

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION BY THE PUBLIC SERVICE)	
COMMISSION OF THE ENVIRONMENTAL)	
SURCHARGE MECHANISM OF EAST KENTUCKY)	
POWER COOPERATIVE, INC. FOR THE)	
SIX-MONTH BILLING PERIODS ENDING)	CASE NO.
JUNE 30, 2006 AND DECEMBER 31, 2006, FOR)	2007-00378
THE TWO-YEAR BILLING PERIOD ENDING)	
JUNE 30, 2007, AND THE PASS THROUGH)	
MECHANISM FOR ITS SIXTEEN MEMBER)	
DISTRIBUTION COOPERATIVES)	

O R D E R

On September 19, 2007, the Commission initiated two 6-month reviews and a 2-year review of East Kentucky Power Cooperative, Inc.'s ("EKPC") environmental surcharge¹ as billed to the member distribution cooperatives for the 6-month periods January 1, 2006 to June 30, 2006 and July 1, 2006 to December 31, 2006 and the 2-year period July 1, 2005 to June 30, 2007. Pursuant to KRS 278.183(3), the Commission must review, at 6-month intervals, the past operations of the environmental surcharge. After hearing, the Commission may, by temporary adjustment in the surcharge, disallow any surcharge amounts found not to be just and reasonable and reconcile past surcharges with actual costs recoverable pursuant to KRS 278.183(1). At 2-year intervals, the Commission must review and evaluate the past operations of the environmental surcharge. After hearing, the Commission must disallow improper

¹ Case No. 2004-00321, Application of East Kentucky Power Cooperative, Inc. for Approval of an Environmental Compliance Plan and Authority to Implement an Environmental Surcharge, final Order dated March 17, 2005.

expenses and, to the extent appropriate, incorporate surcharge amounts found just and reasonable into the existing base rates of the utility.

The September 19, 2007 Order also initiated two 6-month reviews and a 2-year review of the 16 EKPC member distribution cooperatives' ("Member Cooperatives") retail pass through mechanism² as billed to retail member customers for the 6-month periods February 1, 2006 to July 31, 2006 and August 1, 2006 to January 31, 2007 and the 2-year period August 1, 2005 to July 31, 2007.³

The Commission issued a procedural schedule on September 19, 2007 that provided for discovery, the filing of prepared testimony, and an informal conference.⁴ EKPC filed prepared direct testimony and responded to requests for information. The

² Case No. 2004-00372, Application of Big Sandy RECC, Blue Grass Energy Cooperative Corporation, Clark Energy Cooperative, Cumberland Valley Electric, Farmers RECC, Fleming-Mason Energy, Grayson RECC, Inter-County Energy Cooperative, Jackson Energy Cooperative, Licking Valley RECC, Nolin RECC, Owen Electric Cooperative, Salt River Electric, Shelby Energy Cooperative, South Kentucky RECC and Taylor County RECC for Authority to Pass Through the Environmental Surcharge of East Kentucky Power Cooperative, Inc., final Order dated March 17, 2005.

³ The Settlement Agreement approved in Case Nos. 2004-00321 and 2004-00372 allows the Member Cooperatives to pass through the environmental surcharge to their customers at approximately the same time as EKPC bills the environmental surcharge to the Member Cooperatives, thus avoiding a billing lag for the Member Cooperatives. Therefore, the costs incurred from December 2005 through May 2006 are billed to the Member Cooperatives in the months of January 2006 through June 2006, with these same costs passed through to the member customers on the bills for February 2006 through July 2006. The costs incurred from June 2006 through November 2006 are billed to the Member Cooperatives in the months of July 2006 through December 2006, with these same costs passed through to the member customers on the bills for August 2006 through January 2007. The costs incurred in the months of June 2005 through May 2007 are billed to the Member Cooperatives in the months of July 2005 through June 2007, with these same costs passed through to the member customers on the bills for August 2005 through July 2007.

⁴ The September 19, 2007 procedural schedule anticipated, but did not schedule, a public hearing and the filing of briefs.

Commission's February 7, 2008 Order directed EKPC to file a statement indicating whether there were any material issues of fact that warranted a hearing or whether the case could be submitted for adjudication based on the existing record without a hearing. On February 12, 2008, EKPC filed its response, stating it was not aware of any material issue of fact that warranted a hearing, and requested that the case be submitted for adjudication on the record without a hearing.

The Commission's May 1, 2008 Order made the Member Cooperatives parties to this proceeding as part of the review of the pass through mechanism. The May 1, 2008 Order included a data request to the Member Cooperatives concerning the operation of the retail pass through mechanism during the 2-year review period. All of the Member Cooperatives responded to the data request. Gallatin Steel Company ("Gallatin") sought and was granted intervention after the Member Cooperatives were made parties to this proceeding. Gallatin did not request the opportunity to submit data requests or file comments.

SURCHARGE ADJUSTMENT

The September 19, 2007 Order initiating this case indicated that since each of the six periods under review in this proceeding may have resulted in over- or under-recoveries, the Commission would entertain proposals to adopt one adjustment factor to net all over- or under-recoveries. EKPC determined that it had a net over-recovery of its environmental costs of \$1,458,105.⁵ EKPC proposed that the over-recovery be returned to its Member Cooperatives by decreasing the total jurisdictional environmental

⁵ Response to the Commission Staff's First Data Request dated September 19, 2007, Item 1, page 4 of 4.

surcharge revenue requirement by \$243,018 per month for the 6-month period following the Commission's decision in this proceeding.⁶

The Commission has reviewed and finds reasonable EKPC's calculation of a net over-recovery of \$1,458,105 for the review periods covered in this proceeding. The Commission also finds reasonable EKPC's proposal to refund that over-recovery over 6 months, resulting in a decrease of \$243,018 in the total jurisdictional environmental surcharge revenue requirement in each of the first 6 billing months following the date of this Order.

RATE OF RETURN

The Settlement Agreement approved in Case No. 2004-00321 provided that the reasonable rate of return would be based on a weighted average debt cost of the debt issuances directly related to the four projects in EKPC's compliance plan, multiplied by a 1.15 Times Interest Earned Ratio ("TIER") factor. The Settlement Agreement further provided that EKPC would update the return as of the end of each 6-month review period and request Commission approval of the updated average cost of debt, with the 1.15 TIER factor applied to the updated average cost of debt.⁷

EKPC updated the weighted average cost of debt as of May 31, 2007 and determined that the rate of return, utilizing a TIER factor of 1.15, would be 5.61 percent.⁸ In addition to updating the weighted average cost of debt, EKPC proposed

⁶ Bosta Testimony at 6.

⁷ Case No. 2004-00321, March 17, 2005 Order, Appendix A, at 3.

⁸ Response to the Commission Staff's First Data Request dated September 19, 2007, Item 7.

that the 1.15 TIER factor should be updated. EKPC noted that in its recently completed base rate case, Case No. 2006-00472,⁹ it proposed to use a 1.35 TIER to determine revenue requirements. EKPC argued that the reasons supporting the use of a 1.35 TIER in that rate case were applicable now in determining the appropriate TIER for the environmental surcharge. EKPC stated its belief that the TIER used in the rate of return calculations in the environmental surcharge should be consistent with the Commission's decision in Case No. 2006-00472. Utilizing a 1.35 TIER factor, EKPC determined and proposed a rate of return of 6.58 percent.¹⁰

In its December 5, 2007 Order in Case No. 2006-00472, the Commission found that the use of a 1.35 TIER was reasonable for EKPC, given its current financial condition and its need to comply with the requirements of the Rural Utilities Service mortgage agreement and its unsecured credit facility.¹¹ The Commission agrees with EKPC that the TIER used in the environmental surcharge rate of return calculations should be consistent with the TIER found reasonable in its recent rate case.

The Commission has reviewed and finds reasonable EKPC's determination of the updated rate of return, which reflects the updated weighted average cost of debt and a 1.35 TIER factor. EKPC should use a rate of return of 6.58 percent for all environmental surcharge monthly filings submitted after the date of this Order.

⁹ Case No. 2006-00472, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., final Order dated December 5, 2007.

¹⁰ Bosta Testimony at 10-11.

¹¹ Case No. 2006-00472, December 5, 2007 Order, at 33-35.

RETAIL PASS THROUGH MECHANISM

Operation of Retail Pass Through Mechanism

Several of the Member Cooperatives indicated in the responses to the data request that an inequity existed in the methodology used to calculate the retail pass through mechanism. These Member Cooperatives believe that the current retail pass through methodology has not allocated enough of the monthly environmental surcharge to large industrial customers, resulting in an under-recovery of the surcharge revenue from this customer group. The Member Cooperatives stated that EKPC was aware of the problem and was developing a solution that would be presented to the Commission for approval at the earliest possible date.

EKPC currently has pending before the Commission in Case No. 2008-00115¹² an application to amend its environmental compliance plan and environmental surcharge mechanism. EKPC has indicated in that surcharge amendment case that it is considering different approaches to be utilized in the pass through mechanism, but has not finalized what changes it might propose.¹³

EKPC has not yet filed a proposal to revise its environmental surcharge or the retail pass through methodology, and no objections to the continuation of the existing retail pass through methodology have been raised in this proceeding. Therefore, the Commission finds the Member Cooperatives' retail pass through mechanism is

¹² Case No. 2008-00115, The Application of East Kentucky Power Cooperative, Inc. for Approval of an Amendment to Its Environmental Compliance Plan and Environmental Surcharge.

¹³ Case No. 2008-00115, EKPC Response to the Kentucky Industrial Utility Customers, Inc. ("KIUC") Second Data Request dated May 29, 2008, Item 3. Gallatin is a member of KIUC.

reasonable and should be continued in its current form. However, during EKPC's next 6-month surcharge review case, the issue which has been identified by several of the Member Cooperatives as a revenue allocation inequity will be reviewed, and EKPC and its Member Cooperatives should be prepared to present any changes necessary to address that issue in a fair and reasonable manner.

Retail Pass Through Adjustment

Each of the Member Cooperatives determined an over- or under-recovery for its surcharge pass through mechanism, with 9 of the Member Cooperatives having over-recoveries and 7 having under-recoveries. Like EKPC, the Member Cooperatives proposed that the over-recoveries be refunded to, or under-recoveries be collected from, ratepayers as an adjustment to the retail pass through factor for each month in the 6-month period following the Commission's Order in this proceeding.¹⁴

The Commission has reviewed and finds reasonable the Member Cooperatives' calculations of their respective over-recoveries and under-recoveries for the review periods covered in this proceeding. In addition, the Commission finds reasonable the Member Cooperatives' proposal to adjust their respective retail pass through factors in each of the first 6 billing months following the date of this Order. A schedule of the

¹⁴ Id. at 7. The Member Cooperatives' over- or under-recovery for the respective surcharge pass through mechanism reflects activity for 18 billing months, with the exception of the under-recovery for Inter-County Energy Cooperative Corporation ("Inter-County"). The under-recovery for Inter-County reflects activity for 24 billing months. The collection of Inter-County's previous surcharge pass through under-recovery was deferred, pursuant to the Commission's January 31, 2007 Order in Case No. 2006-00131, An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Period Ending December 31, 2005 and the Pass Through Mechanism for Its Sixteen Member Distribution Cooperatives.

over- or under-recovery for each Member Cooperative and the monthly adjustment are shown in Appendix A to this Order.

SURCHARGE ROLL-IN

EKPC argued that it was not appropriate in this case to incorporate, or “roll-in,” surcharge amounts into its existing base rates. EKPC stated that it and the Member Cooperatives had experienced several changes in base rates during 2007. EKPC noted that the appropriate TIER was an issue in Case No. 2006-00472 and in this proceeding and the determination of the appropriate TIER could have a bearing on the appropriate roll-in calculations. EKPC indicated that it may recommend a roll-in of appropriate surcharge amounts at a later date, depending on the timing of its next base rate case and the Commission’s decision in Case No. 2006-00472.¹⁵

The Commission is not persuaded by EKPC’s arguments. While the Member Cooperatives have experienced changes in the EKPC base rates during 2007, EKPC has acknowledged that if the roll-in is properly calculated, the total bill after roll-in to the Member Cooperative should be approximately equal to the total bill prior to the roll-in. The determination of the appropriate TIER in either the base rate case or the environmental surcharge will not affect the determination of the roll-in amount, as the new TIER will be applied prospectively in future periods. EKPC is reminded that KRS 278.183 clearly states that, if appropriate, a roll-in of surcharge amounts occurs in conjunction with a 2-year surcharge review.

¹⁵ Bosta Testimony at 8-9. EKPC filed its testimony in this case on October 24, 2007, prior to the Commission’s December 5, 2007 Order in Case No. 2006-00472.

The Commission has reviewed the settlement agreement relating to the initial establishment of EKPC's environmental surcharge and the retail pass throughs in Case Nos. 2004-00321 and 2004-00372. While that settlement agreement stated how over- and under-recoveries of the surcharge would be handled between EKPC and the Member Cooperatives, the settlement agreement did not address how a change in EKPC's base rates due to a roll-in would be passed through by the Member Cooperatives to their retail customers. Rolling surcharge amounts into EKPC's wholesale base rates without a corresponding mechanism to change the Member Cooperatives' retail base rates would not be reasonable.

Therefore, the Commission finds that it is not reasonable at this time to require EKPC to roll-in surcharge amounts into its existing base rates. However, during its next 2-year surcharge review case, EKPC should calculate a surcharge amount that could potentially be rolled into existing base rates, explain how the surcharge amount should be incorporated into EKPC's existing base rates, and explain how the Member Cooperatives would reflect any change in the wholesale base rates in their respective retail base rates.

IT IS THEREFORE ORDERED that:

1. EKPC shall include a \$243,018 monthly reduction in its jurisdictional environmental revenue requirement determined in each of the first 6 billing months following the date of this Order, as discussed herein.
2. The Member Cooperatives' retail pass through mechanism shall be continued, subject to further review in the next 6-month surcharge review case.

3. The Member Cooperatives shall include the applicable monthly retail pass through adjustments, shown in Appendix A, in the determination of each Member Cooperative's pass through mechanism, as discussed herein.

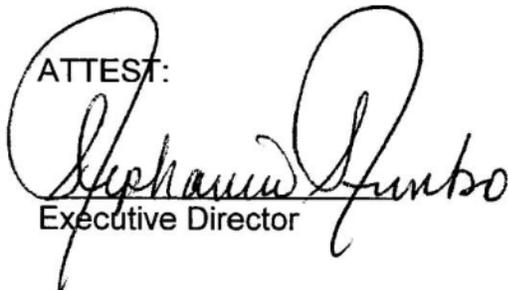
4. EKPC shall use a rate of return of 6.58 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

5. EKPC and its Member Cooperatives shall present any changes to the retail pass through mechanism necessary to address the revenue allocation issue discussed in this Order during the next 6-month surcharge review cases.

6. During its next 2-year surcharge review, EKPC and the Member Cooperatives shall provide information concerning a potential roll-in of its surcharge into existing base rates, as described in this Order.

Done at Frankfort, Kentucky, this 1st day of August

By the Commission

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE
COMMISSION IN CASE NO. 2007-00378 DATED

Member Cooperatives' Adjustment to
Monthly Pass Through Mechanism

The EKPC Member Cooperatives shall include the following monthly adjustments in the determination of the applicable pass through factors for 6 months after the date of this Order.

	<u>Total Amount of Over-Recovery</u>	<u>Monthly Amount Returned</u>
Big Sandy RECC	\$ 42,652	\$ 7,109
Blue Grass Energy Cooperative Corp.	\$ 588,138	\$ 98,023
Cumberland Valley Electric	\$ 303,143	\$ 50,524
Fleming-Mason Energy Cooperative	\$ 212,756	\$ 35,459
Licking Valley RECC	\$ 36,258	\$ 6,043
Nolin RECC	\$ 489,204	\$ 81,534
Shelby Energy Cooperative, Inc.	\$ 85,070	\$ 14,178
South Kentucky RECC	\$ 50,590	\$ 8,432
Taylor County RECC	\$ 27,845	\$ 4,641

	<u>Total Amount of Under-Recovery</u>	<u>Monthly Amount Collected</u>
Clark Energy Cooperative	\$ 71,556	\$ 11,926
Farmers RECC	\$ 22,403	\$ 3,734
Grayson RECC	\$ 19,176	\$ 3,196
Inter-County Energy Cooperative Corp.	\$ 111,933	\$ 18,655
Jackson Energy Cooperative	\$ 109,364	\$ 18,277
Owen Electric Cooperative	\$ 591,010	\$ 98,502
Salt River Energy Cooperative Corp.	\$ 129,779	\$ 21,630