BACKGROUND

On November 13, 2006, EKPC filed notice of its intent to apply for an increase in its wholesale electric rates utilizing a historic test period.[2] On January 29, 2007, EKPC filed its application in which it sought an increase in wholesale electric rates of $43,364,219, an increase of 6.56 percent. EKPC requested that the proposed rate increases become effective on April 1, 2007 or, in the event that the Commission denied its request for interim rate relief, that the rates become effective on March 1, 2007. EKPC's application was found to be deficient and on February 6, 2007 it supplemented its application to cure the cited deficiencies and requested a deviation from the Commission's filing regulations. In its February 13, 2007 Order, the Commission granted the requested deviation, determined that the cited deficiencies were cured, declared EKPC's application to be filed as of February 6, 2007, and accepted EKPC's proposed effective date of April 1, 2007.

The Commission's March 27, 2007 Order found that additional proceedings were necessary to determine the reasonableness of the proposed rates and that the investigation could not be completed by April 1, 2007. The Commission, pursuant to KRS 278.190(2), suspended the proposed rates for 5 months up to and including August 31, 2007.

The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"), Kentucky Industrial Utility Customers, Inc. ("KIUC"),

[2] The November 13, 2006 notice stated that EKPC intended to file its application on or after December 11, 2006. However, on December 8, 2006, EKPC submitted a revised notice stating it would file its application sometime in early 2007 to support an April 1, 2007 effective date.

and the Cumberland Chapter of the Sierra Club ("Sierra Club") requested and were granted full intervention.

Following a hearing on March 22, 2007 on EKPC's request to place rates into effect during the pendency of the suspension period, the Commission found that EKPC would experience a material credit and operational impairment unless interim rate relief was granted. Accordingly, the Commission granted EKPC an interim increase in its base rates of $19.0 million on an annualized basis for service rendered on and after April 1, 2007. While we note that three parties to the proceeding reached a settlement and entered into a written agreement that called for an interim increase of $19.0 million, the agreement was not unanimous. As such, the Commission could not and did not approve or adopt the non-unanimous settlement agreement. We did, however, based on our review of the record accepted EKPC's judgment that a $19.0 million interim increase was reasonable.[3]

The interim rate relief was to be collected subject to refund and, if EKPC ultimately collected more revenue under the interim rates than it was authorized to collect under permanent rates established at the end of this proceeding, EKPC would refund the difference with interest.[4] The interim increase was to be allocated to the individual sections of EKPC's wholesale rate schedule on the same percentage basis

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[3] April 1, 2007 Order at 11-12. Contrary to assertions made by EKPC during this proceeding, the Commission did not set the interim increase at $19.0 million based "on a determination that the amount of the increase agreed among EKPC, the AG, and KIUC was reasonable." See Joint Post-Hearing Brief of EKPC, the AG, and KIUC on General Revenue Requirements and Rate Design at 4.

[4] April 1, 2007 Order at 13.

and according to the same rate design methodology as in the proposed tariffs filed in EKPC's application.[5]

On April 18, 2007, the Commission issued a procedural schedule that provided for discovery, intervenor testimony, rebuttal testimony, and a public hearing.[6] On August 31, 2007, EKPC, the AG, and KIUC filed with the Commission a Joint Stipulation and Recommendation ("Joint Stipulation") that addressed the revenue requirements and rate design issues in this proceeding. The Joint Stipulation provided for an additional annual increase in revenues of $19.5 million over the interim increase of $19.0 million, for a total increase of $38.5 million, effective for service rendered no earlier than November 1, 2007 and no later than January 1, 2008. The Joint Stipulation also included a recommended change in the rate design that had been negotiated by EKPC, the AG, and KIUC. However, the Joint Stipulation was not unanimous, as it did not resolve issues raised by the Sierra Club and the Sierra Club was not a signatory to the document.

A public hearing was held on September 5, 2007. All parties filed written briefs on October 5, 2007.[7] All information requested at the public hearing has been filed and the case now stands submitted for a decision.

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[5] Id. at 14.

[6] The April 18, 2007 procedural schedule was amended on June 29, 2007 and July 6, 2007 to change the dates for the filing of intervenor testimony and EKPC's rebuttal testimony.

[7] EKPC, the AG, and KIUC filed a Joint Brief on the revenue requirements and rate design issues. EKPC also filed a separate brief on October 5, 2007 addressing the recommendations of the Sierra Club.

TEST PERIOD

EKPC proposed the 12-month period ending September 30, 2006 as the test period for determining the reasonableness of its proposed wholesale electric rates. The Commission finds the use of the 12-month period ending September 30, 2006 as the test period in this proceeding is reasonable. In utilizing a historic test period, the Commission has given full consideration to appropriate known and measurable changes.

RATE BASE

EKPC proposed a net investment rate base ("rate base") of $1,883,596,862.[8] The AG, KIUC, and the Sierra Club did not propose a rate base for EKPC. EKPC determined its rate base starting with the test-year-end balances for plant in service; construction work in progress ("CWIP"); the 13-month average for materials and supplies, prepayments, and fuel stock;[9] accumulated depreciation; and a cash working capital allowance based on one-eighth of operating and maintenance ("O&M") expenses.[10] EKPC then made several adjustments to the balances. Plant in service was adjusted to reflect EKPC's proposed post-test-year fixed asset additions,[11] net of associated plant retirements. CWIP was adjusted to reflect post-test-year additions for

[8] Application Exhibit K, page 2 of 5.

[9] Fuel Stock includes balances for limestone and emission allowances.

[10] O&M expenses are exclusive of depreciation, taxes, interest on long-term debt, and other deductions.

[11] The post-test-year fixed asset additions include four substation projects, one coal handling facility, and one high voltage transmission line. All the projects were placed into service by March 2007.

on-going construction projects and the allowance for funds used during construction ("AFUDC") associated with those projects, net of the proposed post-test-year fixed asset addition.[12] Accumulated depreciation was adjusted to reflect all proposed adjustments to depreciation expense[13] and the plant retirements associated with the post-test-year fixed asset additions. The cash working capital allowance was adjusted to reflect the affects of all proposed adjustments to O&M expenses.

The Commission agrees with EKPC's proposed adjustments with the following exceptions. The inclusion of post-test-year additions to CWIP for on-going construction projects and the associated AFUDC adjustment is not consistent with the matching principle. A historic test period normally is not adjusted to reflect post-test-period plant adjustments unless all revenues, expenses, rate base, and capital items have been adjusted to reflect the same time periods. EKPC has proposed to include the post-test-year additions to CWIP for on-going construction projects and the associated AFUDC for 6 months beyond test-year-end without updating its revenues, expenses, and capital items to the same time period. Consequently, the Commission finds this adjustment is not reasonable and will not include it in the determination of EKPC's rate base. The Commission will include the post-test-year fixed asset additions in the rate base,[14] as

[12] The post-test-year fixed asset additions are reflected as a reduction to CWIP and an addition to plant in service.

[13] The proposed adjustments to depreciation expense include annualization of test-year depreciation expense, recognition of changes in depreciation rates, depreciation expense on the post-test-year fixed asset additions, and the removal of depreciation expense associated with affiliate activities.

[14] The Commission notes that the actual fixed asset balances have been included in the determination of the rate base. EKPC had based its adjustment on estimated balances.

this adjustment is consistent with the matching principle since the fixed asset additions were already reflected in the capital items and EKPC updated its revenues and expenses associated with the fixed asset additions.

Concerning the cash working capital allowance, the Commission has adjusted the included amount to reflect the accepted pro forma adjustments to O&M expenses as discussed later in this Order.

In 2005 the Commission approved an environmental compliance plan for EKPC and authorized an environmental surcharge mechanism. An environmental surcharge provides eligible electric utilities with the opportunity to recover certain environmental costs and to earn a return on qualifying environmental control-related investments that are not reflected in existing base rates. Because the environmental surcharge is limited to plant and expenses not already included in existing rates, it is a stand-alone cost recovery mechanism.

In its application, EKPC did not exclude any rate base items, revenues, or expenses associated with its environmental surcharge from the determination of base rate revenue requirements. EKPC stated that it did not eliminate the effect of the environmental surcharge revenues or environmental surcharge-related expenses from the filing under the assumption that the environmental surcharge revenues cover the related costs for the test year as well as on an on-going basis.[15] EKPC argued that the only adjustment required for excluding the environmental surcharge from book data is the synchronization adjustment it proposed in its application and that this position is in compliance with KRS 278.183(2). EKPC contended that by including the same level of

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[15] Response to KIUC's First Data Request dated February 19, 2007, Item 3.

environmental surcharge per book revenues and environmental surcharge costs in the determination of base rates, the effect of the surcharge is effectively eliminated.[16] However, EKPC concurred that if the environmental surcharge were to be excluded, the approach the Commission utilized in Case Nos. 1998-00426[17] and 1998-00474[18] was appropriate.[19]

The Commission finds that EKPC's approach to handling the environmental surcharge in this proceeding is inappropriate and inconsistent with previous Commission decisions. As the environmental surcharge is a stand-alone cost recovery mechanism, it is not appropriate to include the environmental surcharge revenues and expenses in the determination of base rates. If the environmental surcharge-related revenues are not excluded, the determination of base rate earnings will be over-stated. If the environmental surcharge-related expenses are not excluded, EKPC would recover these costs twice: through base rates and the monthly surcharge rate.

Therefore, the Commission will exclude EKPC's environmental surcharge-related rate base items, revenues, and expenses from the determination of the base revenue

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[16] Response to the Commission Staff's Fourth Data Request dated May 30, 2007, Item 2.

[17] Case No. 1998-00426, Application of Louisville Gas and Electric Company for Approval of an Alternative Method of Regulation of Its Rates and Service, final Order dated January 7, 2000, at 60-62 and 77.

[18] Case No. 1998-00474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of Its Rates and Service, final Order dated January 7, 2000, at 56-58 and 74-75.

[19] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 5.

requirements in this proceeding. This exclusion will require adjustments to EKPC's rate base and capitalization. Appendix A to this Order details the amounts to be excluded.

Based upon the previous findings, we have determined EKPC's rate base for rate-making purposes as of September 30, 2006 to be as follows:

Utility Plant in Service	$1,855,408,638
CWIP	279,973,432
Total Plant in Service	$2,135,382,070
Add:	
Materials and Supplies	32,721,924
Prepayments	1,700,755
Fuel Stock	44,499,883
Cash Working Capital Allowance	36,455,485
Subtotal	$ 115,378,047
Deduct:	
Accumulated Depreciation	$ 756,112,778
RATE BASE	$1,494,647,339

CAPITALIZATION

EKPC's capitalization as of test-year end was $1,715,235,531,[20] consisting of $91,985,974 in equity and $1,623,249,557 in long-term debt. The debt balance reflects the inclusion of a sick leave reserve of $1,987,718.

The Commission finds EKPC's test-year-end capitalization for rate-making purposes to be $1,498,826,722, consisting of $91,985,974 in equity and $1,406,840,748 in long-term debt. The Commission has excluded the sick leave reserve from the debt balance, as this reserve does not reflect loans or notes payable. As discussed previously in this Order, EKPC's investment in environmental assets has been excluded. The Commission has normally made adjustments to capitalization by allocating the adjustment on a pro rata basis to all capital components, unless good

[20] Application Exhibit K, page 2 of 5.

cause existed to allocate to a specific component. The Commission believes such cause exists and has removed EKPC's environmental asset investment from the long-term debt component of the capitalization. The rate of return on rate base utilized in the environmental surcharge reflects only a debt component. If the environmental investment were removed on a pro rata basis, it would treat these investments as if the rate of return used in the environmental surcharge mechanism reflects both a debt and equity component. Therefore, it is appropriate to adjust only the debt component of EKPC's capitalization. The calculation of the capitalization is shown on Appendix A.

REVENUES AND EXPENSES

For the test year, EKPC reported negative net margins of $47,655,661.[21] EKPC proposed a series of adjustments to revenues and expenses to reflect more current and anticipated operating conditions, resulting in an adjusted negative net margin of $6,214,067.[22]

Neither the AG nor the Sierra Club filed testimony concerning EKPC's revenue requirement or proposed adjustments to EKPC's revenues and expenses. At the hearing, the Sierra Club stated its belief that the revenue increase granted to EKPC should be augmented by approximately $1.5 million per year to enable EKPC to significantly expand its energy efficiency programs for customers and come closer to what the Sierra Club believes to be EKPC's least-cost expansion plan. The Sierra Club indicated that it would support at least an increase of $38.5 million plus the additional

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[21] Application Exhibit F, page 1 of 4.

[22] Id., page 4 of 4.

increment of $1.5 million that would be dedicated to demand-side management programs.[23]

KIUC recommended that the Commission continue the $19.0 million interim increase on a permanent basis.[24] KIUC noted that EKPC had actually failed to justify any permanent increase, based upon KIUC's correction of various errors, removal of various inappropriate or improperly computed adjustments, and updating the application to reflect actual results through March 2007.[25] However, KIUC based its recommendation on extenuating factors it believes the Commission should consider in addition to the test-year data. KIUC considered extenuating factors such as whether EKPC will be able to meet its Times Interest Earned Ratio ("TIER") and Debt Service Coverage Ratio ("DSC") requirements for 2007 and 2008, whether EKPC could avoid or delay another base rate increase in 2008 given the likelihood of a base rate increase when the Spurlock 4 generating station goes into service in 2009, and that EKPC's financial budgets and forecasts indicate that expenses will continue to grow and outpace revenue growth as EKPC completes the construction of the Spurlock 4 generating station.[26]

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[23] Transcript of Evidence ("T.E."), September 5, 2007, at 95-96. The Sierra Club was not a signatory to the non-unanimous Joint Stipulation.

[24] Kollen Direct Testimony at 4. KIUC stated that based on its analysis of the application, a rate reduction was indicated and KIUC provided its analysis that supported a rate reduction. However, as KIUC's recommendation was to make the $19.0 million interim revenue increase permanent, the merits and reasonableness of the various adjustments included in KIUC's analysis will not be addressed in this Order.

[25] Kollen Direct Testimony at 4-5.

[26] Id. at 5.

The Commission finds that 13 of the adjustments proposed in EKPC's application are reasonable and should be accepted. These 13 adjustments are set forth in detail in Appendix B.

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

Synchronization of Revenues

EKPC proposed a net reduction in its test-year revenues of $159,157 to reflect the synchronization of its Fuel Adjustment Clause ("FAC") revenues and environmental surcharge revenues included in the test year with the corresponding revenues in the expense month of the test year. The adjustment also recognized the normalization of test-year base rate revenues.

As discussed previously in this Order, the Commission has found that environmental surcharge revenues must be excluded from the determination of base revenue requirements in this proceeding. Utilizing information contained in the monthly environmental surcharge filings,[27] the Commission has determined that EKPC's electric energy revenues should be reduced $57,472,974. In addition, a portion of EKPC's monthly environmental surcharge revenue requirement is allocated to its off-system sales. Utilizing the monthly surcharge allocation factors, the Commission has determined that off-system sales revenues should be reduced $593,637 to reflect the exclusion of the environmental surcharge. Therefore, the Commission finds that EKPC's operating revenues should be reduced $58,066,611 to reflect the exclusion of environmental surcharge revenues.

[27] Response to KIUC's First Data Request dated February 19, 2007, Item 2.

The FAC, as prescribed by 807 KAR 5:056, permits electric utilities to recover increases in fuel costs each month subject to later scrutiny by the Commission. The monthly FAC adjustment factor is the result of comparing the current fossil fuel expenses divided by the current sales with a base period level of fossil fuel expenses divided by a base period level of sales. Like the environmental surcharge, the FAC is a stand-alone cost recovery mechanism. Consequently, FAC revenues and expenses should be excluded from the determination of the base revenue requirement in this proceeding. The Commission has determined and finds that EKPC's operating revenues should be reduced by $90,993,304.[28]

The Commission has reviewed the components of EKPC's proposed revenue synchronization adjustment related to base revenues and agrees that an adjustment is necessary. Utilizing the data supplied with the proposed adjustment, the Commission has determined and finds that operating revenues should be reduced $263,505.[29]

Environmental Surcharge-Related Expenses

As previously discussed in this Order, the Commission has found that expenses related to EKPC's environmental surcharge should be excluded from the determination of base revenue requirements in this proceeding. The Commission has determined that the 12-month balances for expenses recovered through the environmental surcharge

[28] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 3.

[29] Application Exhibit F, Schedule 1. The adjustment was determined by comparing the base rate revenues, load center and metering point revenues, and buy-through revenues shown on page 1 of 4 with the per book base rate member system revenues shown on page 4 of 4.

should be excluded. Utilizing the monthly environmental surcharge reports,[30] the Commission finds that O&M expenses should be reduced $6,293,665; depreciation expense should be reduced $9,676,592;[31] taxes other than income taxes should be reduced $262,477; insurance expense should be reduced $375,246; and emission allowance expense should be reduced $32,748,327. The total of these expense reductions is $49,356,307.

The rate of return on environmental compliance rate base is a function of the blended interest rate for certain debt instruments and TIER. Consequently, an adjustment to EKPC's interest on long-term debt is also necessary to complete the exclusion of the environmental surcharge from the determination of the base revenue requirements. Utilizing the net book values of the environmental compliance plant in service as of test-year end and the applicable blend interest rates also as of test-year end, the Commission has determined that interest on long-term debt should be reduced $9,241,363.[32]

FAC-Related Expenses

EKPC did not exclude FAC-related expenses from the determination of its base revenue requirement. As discussed previously in this Order, the Commission has found that FAC expenses should be excluded from the base revenue requirements

[30] Response to KIUC's First Data Request dated February 19, 2007, Item 2.

[31] The adjustment to depreciation expense is exclusive of the adjustments to depreciation expense accepted by the Commission as reasonable and shown on Appendix B of this Order.

[32] The adjustment to interest on long-term debt is exclusive of the normalization of interest on long-term debt addressed later in this Order.

determination. Therefore, the Commission has reduced operating expenses $91,609,185.[33]

Interest Income

EKPC proposed to reduce its test-year interest income by $3,285,946, in order to reflect the significant fluctuations resulting from the availability of funds for investment and applicable interest rates. EKPC determined its proposed adjustment by calculating the average interest income for the 5 calendar years prior to the test-year end and comparing the average to the test-year-end level of interest income. EKPC stated that this approach allowed it to reflect a range of interest rate environments and the use of a 5-year average was desirable because it covered a wider spectrum of interest rate environments as opposed to a 3-year average.[34]

The determination of a reasonable adjustment to interest income was extensively discussed in EKPC's last general rate case, Case No. 1994-00336.[35] The Commission found in that proceeding that the adjustment to interest income should be determined by using the test-year-end balances of funds available for investment multiplied by the most currently available interest rates. EKPC has provided no evidence in the current proceeding to persuade us that the continued application of this approach is inappropriate. Therefore, the Commission has determined that EKPC's interest income

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[33] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 3.

[34] Id., Item 6.

[35] Case No. 1994-00336, Application of East Kentucky Power Cooperative, Inc. to Adjust Electric Rates, final Order dated July 25, 1995 and rehearing Order dated February 28, 1996. The interest income adjustment was the only issue granted a rehearing in this case.

adjustment should be calculated using the test-year-end balance of funds available for investment multiplied by the most current interest rates.[36] Using this approach, the Commission finds that interest income should be increased $4,300,497.

AFUDC

EKPC proposed to increase its AFUDC by $15,491,050, which reflected the annualization of its test-year levels of AFUDC and an additional incremental amount based upon the expected balances of on-going projects included in CWIP. EKPC noted that it had proposed a similar adjustment to its interest on long-term debt and stated its belief that if long-term debt were "trued up" to reflect post-test-year additions the same treatment was necessary for AFUDC.[37]

As discussed previously in this Order, the recognition of post-test-year CWIP for on-going construction projects and an adjustment for the associated AFUDC is not consistent with the matching principle. The Commission has the obligation to consistently apply established rate-making concepts, like the matching principle, and to only deviate from those concepts when sufficient evidence has been provided to justify the deviation. In this case, EKPC has failed to provide adequate justification for a

[36] The test-year-end balance of funds available for investment was taken from the Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 6(e), page 6 of 6. The interest rates were as of March 31, 2007 and were taken from the Response to KIUC's Second Data Request dated April 30, 2007, Item 41, page 15 of 15. Where interest rates were stated as a range, a blended interest rate was determined using the March 31, 2007 monthly interest income dividend by the March 31, 2007 balance of funds available for investment, with the resulting monthly interest rate annualized.

[37] T.E., September 5, 2007, at 66.

deviation from the matching principle. Consequently, the post-test-year incremental adjustment to AFUDC is denied.

The Commission has determined that the adjustment to AFUDC should be based on the test-year-end CWIP balances for the on-going projects and the most currently available interest rates. Therefore, the Commission finds that AFUDC should be increased $5,605,609.[38]

Wages and Salaries

EKPC proposed to increase its test-year expense for wages and salaries by $2,539,484. The proposed adjustment reflected a 3 percent increase in wages and salaries effective November 5, 2006 and recognized the annualized wages and salaries for 30 additional employees EKPC anticipated hiring in the 6 months after the end of the test-year. EKPC acknowledged that by March 31, 2007 it had actually hired 7 additional employees rather than 30, and agreed that the wage and salary normalization should reflect the actual post-test-year additional employees.[39]

During the first quarter of 2007, EKPC offered an “early-out” program to eligible employees. Eligible employees had from March 1, 2007 to March 31, 2007 to decide whether or not to retire under the program. The effective date of the “early-out” program was April 1, 2007.[40] Of the 21 employees eligible, 5 actually retired under the

[38] The most currently available interest rates are as of April 30, 2007, as provided in the Response to KIUC’s Second Data Request dated April 30, 2007, Item 35.

[39] Response to the Commission Staff’s Fourth Data Request dated May 30, 2007, Item 4.

[40] Wood Rebuttal Testimony at 1.

program.[41] The annual savings associated with the "early-out" program was $878,476[42] while the total costs were $601,451 which EKPC paid in one payment.[43] EKPC stated that the annual savings would be 100 percent expensed, as the wages and salaries of the employees electing the "early-out" program normally were 100 percent expensed.[44] EKPC agreed that for rate-making purposes both the savings and costs associated with the "early-out" program should be recognized,[45] and that an amortization of the costs over 3 years was an option.[46]

Utilizing workpapers provided by EKPC, the Commission has recalculated the wage and salary adjustment. The recalculated adjustment reflects the 3 percent rate increase for wages and salaries, the annualized wages and salaries for 7 additional employees hired in the 6 months after test-year end, the test-year labor capitalization rate, and the removal of $565,845 in expense savings associated with the "early-out" program. Based on this recalculation, the Commission finds that EKPC's wage and salary expenses should be increased $565,074.

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[41] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 10(d).

[42] Response to the Commission Staff's Fourth Data Request dated May 30, 2007, Item 5(b). The savings identified by EKPC were in salaries, payroll taxes, and benefits.

[43] Id., Item 5(c).

[44] T.E., September 5, 2007, at 74.

[45] Wood Rebuttal Testimony at 2.

[46] T.E., September 5, 2007, at 75.

In addition, as the Commission is recognizing the savings resulting from the "early-out" program, it is appropriate to recognize the associated costs that generated the savings. The Commission finds it is reasonable to amortize the $601,451 in "early-out" program costs over a period of 3 years, with the first-year amortization resulting in an increase in operating expenses of $200,484.

Payroll Taxes

Based on its proposed adjustment to wages and salaries, EKPC proposed an adjustment to its payroll taxes[47] of $207,570. The adjustment reflected the 2007 FICA, Federal, and State Unemployment wage limits.

The Commission has recalculated the payroll taxes based on the recalculated wage and salary adjustment, applicable payroll tax rates, the test-year labor capitalization rate, and the removal of $28,911 in payroll tax expense savings associated with the "early-out" program. Based on this recalculation, the Commission finds that EKPC's payroll tax expense should be increased $74,577.

Employee Benefits Expense

EKPC proposed to increase its employee benefits[48] expense by $2,654,077. During the proceeding, EKPC acknowledged it had not properly included the labor expense factor when determining the adjustments for the defined benefit plan, the defined contribution plan, and the post-retirement benefits. After correcting this error,

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[47] Payroll taxes include the Federal Insurance Contribution Act ("FICA"), Medicare, and Federal and State Unemployment.

[48] Employee benefits include medical benefits, a defined benefit plan, a defined contribution plan, and post-retirement benefits.

EKPC calculated that the proposed increase to employee benefits expense should be $1,514,145.[49]

The Commission has reviewed the revised calculations and finds the revised adjustment to be reasonable. In addition, the Commission has removed the "early-out" program employee benefit savings of $283,720. Therefore, the Commission finds that employee benefits expense should be increased $1,230,423.[50]

Interest on Long-Term Debt

EKPC proposed a three-part adjustment to its test-year interest on long-term debt. First, EKPC normalized the interest expense as of the end of the test year. Second, it included normalized interest expense on additional long-term debt expected to be issued between November 2006 and March 2007. Third, EKPC normalized the interest expense associated with expected repayments of principal between October 2006 and March 2007. The net result was a proposed increase in interest on long-term debt of $26,762,682.

During the hearing, EKPC acknowledged that it was not aware that the Commission normally did not recognize post-test-year additions to long-term debt when determining revenue requirements. EKPC stated that it believed that in previous cases the Commission had requested updates on long-term debt in order to have an understanding of current conditions. EKPC noted that it had provided updated long-term debt information through March 31, 2007 and requested that it be allowed to

[49] Response to KIUC's First Data Request dated February 19, 2007, Items 17, 18, and 19.

[50] The final adjustment corrected rounding errors contained in EKPC's revised calculations.

recover that expense in order to avoid having to come in for another rate increase in the near future.[51]

While the Commission is keenly aware of EKPC's needs for long-term debt financing due to its significant construction program, it cannot ignore well-established rate-making concepts when determining the revenue requirements. As was the case with the post-test-year additions of CWIP related to on-going construction projects, the recognition of the interest expense for post-test-year increases in long-term debt is not consistent with the matching principle. EKPC did not propose to update all revenues, expenses, rate base, and capital items in conjunction with the recognition of the additional long-term debt. The possibility that EKPC might have to file another base rate case soon after the completion of the current proceeding does not provide reasonable justification for the Commission to deviate from the matching principle. As a not-for-profit cooperative corporation engaged in a significant capital construction program, EKPC should have realized it may be necessary to seek numerous adjustments to its base rates during the construction period.

Therefore, the adjustment to interest on long-term debt will be based upon the test-year-end outstanding balance of long-term debt and the most currently available

[51] T.E., September 5, 2007, at 65.

long-term debt interest rates.[52] Under this approach, the Commission finds that interest on long-term debt should be increased by $11,941,654.[53]

Directors Fees and Expenses

For the test year, EKPC's directors' fees and expenses totaled $368,535. EKPC proposed to reduce the test-year expense by $65,484, which reflected the exclusion of expenses for affiliate conferences, legislative events, gifts to directors, a severance bonus, spouse expenses, and limiting costs for educational forums to two members of the board of directors.

The Commission agrees with EKPC and will exclude these items for rate-making purposes. In addition, after reviewing all of the directors' fees and expenses, the Commission finds that a further reduction of $48,087 should be made for the following items:

Official Duty Fees. EKPC paid board committee chairmen a $200 fee per meeting for directing and managing their respective committee meetings. EKPC stated that this is a legitimate business function of the board and should be reflected in rates.[54] A review of the directors' fees and expenses reveals these committee meetings are held on the same day as the regular monthly board meetings. EKPC has not adequately

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[52] The most current interest rates are as of April 30, 2007; See Response to KIUC's Second Data Request dated April 30, 2007, Item 30.

[53] As noted previously in this Order, the adjustment to interest on long-term debt does not reflect the adjustment to exclude interest on long-term debt associated with the environmental surcharge.

[54] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 42(f).

demonstrated why this practice is necessary or reasonable. The Commission will exclude $18,200 from expenses for this item.

Per Diem for Meetings Other Than Board Meetings. EKPC's Policy No. 111 – Compensation of Directors[55] provides that directors will receive a per diem plus travel and out-of-pocket expenses when attending member or other EKPC meetings on official business. In previous cooperative rate cases, the Commission has excluded for rate-making purposes the per diem for such meetings, but included the actual expenses. EKPC indicated it was not aware of this treatment and contended that due to the need for its directors to be as informed as possible, it was not unreasonable to include the per diems for rate-making purposes.[56] EKPC has provided no evidence to persuade the Commission to deviate from the previous treatment of the per diems. Therefore, the Commission will exclude $15,900 from expenses for this item.

Negotiation Meetings and Bid Opening. During the test year, one director was paid a per diem and expenses for attending 14 negotiation meetings and 8 bid openings, at a total expense of $7,939. EKPC stated that these meetings are held to ensure all contracts are entered into as economically and competitively as practical and in accordance with all applicable requirements of the Rural Utilities Service ("RUS").[57] EKPC contends that the chairman of the Negotiating Committee must be present at

[55] Response to the Commission Staff's First Data Request dated December 5, 2006, Item 25(c).

[56] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 43(b).

[57] Id., Items 42(g)(2) and 42(g)(8).

these meetings.[58] The Commission does not believe EKPC has adequately justified this practice as necessary or reasonable. EKPC also has not adequately explained why a member of the board must be present at these negotiating meetings and bid openings. Therefore, the Commission will exclude the test-year amount from expenses.

Internet Service. During the test year, EKPC paid for Internet service for 12 of its 16 directors. EKPC stated that the service is available to all directors; however, all had not chosen to use the service or seek reimbursement of their Internet service.[59] EKPC argued that providing Internet service to its directors provides a means of communication that is timely and comprehensive between EKPC and its directors. EKPC contended that this expense is a legitimate business expense because directors have more timely access to critical information upon which decisions are made.[60] While the Commission can appreciate the desire for rapid communication between EKPC and its directors, EKPC has not provided adequate information to demonstrate that its provision of this service is reasonable. The Commission will exclude $3,564 from expenses for this item.

Extra Board Meeting. The review of the directors' fees and expenses revealed one director was paid a per diem and expenses for a 13th regular board meeting. Regular board meetings are held once a month, or 12 meetings annually. The Commission has excluded $729 from expenses for this item.

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[58] Response to the Commission Staff's Fourth Data Request dated May 30, 2007, Item 14(d).

[59] Id., Item 14(b).

[60] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 42(d).

Landfill Dedication. EKPC paid two directors a per diem and expenses to attend the dedication of one of its landfill generation projects. EKPC stated that all board members are invited to each dedication and by attending the director can observe the facilities in person and learn how they operate, allowing the director to make more informed decisions in the future.[61] The Commission is not persuaded that this expense is reasonable or that attendance at a site dedication assists the directors to make more informed decisions in the future. The Commission will exclude $698 from expenses for this item.

Kentucky Association of Electric Cooperatives ("KAEC") Annual Meeting. During the test year a director was paid a per diem and expenses for attending the KAEC annual meeting. The director was not identified as the delegate or alternative delegate for EKPC. In previous cooperative rate cases, the Commission has allowed the actual expenses for only the delegate and alternative delegate to the KAEC annual meeting. The Commission will exclude $673 from expenses for this item.

Consultant Meeting. During the test year, a director was paid a per diem and expenses in conjunction with a meeting with a consultant retained by the board. However, EKPC has stated it is no longer using the services of this consultant.[62] As EKPC is no longer utilizing this consultant's services, this expense is not recurring. The Commission will exclude $384 from expenses for this item.

Board Compensation. The Commission has reviewed Policy No. 111, Section II – Content, Part A, which states:

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[61] Id., Item 42(e).

[62] Id., Item 50(p).

> Per diem of $400 plus travel from the Director's home and out-of-pocket expenses, will be paid to Directors when attending Board and committee meetings. Per diem of $300 plus travel from the Director's home and out-of-pocket expenses will be paid to Directors when attending member or other EKPC meetings on official business. . . . However, notwithstanding anything stated herein to the contrary, except for the unexcused absence provision stated hereinabove, a Director shall be compensated a minimum of $800 per month plus expenses.

The current per diem levels were established in May 2000. EKPC contended that given its relative size and number of member systems, the receipt of a minimum $800 per diem was reasonable. EKPC provided a survey reviewing generating and transmission ("G&T") cooperative per diem policy for 2006 as support for its policy.[63] A review of the 2006 survey shows that a per diem of $800 is above the monthly per diem paid by the surveyed G&T cooperatives.[64] The survey also indicates that EKPC's directors meet once a month for one day. If the regular board meeting and committee meetings are held on the same day, the Commission questions whether there is sufficient justification to pay a $400 per diem for each meeting. Though it is beyond the scope of this proceeding, the Commission is uncertain why EKPC's directors should be guaranteed a minimum per diem. Unlike an investor-owned utility where the equity owners of the utility may or may not also be customers of the utility, an RECC is governed and owned by its members, who are also its customers. While members of the 16 member

[63] Id., Items 43(a) and 43(c).

[64] The 2006 G&T compensation survey summary presented responses from 43 G&T cooperatives nationwide. Of this total, 36 G&T cooperatives had boards of directors who meet once a month, like EKPC. Of the 36 G&T cooperatives, eight paid $800 or more in fees per day. The average fee per day for all survey respondents was shown to be $651, but included two levels of fee payments from the same G&T cooperative.

systems have an interest in keeping their distribution cooperative's rates as low as possible, they also have an interest in keeping their distribution cooperative's equity position in EKPC viable. The directors of EKPC – who generally are also officers and directors of the 16 member systems – have an obligation to either seek an increase or decrease in EKPC's base rates when the balance between low rates for end users and sufficiently high rates to EKPC viable falls out of equilibrium. Though there is a constant friction between these interests, it is one EKPC's board members voluntarily undertake. A guaranteed per diem is not required by law and EKPC has not provided any evidence that justifies the practice. The Commission finds that while Policy No. 111 is not per se unreasonable, the $800 minimum per diem policy may be unreasonable as applied. In subsequent base rate proceedings, the Commission will continue to examine EKPC's formulation and application of Policy No. 111.

Rate Case Expenses

EKPC estimated that the total cost of the rate case would be $77,000. EKPC proposed that its actual rate case expenses should be amortized over a 3-year period. Based on its estimated rate case costs, EKPC proposed an adjustment for rate case expense of $25,667.

The Commission finds that EKPC's updated actual rate case expenses should be amortized over a 3-year period for rate-making purposes. We further find that the first year of a 3-year amortization of the actual rate case expenses is $26,053[65] and that operating expenses should be increased by this amount.

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[65] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 56.

Forced Outage Costs

EKPC proposed an adjustment to recognize a level of forced outage costs in its base rates. The proposed adjustment was calculated using a 5-year average of forced outage megawatt hours multiplied by the test-year per unit cost for replacement power, with the results compared to the test-year-actual forced outage costs. EKPC proposed an increase in expenses of $4,626,194. EKPC argued that forced outages were recurring events and using a 5-year average allowed for an adjustment that truly reflected its on-going operations.[66] While acknowledging that the 5-year average included a significant forced outage at the Spurlock 1 generating station in 2004, EKPC contended that the average also included years with low forced outages and noted that its forced outage rates were far below the national average.[67]

The Spurlock 1 generating station experienced a significant forced outage, beginning on July 1, 2004 and ending on October 27, 2004. While EKPC stated that forced outages are recurring events and not extraordinary occurrences, it did agree that the length of this forced outage could be considered extraordinary. EKPC estimated the total cost of the Spurlock 1 forced outage to be $20,514,346.[68]

The Commission does not believe it is appropriate to use a 5-year average to calculate the forced outage expense. The duration of the Spurlock 1 forced outage significantly affects the 5-year average of megawatt hours used in the proposed

[66] Id., Item 15.

[67] Eames Rebuttal Testimony at 2.

[68] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 15.

adjustment.[69] Because of the duration, the 2004 Spurlock 1 forced outage should be considered an extraordinary event. Indeed, it was the forced outage of Spurlock 1 that constituted part of the justification for awarding EKPC extraordinary interim relief.[70] When using an average of annual actual activity to determine the reasonable, on-going levels of an expense, the average should not include extraordinary events. Consequently, the Commission finds the adjustment as proposed by EKPC is not reasonable and it should be rejected.

However, the 2004 Spurlock 1 forced outage has had a significant effect upon the financial condition of EKPC.[71] Given the magnitude of the associated costs and the extraordinary nature of the event, the Commission believes that, in this case, it is reasonable to provide for the recovery of the 2004 Spurlock 1 forced outage costs through base rates. Therefore, the Commission finds that the 2004 Spurlock 1 forced outage costs of $20,514,346 should be amortized over a 3-year period. The Commission has increased operating expenses by $6,838,115 to reflect the first year of the 3-year amortization.

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[69] The 5-year average of megawatt hours shown in the Application, Exhibit F, Schedule 18, which included the 2004 Spurlock 1 forced outage, was 309,872. The 5-year average of megawatt hours excluding the 2004 Spurlock 1 forced outage, shown in the Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 15(f), was 158,363.

[70] April 1, 2007 Order at 8.

[71] This event has been consistently cited as one of the major reasons for the deterioration of EKPC's financial condition over the past few years. See Application Exhibit G, Marshall Direct Testimony at 3.

Revenues and Expenses Associated with Post-Test-Year Fixed Asset Additions

EKPC proposed adjustments to recognize additional revenues and expenses associated with its post-test-year fixed asset additions. EKPC determined that metering point revenues should be increased $164,040. EKPC initially estimated that depreciation expense should be increased $676,185 and property tax expense should be increased $40,657.[72] EKPC later recalculated the expense adjustments based on the actual cost of the fixed asset additions, and determined that depreciation expense should be increased $702,797 and property tax expense should be increased $41,671.[73]

As discussed previously in this Order, EKPC has followed the matching principle concerning the inclusion of the post-test-year fixed asset additions by recognizing the additional revenues and expenses associated with these assets. The Commission finds the proposed adjustments, based on the actual cost of the fixed asset additions, are reasonable and should be included for rate-making purposes. Therefore, the Commission has increased revenues by $164,040, depreciation expense has been increased by $702,797, and property tax expense has been increased by $41,671.

PSC Assessment

EKPC proposed to recognize an increase of $71,255 to its PSC Assessment based on its proposed annual revenue increase, using the assessment rate available at the time the application was filed. The Commission believes that the concept of such

[72] Application Exhibit F, Schedule 25, page 2 of 2.

[73] Response to the Commission Staff's Fourth Data Request dated May 30, 2007, Item 10, page 2 of 2.

an adjustment is reasonable, and will address this subject when it determines the revenue requirements later in this Order.

Electric Power Research Institute ("EPRI") Membership Dues

During the test year, EKPC was a member of EPRI; however, due to cost-containment requirements in 2007, EKPC relinquished full membership in EPRI and determined to utilize the research and development services on a project-by-project basis. The annual membership dues to EPRI were $1,088,806.[74] EKPC did not propose an adjustment to remove the membership dues from the test-year operating expenses.

The Commission believes it is not reasonable to include the EPRI membership dues for rate-making purposes when EKPC is no longer a member obligated to pay those dues. The Commission finds that the test-year membership dues should be removed, and has reduced operating expenses $1,088,806.

Miscellaneous General Expenses

The Commission has reviewed EKPC's test-year expenses for organization dues and professional services. For several organizations, EKPC was requested to describe the nature and purpose of the organization and explain why the dues should be included for rate-making purposes. Based on EKPC's responses, the Commission has determined that dues for six of the organizations should not be included for rate-making purposes, as membership in the organization does not appear to be related to the

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[74] Response to the Commission Staff's First Data Request dated December 5, 2006, Item 45.

provision of electric service to EKPC's member systems[75] or the primary function of the organization is to support and promote the use of coal as a fuel source.[76] The Commission finds these organization dues should be excluded for rate-making purposes and has reduced operating expenses $47,497.

In response to data requests, EKPC acknowledged it was no longer utilizing the services of four providers of professional services.[77] As EKPC is no longer utilizing these services, the Commission believes the test-year expenses for these providers should be excluded for rate-making purposes as non-recurring expenses. The Commission finds that operating expenses should be reduced $269,697.

Pro Forma Net Income Summary

After consideration of all pro forma adjustments, the adjusted net income for EKPC is as follows:

	Actual Test Period	Pro Forma Adjustments	Adjusted Test Period
Operating Revenues	$667,783,607	$(148,099,091)	$519,684,516
Operating Expenses	617,036,820	(165,803,092)	451,233,728
Net Operating Income	50,746,787	17,704,001	68,450,788
Interest on Long-Term Debt	79,393,488	2,700,291	82,093,779
Other Income and Deductions – Net	(19,008,960)	42,618,488	23,609,528
NET INCOME	$ (47,655,661)	$ 57,622,198	$ 9,966,537

[75] These organizations are Bluegrass Tomorrow, the Energy and Mineral Law Foundation, and the National Food and Energy Council, Inc.

[76] These organizations are the Kentucky Coal Association Corporation, the University of Kentucky Mining Engineering Foundation, and the Center for Energy and Economic Development.

[77] The four providers were Execquest, Gannett Fleming, Inc., Richard K. Byrne, and RMB Consulting and Research, Inc.

REVENUE REQUIREMENTS

The actual rate of return earned on EKPC's rate base for the test year was 1.89 percent. Its actual TIER for the test year was 0.40X and DSC was 0.67. EKPC requested rates that would produce a rate of return on rate base of 7.61 percent on its proposed rate base of $1,883,596,862. EKPC's proposed increase in revenues of $43,364,219 would achieve a TIER of 1.35X and a DSC of 1.25.[78]

EKPC proposed that its revenue requirements be based on a 1.35X TIER, which applied to its adjusted test year would produce a $43,364,219 increase in revenues. EKPC believed this increase in revenues would allow it to rebuild its equity level and meet its financial obligations pursuant to the RUS mortgage agreement and the unsecured credit facility.[79]

EKPC's RUS mortgage agreement requires that the average TIER during the two best years out of the last three calendar years must be no less than 1.05X and that the average DSC during the two best years out of the last three calendar years must be no less than 1.00. Based on EKPC's financial performance for calendar year 2006,[80] it failed to meet both the TIER and DSC requirements contained in the RUS mortgage agreement.[81] On May 1, 2007, EKPC submitted to RUS its "plan of remedy" as required

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[78] Application Exhibits J and K.

[79] Application Exhibit G-2, Eames Direct Testimony at 9.

[80] The test year is the 12 months ending September 30, 2006, or 3 months before the end of calendar year 2006.

[81] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 58.

by the RUS mortgage agreement.[82] EKPC's plan consisted of two components: the reduction of costs and an increase in rates.[83] The "plan of remedy" projected EKPC's TIER and DSC for 2007, which if achieved should meet the TIER and DSC requirements of the RUS mortgage agreement. EKPC also stated, "It is also anticipated that EKPC may need to file two or three more rate cases over the next four or five years in order to ensure that EKPC's finances stay on a strong footing."[84]

As noted previously in this Order, EKPC, the AG, and KIUC filed with the Commission a non-unanimous Joint Stipulation that provided for an additional annual increase in revenues of $19.5 million over the interim increase of $19.0 million, for a total increase of $38.5 million. EKPC stated that the $38.5 million annual rate increase would not fully resolve its financial challenges, but would demonstrate progress toward achieving long-term improvement.[85] However, as the parties to this case have been repeatedly reminded, the non-unanimous Joint Stipulation cannot be considered by the Commission as a resolution of the revenue requirement issues or rate design issues.

The Commission finds that the use of a 1.35X TIER is reasonable for EKPC, given the current financial condition of EKPC and its need to comply with the

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[82] Id., page 7 of 8.

[83] The "plan of remedy" also acknowledged the interim $19.0 million increase in rates authorized by the Commission on April 1, 2007.

[84] Response to the Commission Staff's Third Data Request dated May 1, 2007, Item 58, page 7 of 8.

[85] Joint Post-Hearing Brief of EKPC, the AG, and KIUC on General Revenue Requirements and Rate Design at 8-9. EKPC indicated the $38.5 million increase would result in TIER and DSC levels in 2008 that would barely meet the requirements of the RUS mortgage agreement, but would not be sufficient to allow it to increase its equity to achieve a BBB credit rating.

requirements of the RUS mortgage agreement and the unsecured credit facility. However, in order to achieve a 1.35X TIER, the adjusted test-year results would support an increase in EKPC's annual revenues of only $18,798,301.[86] An increase in revenues at this level would result in a DSC of 1.065, based upon the adjusted test year. It would produce a rate of return on rate base of 5.84 percent on the rate base of $1,494,647,339. This increase is only $201,699 lower than the interim increase granted to EKPC by the Commission on April 1, 2007.

After considering the evidence of record and our analysis of the information, the Commission finds that the April 1, 2007 interim increase of $19.0 million is a reasonable on-going level and should be continued, with no additional revenues granted to EKPC at this time. As correctly noted by KIUC and described in this Order, EKPC's application and support for a $43,364,219 increase in revenues included several errors and inappropriate or improperly calculated adjustments. The determination of the revenue requirement must reflect a consistent application of well-established rate-making principles, concepts, and treatments. Deviations from these principles, concepts, and treatments must be adequately supported, documented, and explained.

The Commission's determination that a 1.35X TIER applied to the adjusted test year supported an increase in revenues of $18,798,301 has been based on our understanding of the extensive information provided in this rate case. If EKPC believes there has been a misunderstanding, misinterpretation, or miscalculation of certain

[86] This increase includes an additional $32,015 to reflect the associated increase needed for EKPC's PSC Assessment. The most current PSC Assessment rate was used to determine the increase.

information, it is welcome to seek a rehearing of the Commission's decision, pursuant to KRS 278.400.

PRICING AND TARIFF ISSUES

Economic Development Rider

EKPC proposed the elimination of its Economic Development Rider in addition to the proposed changes in its rates. EKPC proposed this change because the 5-year period covered by the rider had expired. None of the parties stated an objection to the change. The Commission finds that the elimination of the rider is reasonable and should be approved.

Cost of Service Study

EKPC filed a fully allocated, embedded cost-of-service study in order to determine the contribution that each customer class was making toward its overall rate of return and as an indicator of whether its rates reflect the cost to serve each customer class. EKPC followed the procedures outlined in the electric utility cost allocation manual published by the National Association of Regulatory Utility Commissioners.

EKPC has three primary rate classes, Rate E, Rate B, and Rate C, and five special contract rate customers. Costs were directly assigned whenever possible. When the costs had to be allocated, the energy costs were allocated based on kWh usage to total energy consumed and the demand costs were allocated using the average and excess methodology. EKPC used this methodology in its last rate case which was accepted by the Commission. One customer, Gallatin Steel, was handled differently. Because Gallatin Steel is predominantly interruptible in nature, it was assigned demand costs based on average demand and its 15 MW of firm load. EKPC

believes that this gives Gallatin Steel a fair and proportionate share of demand costs for its level of service. EKPC's cost-of-service study indicates that the only class providing a positive rate of return is the contract with Inland Steam, all of the other rate classes and contracts are producing negative returns.

The Commission finds that EKPC's cost-of-service study is reasonable and consistent with the methodology accepted in previous rate cases and should be used as a basis for determining the allocation of any increase in revenues.

Revenue Allocation

East Kentucky proposed to allocate its increase as follows:

Section E	80.04%
Section B	5.94%
Section C	3.43%
Inland Electric	1.15%
Inland Steam	1.79%
Gallatin Steel	6.85%
AGC Automotive	.80%
Total	100.00%

EKPC proposed to allocate all of the increase to the demand charges in each of the rate classes, with the exception of Section E. EKPC proposed to allocate Section E's increase to the energy charge. EKPC states that it proposed no significant rate design changes in this rate case because of its need for immediate rate relief.

KIUC objected to the allocation of the revenue increase based on total revenue currently recovered from each class. KIUC objected because 50 percent of EKPC's revenues are comprised of fuel and purchased power costs. KIUC argued that the revenue deficiency driving EKPC's need for an increase was related to its fixed costs and, therefore, any revenue increase should be apportioned on the basis of each

class's demand-related revenues.[87] In addition, KIUC recommended that the revenue allocation for Gallatin Steel be determined separately from the other four special contract customers because of its size and large interruptible load. KIUC supports EKPC's use of the average and excess demand method, but disagrees with the allocation of Gallatin Steel's interruptible load.

On April 1, 2007, the Commission granted EKPC's request for interim relief of $19.0 million and accepted EKPC's allocation of the increase to the rate classes as proposed in the application. KIUC did not voice any opposition to the allocation methodology used for the interim increase.

Having reviewed EKPC's proposed allocation and KIUC's recommendation, we find that EKPC's allocation is reasonable and should be approved in this proceeding.

Small Power Production and Cogeneration Facilities Tariffs

The Sierra Club recommended that EKPC's Small Power Production and Cogeneration Facilities ("QF") tariffs be amended, contending that the existing tariffs discriminate unduly against potential developers of environmentally beneficial cogeneration and small power production projects. Based upon its interpretation of the Public Utility Regulatory Policies Act of 1978 and 807 KAR 5:054, the Sierra Club argued that to avoid discrimination the QF tariffs should state the EKPC will pay higher rates for "clean" electricity than it will pay for electricity generated by more highly polluting fuels and technologies.[88] The Sierra Club disagreed with the determination of the capacity payments included in the QF tariffs, noting that there was no reason why

[87] Higgins Direct Testimony at 3.

[88] Sierra Club Brief at 23 of 28.

capacity should be less valuable to EKPC than energy.[89] In addition, the Sierra Club identified several provisions of the existing QF tariffs that it believed are unreasonable and discriminatory and contended those provisions should be modified or deleted from the tariffs.[90]

EKPC opposed the changes proposed by the Sierra Club, contending that the proposals represented changes to 807 KAR 5:054. EKPC argued that many of the proposals of the Sierra Club shift costs and risks to the purchasing utilities. It also stated its belief that other proposals are in conflict with or not consistent with the current regulations, especially the Sierra Club's concept of avoided costs. EKPC contended that the criticisms offered by the Sierra Club reflect a lack of detailed understanding of the EKPC system. EKPC did acknowledge that the purchase rates contained in the QF tariffs need to be updated and it committed to preparing and submitting new QF tariff rates by the end of 2007.[91]

The Commission is not persuaded that the proposals recommended by the Sierra Club are consistent and in compliance with the provisions of 807 KAR 5:054, as currently enacted. It appears that several of the Sierra Club's proposed solutions to problems with the QF tariffs will not result in rates for sale that are just and reasonable, in the public interest, and nondiscriminatory. The Sierra Club's concept of avoided costs appears to be broader than the definition of avoided costs contained in 807 KAR

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[89] Young Prepared Testimony at 30 of 41.

[90] Id. at 30-32 of 41.

[91] EKPC Post-Hearing Brief on the Recommendations from the Sierra Club at 12-15.

5:054, Section 1(1). The Commission notes that the sample QF tariffs provided by the Sierra Club appear to contain only terms and conditions, and do not include the applicable rates.

Therefore, the Commission finds that the Sierra Club's proposed modifications to EKPC's QF tariffs are not reasonable and should be denied. The Commission does agree with EKPC that the QF purchase rates should be updated to reflect its most current avoided costs. EKPC should also review the terms and conditions contained in the tariffs to see if they are still consistent with the provisions of 807 KAR 5:054. EKPC had committed to submitting new rates by the end of 2007; however, the Commission believes that EKPC should have adequate time to develop the updated QF tariffs. The Commission finds that EKPC should submit its updated QF tariff rates for approval, along with any additional revisions, no later than March 31, 2008. EKPC's application should include all calculations and assumptions utilized to develop the provisions in the updated QF tariffs.

The Commission further finds it appropriate to revisit the finding in our June 18, 2007 Order which stated that, even though EKPC's application did not propose to modify the QF tariff, that tariff was subject to review in this case. Based on the evidence introduced since that finding was made, it has become clear that the QF tariff is based on a determination of EKPC's avoided cost. The relevant factors that must be considered in determining avoided cost include the fixed and variable cost of existing generation, as well as the fixed and variable cost of future planned generation. A rate case does not typically include evidence on these factors, which are more closely related to a utility's integrated resource plan than to its revenue requirements.

Consequently, a rate case is not the appropriate forum to challenge an existing QF tariff.

OTHER ISSUES

Statistical Recoupling

The Sierra Club argued that the traditional rate structure utilized by EKPC and its 16 member systems discouraged programs that save energy and that the rate structure should be amended. The Sierra Club contended that the absence of a mechanism to decouple revenues from the amount of electricity sold and the presence of the FAC gave EKPC and its 16 member systems a very strong financial disincentive to assisting customers in saving energy.[92] To remedy this situation, the Sierra Club proposed that the Commission decouple EKPC's revenues from the amount of electricity it sells utilizing an approach called "statistical recoupling."[93] The Sierra Club stated its belief that the 16 member systems need to have the same set of financial incentives and the same general rate structure as EKPC, in order to avoid creating competing incentives and lessening the degree of cooperation between the member systems and EKPC. The Sierra Club noted that the 16 member systems currently have general rate cases before the Commission, which would enable the Commission to institute statistical recoupling for each of the member systems as well as EKPC.[94]

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[92] Sierra Club Brief at 1-2 of 28.

[93] In order to promote the implementation of energy-efficient programs, the Sierra Club proposed that in addition to the adoption of statistical recoupling, EKPC should be permitted to recover its legitimate demand-side management costs and a shared savings incentive be developed. See Young Prepared Testimony at 24 of 41.

[94] Sierra Club Brief at 12-13 of 28.

EKPC opposed the recommendation to implement statistical recoupling. EKPC noted that neither its board of directors nor the boards of directors for the 16 member systems have approved the concept. It contended that without such approval, a decoupled rate design would distort EKPC's revenue recovery with no potential to encourage energy efficiency at the retail level.[95] EKPC argued that the Sierra Club did not appear to have provided a workable decoupling mechanism because it has not addressed implementation issues such as the accurate determination of computed electricity use and statistical recoupling's focus on energy use rather than demand.[96] EKPC further argued that the Sierra Club's proposal for statistical recoupling is vague as it has not explained why it selected the particular linear regression model submitted, how it would measure one of the variables in the model, and why "dummy" variables were not incorporated into the submitted model.[97] EKPC concluded that,

> Given the lack of support for the decoupling concept from EKPC and its Member Systems, the weak arguments for imposing decoupling on cooperative rate designs, and the financial challenges currently faced by EKPC, this is not a proper time to force an unproven, experimental change in rate design on EKPC.[98]

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[95] EKPC Post-Hearing Brief on the Recommendations from the Sierra Club at 7.

[96] Kirsch Rebuttal Testimony at 21-23 and 26.

[97] Id. at 25.

[98] EKPC Post-Hearing Brief on the Recommendations from the Sierra Club at 11.

Statistical recoupling[99] was introduced in a report issued in September 1993 as a means to address the net loss revenue problem associated with demand-side management programs and the Sierra Club presented this report in support of its proposal. The author of the report was Dr. Eric Hirst with the Oak Ridge National Laboratory, and the report was sponsored by the Office of Energy Efficiency and Renewable Energy of the U. S. Department of Energy. As developed by Dr. Hirst,

> Statistical recoupling uses statistical models, based on historical data, that explain retail electricity sales as functions of the number of utility customers, winter and summer weather, the condition of the local economy, electricity price, and perhaps a few other key variables. These models, along with the actual values of the explanatory variables, are then used to estimate "allowed" electricity sales and revenues in future years.[100]

Concerning the implementation of statistical recoupling, Dr. Hirst wrote,

> Implementation involves two steps. In the first step, the utility, working with other interested parties, develops alternative statistical models. After review of these models, the company and other parties agree on a particular model to use, subject to approval by the PUC.[101]

[99] Statistical recoupling is one type of decoupling mechanism. Decoupling mechanisms are a two-step process. The first part "breaks" the link between utility revenues and kWh sales. The second part, which is more difficult, involves the "recoupling" of revenues to something else, such as growth in the number of customers, the changes in fixed costs, or other factors.

[100] Response to the Commission Staff's First Data Request to the Sierra Club dated July 25, 2007, Item 5, page 6 of 55.

[101] Young Prepared Testimony, Attachment B, page 14 of 17.

The Sierra Club has indicated that it is unaware of any updates or revisions to Dr. Hirst's 1993 report.[102]

The application of a decoupling mechanism has often been discussed in conjunction with demand-side management programs. The Commission has been and continues to be willing to consider and evaluate alternative rate structures in recognition of changes and issues in the electric industry. However, in order to adopt and approve any alternative rate structure the proposal should be adequately documented and developed; it should be demonstrated that the proposal will result in rates that are fair, just, and reasonable; and it should comply with current statutes and regulations.

Based upon our review of the evidence in this record, the Commission finds that the Sierra Club's proposal to adopt statistical recoupling for EKPC should be rejected. The Sierra Club was not aware of any state regulatory commission that has adopted statistical recoupling.[103] The Sierra Club's witness does not appear to have any personal experience in the development or application of the statistical models or formulas required under statistical recoupling.[104] The Sierra Club's proposal was not adequately documented and developed and it did not present Dr. Hirst as a witness to support the statistical model proposed.[105]

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[102] Response to the Commission Staff's First Data Request to the Sierra Club dated July 25, 2007, Item 5(b).

[103] Id., Item 5(c).

[104] Id., Item 6(b).

[105] T.E., September 5, 2007, at 136.

The Commission notes that the Sierra Club provided copies of an April 2007 presentation made to the Kentucky Energy Efficiency Working Group which evaluated decoupling mechanisms and included a discussion of statistical recoupling.[106] The presentation was made by Dr. Richard Stevie of Duke Energy,[107] who noted one of the arguments against statistical recoupling was the approach required sophisticated modeling and estimation.[108] The Sierra Club has consistently argued the modeling is "not particularly daunting."[109]

The Commission does agree with the Sierra Club that if statistical recoupling were implemented for EKPC, it would be necessary to implement the approach at the 16 member systems as well. However, the Commission disagrees with the Sierra Club's assertion that the applications filed by the 16 member systems under KRS 278.455 constitute general rate cases. The provisions of KRS 278.455 clearly state that applications filed under this statute relate to the flow through of rate increases by a distribution cooperative's wholesale power supplier and that there can be no change in the rate design. The flow through of an increase in rates from the wholesale power supplier becomes effective on the same date as the increase in the wholesale power supplier's rates becomes effective. Consequently, statistical recoupling cannot be

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[106] Response to the Commission Staff's First Data Request to the Sierra Club dated July 25, 2007, Item 4, pages 13 through 28 of 28.

[107] The Sierra Club acknowledged that Dr. Stevie has the background and experience necessary to understand decoupling mechanisms and statistical recoupling. See T.E., September 5, 2007, at 135.

[108] Response to the Commission Staff's First Data Request to the Sierra Club dated July 25, 2007, Item 4, page 28 of 28.

[109] Id., Item 6(b).

implemented at the 16 member systems as part of the applications filed under KRS 278.455.

The Commission notes that to implement statistical recoupling, Dr. Hirst advocates a collaborative process, where the statistical models and accompanying formulas are developed by the utility and interested parties and then submitted to the regulatory commission for approval. The Commission perceives this approach to be the opposite of the approach advocated by the Sierra Club, which throughout this proceeding has recommended that statistical recoupling should be ordered now for EKPC. It appears to the Commission that the approach advocated by Dr. Hirst would be more reasonable.

While the Commission has repeatedly expressed its support for cost-effective demand-side management programs, it has serious concerns about adopting statistical recoupling given EKPC's overall financial condition. The Commission's rejection of the statistical recoupling approach should not be viewed as diminishing this previous support. But given EKPC's financial condition, the Commission does not believe it is reasonable to adopt an untried and unproven rate structure.

Financial Monitoring

In the Commission's April 1, 2007 Order, EKPC was required to file with the Commission a monthly accounting of its expenses and revenues in a monthly format and a 12-month ending format to enable the Commission and the parties to monitor EKPC's margins, which, generally speaking, have improved since implementation of the April 1, 2007 interim rate increase. EKPC was also directed to provide monthly budget information for calendar year 2007 and a calculation of its TIER and DSC as of the 12-

month period ending for each month included in the monitoring period. The required financial information was to be filed no later than 30 days after the end of the reporting month. The monitoring period was to begin on April 1, 2007 and end on the effective date of the Commission's final Order in this case.

The Commission finds that it is reasonable to continue this financial monitoring. The formats currently utilized by EKPC should continue to be used. The monthly budget information should continue with the 2008 budget submitted with the report including the month of January 2008. Subsequent calendar budgets should be submitted with the report including the first month of the applicable year.

During the monitoring period, EKPC has been filing this information as a separate report. The Commission believes it is reasonable and would be administratively efficient for this monthly information to be incorporated as part of the monthly reporting EKPC already submits to the Commission. The Commission finds that the continued financial monitoring reports should be part of the monthly reports EKPC submits to the Commission within 45 days of the end of the reporting month.

Future Rate Cases

In its May 1, 2007 "plan of remedy" filed with the RUS, EKPC indicated that it anticipated filing two or three more rate cases in the next four to five years in order to keep its finances on a strong footing. Given EKPC's current financial condition and its on-going capital construction program, the Commission would agree this is a reasonable expectation. The Commission expects EKPC to closely monitor its financial situation and file applications for rate cases in a timely manner.

The Commission believes that the latest date for EKPC's next base rate case should be no later than 9 months after the Spurlock 4 generating station goes into service. If EKPC waits until this date to file its next base rate case, the Commission will expect EKPC to select a test year that includes at least 6 months of Spurlock 4 operations. However, the Commission stresses that it believes this is the latest date for the filing of the next rate case. If conditions warrant an earlier application, the Commission expects EKPC to file that application.

Environmental Compliance Plan and Surcharge Mechanism

EKPC currently has under construction flue gas desulfurization control equipment ("scrubbers") at its Spurlock 1 and Spurlock 2 generating stations. EKPC is also constructing the Spurlock 4 generating station, which is a circulating fluidized bed coal unit similar to the Gilbert generating station.

Since it was approved in 2005, EKPC has not amended its environmental compliance plan and surcharge mechanism to reflect the addition of any applicable environmental compliance projects. It would appear to the Commission that the scrubbers at Spurlock 1 and 2 could be eligible for inclusion in the environmental compliance plan and for cost recovery through the environmental surcharge. Certain specified components of the Gilbert generating station are currently recovered through the environmental surcharge, and it would appear likely that similar components would be present at Spurlock 4.

Given its current financial condition, it is essential that EKPC utilize all available options to provide for timely recovery of costs. The Commission believes that EKPC should immediately review all of its environmental compliance projects and activities

and, to the extent appropriate, file an application with the Commission to amend the environmental compliance plan approved in 2005 to include eligible compliance projects and include the approved projects in its surcharge mechanism. Under KRS 278.183, the Commission has 6 months to process these environmental compliance plans and approve a surcharge mechanism. Even though it utilizes AFUDC accounting for these construction projects, EKPC could seek to amend the environmental compliance plan and surcharge mechanism to include applicable environmental compliance projects prior to the projects going into service.

FAC Roll-In

In its July 25, 2007 Order in Case No. 2006-00508,[110] the Commission approved the transfer, or roll-in, of 6.13 mills per kWh from EKPC's FAC to its base rates. The rates incorporating this roll-in were effective for service rendered on and after August 1, 2007. EKPC's base rates at the time of the roll-in reflected the $19.0 interim increase in revenues approved by the Commission on April 1, 2007.

As the Commission has found in this Order that the $19.0 million increase in revenues should be made permanent and no additional increase in revenues should be approved, no change or revision to EKPC's current rates will be necessary.

[110] Case No. 2006-00508, An Examination of the Application of the Fuel Adjustment Clause of East Kentucky Power Cooperative, Inc. from November 1, 2004 to October 31, 2006.

IT IS THEREFORE ORDERED that:

1. The rates proposed by EKPC are denied.

2. The April 1, 2007 interim increase in revenues of $19.0 million is approved as the final increase in revenues authorized in this proceeding. No change to EKPC's base rates is necessary.

3. The allocation of the $19.0 million increase in revenues and resulting rate design as determined in the April 1, 2007 Order are reasonable and are approved. The allocation and rate design changes proposed by KIUC are denied.

4. EKPC shall, within 20 days of the date of this Order, file its revised tariff sheets reflecting the termination of the Economic Development Rider.

5. The changes proposed by the Sierra Club to EKPC's QF tariffs are denied.

6. EKPC shall file an application to update the avoided costs reflected in its QF tariffs no later than March 31, 2008, as described in this Order.

7. The proposal of the Sierra Club to adopt statistical recoupling is rejected.

8. The financial monitoring established by ordering paragraph number 6 of the April 1, 2007 Order is continued, subject to the modifications described in this Order.

9. EKPC shall continue to monitor its financial condition and shall file its next base rate case when conditions warrant, but in no event shall such filing be made later than 9 months after the Spurlock 4 generating station goes into service. In the event EKPC's financial condition permits it to refrain from filing a rate case until after Spurlock 4 goes on line, the test year shall include 6 months of Spurlock 4 operations.

Done at Frankfort, Kentucky, this 5th day of December, 2007.

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2006-00472 DATED December 5, 2007

EXCLUSION OF EKPC's
ENVIRONMENTAL SURCHARGE COMPONENTS

RATE BASE

The balances for rate base items are from the monthly environmental surcharge reports, which were provided in the Response to KIUC's First Data Request dated February 19, 2007, Item 2. The plant and accumulated depreciation balances are as of the September 2006 expense month.

Gross Eligible Pollution Control Plant	$221,507,350
Accumulated Depreciation on Eligible Pollution Control Plant	32,079,428
13-Month Average Balance for Limestone	204,745
13-Month Average Balance for Emission Allowances	24,788,430

As noted previously in this Order, Limestone and Emission Allowances were included as part of the Fuel Stock balance.

CAPITALIZATION

The adjustment to the long-term debt portion of the capitalization was determined as follows:

Gross Eligible Pollution Control Plant	$221,507,350
Plus 13-Month Average Balance for Limestone	204,745
Plus 13-Month Average Balance for Emission Allowances	24,788,430
Minus Accumulated Depreciation on Eligible Pollution Control Plant	32,079,428
Net Adjustment to Long-Term Debt Portion of Capitalization	$214,421,097

OPERATING STATEMENT

Information concerning environmental surcharge revenues and expenses were taken from the Response to KIUC's First Data Request dated February 19, 2007, Item 2 and the Response to KIUC's Second Data Request dated April 30, 2007, Item 44.

Revenues	Surcharge Revenues	Off-System Sales Allocation Factor	Compu Sale
October 2005	$ 4,457,295	99.27%	
November	4,674,894	99.26%	
December	6,646,702	99.16%	
January 2006	3,386,525	98.74%	
February	4,345,255	98.75%	
March	4,393,841	98.74%	
April	3,527,736	98.77%	
May	3,933,880	98.85%	
June	4,624,694	98.93%	
July	5,326,879	98.99%	
August	7,021,816	99.02%	
September 2006	5,133,457	99.00%	
Totals	$57,472,974		

Expenses	O&M Expenses	Depreciation Expense	Taxes Other Than Income	Insurance Expense
October 2005	$ 454,917	$ 806,336	$ 16,380	$ 26,696
November	129,237	806,336	16,380	26,696
December	332,446	806,336	16,380	26,696
January 2006	1,250,319	806,336	16,380	26,696
February	186,107	806,336	16,380	26,696
March	393,387	806,336	33,061	26,696
April	510,470	806,336	24,586	35,845
May	190,981	806,336	24,586	35,845
June	272,939	806,336	24,586	35,845
July	618,110	806,336	24,586	35,845
August	1,070,817	806,616	24,586	35,845
September	883,935	806,616	4,586	35,845
Totals	$ 6,293,665	$ 9,676,592	$ 262,477	$ 375,246

Interest on Long-Term Debt

Information for the adjustment to interest on long-term debt is taken from the Response to KIUC's First Data Request dated February 19, 2007, Item 2 and Application Exhibit F, Schedule 10. The adjustment to interest on long-term debt was computed using the test-year-end balances for the Federal Financing Bank Y-8 Series and Z-8 Series 30-year Notes, the corresponding interest rates on this debt as of test-year end, and the net book value of the environmental compliance projects as of test-year end.

Compliance Project	Net Book Value	Blended Interest Rate	Inter
Gilbert	$ 66,167,656	4.725%	$
Spurlock 1 – Precipitator	20,997,954	4.961%	
Spurlock 1 – SCR	69,325,477	4.961%	
Spurlock 2 – SCR	32,936,835	4.961%	
Totals	$ 189,427,922		

Note: SCR is Selective Catalytic Reduction Equipment.

APPENDIX B

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 2006-00472 DATED December 5, 2007

SCHEDULE OF ADJUSTMENTS

The following adjustments were proposed by EKPC in its application, and have been found reasonable and accepted by the Commission. The "+" indicates an increase while "-" indicates a decrease.

	Description	Application Reference Exhibit F	Change to Revenues	Change to Expenses
1.	Normalize Depreciation Expense and reflect new Depreciation rates	Schedule 7 & 8	0	-$15,221,253
2.	Normalize Property Taxes	Schedule 8 & 9	0	-$375,423
3.	Annualize Debt Issuance Expense	Schedule 11	0	+$102,718
4.	Annualize Transmission Revenues and Expenses With Kentucky Utilities Co	Schedule 12	+$228,230	+$707,276
5.	Remove Promotional Advertising Expenses	Schedule 13	0	-$1,152,935
6.	Remove Donations	Schedule 15	0	-$502,476
7.	Amortization of Metering Point Revenue and Substation Revenue	Schedule 17	+$112,059	0
8.	Eliminate Affiliate Cost	Schedule 19	-$59,049	0
9.	Out of Period Adjustments:			
	EPA Notice of Violation	Schedule 20	Confidential	Confidential
	Gallatin Steel Billing Dispute	Schedule 20	+$720,000	0
	Transmission Dispute	Schedule 20	-$219,603	+$30,580
10.	Remove Lobbying Expenses	Schedule 21	0	-$152,716
11.	Remove Touchstone Energy Dues	Schedule 22	0	-$376,000

	Description	Application Reference Exhibit F	Change to Revenues	Change to Expenses
12.	SERC/TVA Reliability Coordinator Services	Schedule 23	0	-$12,763
13.	Miscellaneous Benefit Expense Elimination	Schedule 24	0	-$49,424

Note: Concerning Item 9, confidential treatment was granted information relating to the EPA Notice of Violation.