Expense Reduction Plan and Report

Cumberland Valley Electric, Inc.

August 1, 2017

VERIFICATION OF TED HAMPTON

STATE OF KENTUCKY)

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COUNTY OF Knox)

Ted Hampton, President and Chief Executive Officer of Cumberland Valley Electric, Inc., being duly sworn, states that he has supervised the preparation of the following Expense Reduction Plan and Report and that the matters and things set forth therein are true and accurate to the best of his knowledge, information and belief, formed after reasonable inquiry.

Ted Hampton

Subscribed and sworn to before me on this 1st day of August, 2017.

NOTARY PUBLIC, Notary # 414654

Commission expiration: 2-25-18

I. Background

On or about June 23, 2016, Cumberland Valley Electric, Inc. ("Cumberland Valley"), filed an application for an adjustment of its retail rates with the Kentucky Public Service Commission ("Commission"). Cumberland Valley's rate filing was precipitated by the significant deterioration of the cooperative's financial condition, due in large part to an ongoing substantial decline in the revenue generated by sales to Cumberland Valley's members. Although Cumberland Valley took numerous actions to minimize its costs and improve efficiency during this timeframe, increased expenses and the erosion of revenue resulted in Cumberland Valley being unable to achieve the financial metrics required by its lenders and seeking an increase in its electric base rate of approximately $1,975,000. The Commission ultimately granted rate relief to Cumberland Valley (providing for $1,679,680 in additional revenue) by Order entered February 6, 2017, in Case No. 2016-00169. The Commission also found, as part of that same Order, that Cumberland Valley "should conduct a formal study of its expenses and, within six months of the date of this Order, file with the Commission a formal plan to reduce Cumberland Valley's expenses."[1]

II. Plan Development

Immediately following entry of the Commission's Order, Cumberland Valley leadership commissioned the formation of a Cost Reduction Committee to thoroughly and formally examine all aspects of the cooperative's expenses and develop a robust, systematic plan to cut costs. The Committee, comprised of the following individuals, was intentionally designed to include multiple departments and disciplines to ensure diversity of viewpoint and expertise: Office Manager, Accounting Supervisor, Accountant, Manager of Engineering, Superintendent, Assistant Superintendent, Director of Marketing & Economic Development and Billing Supervisor. The

[1] *See* Order, at p. 24.

Committee was tasked with compiling and analyzing Cumberland Valley's financials and making recommendations to the President/Chief Executive Officer on ways to reduce expenses.

The Committee's first meeting took place on February 23, 2017. At this meeting, the Committee set an initial goal of identifying at least $1,000,000 in expenses that could be temporarily or permanently reduced consistent with prudent utility management. The Committee subsequently met on seven unique occasions and presented its primary findings/recommendations to the President/Chief Executive Officer on April 5, 2017.

A. Methodology

The Committee developed a systematic approach to the evaluation of expenses and for making recommendations to the President/Chief Executive Officer. Below is a summary of the step-by-step approach the Committee took in forming its conclusions and recommendations:

> *Step 1 (Gathering of Data)* – The cooperative's accounting department performed an evaluation of all 2016 expenses. Based on this analysis, each area of expense was identified, organized, and added to a meeting agenda to be discussed. Initial meetings examined expenses that would have the greatest impact on meeting the Committee goal of at least $1,000,000, while later meetings performed a line-by-line analysis of the Income Statement in order to examine every expense that had not yet been addressed.
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> *Step 2 (Initial Discussion)* – The Committee discussed all expenses put forth on the meeting agenda and debated the merits of each expense. The Committee took note of the size of each expense, its relative value to the cooperative and its customers, and the availability of any alternative strategies that could be employed to reduce an expense or expense category. For some items, a consensus recommendation was easily reached, while on others additional research or discussion proved necessary. Occasionally, expenses not listed on the current meeting's agenda would be discussed by the Committee and if further evaluation needed to be done, it would be added to the next meeting's agenda.
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> *Step 3 (Additional Data Gathering [if needed])* – A few expenses took additional time to evaluate and consider alternatives; these expenses were further analyzed after the initial discussion of the Committee before a recommendation was formed.
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> *Step 4 (Forming of Recommendation)* – After an expense was thoroughly discussed by the Committee, the accounting department (and any other interested department, as

appropriate) conducted and generated its own expense evaluation based on the directives of the Committee. If the Committee could not reach a consensus with respect to the proper strategy to be employed concerning a particular expense or expense category, both the majority and dissenting option(s) were presented to the President/Chief Executive Officer for a decision.

Step 5 (Finalizing the Evaluation) – Once the Committee and any relevant departments completed their evaluations, the Committee finalized its recommended course of action and presented it to the President/Chief Executive Officer for his final review and decision.

Step 6 (Implementing Expense Reduction Strategies) – Guided by the recommendations of the Committee, the President/Chief Executive Officer determined which strategies to pursue in light of all relevant factors, with the ultimate goal of providing safe, reliable, cost-effective electric service.

B. Results

As a result of its formal, systematic efforts to reduce its expenses, Cumberland Valley has successfully identified a number of savings opportunities in various areas of its operations. Listed below is a summary of the one-time and recurring expenses that Cumberland Valley has determined it may prudently avoid at this juncture.

1. Require Employee Contributions to Medical/Dental Insurance Premiums
    a. Plan: Adjust the employee contribution schedule to ensure salaried employees pay a portion of both their medical and dental insurance premiums; Board resolution passed and submitted to Commission with respect to this matter
    b. Estimated Savings:

Timeframe	Projected Annual Savings (Medical)
4/1/17 – 3/31/18	$7,232.70
4/1/18 - 3/31/19	$10,849.05
4/1/19 – 3/31/20	$14,465.41
4/1/20 - indefinitely	$17,901.75

Timeframe	Projected Annual Savings (Dental)
4/1/17 – indefinitely	$931.01

2. Reduce/Eliminate Use of Construction Contractors
    a. Plan: Use Cumberland Valley employees for construction and retirement work whenever possible; competitively bid other work when appropriate
    b. Estimated Savings: $882,161 annual cash savings ($70,572 bottom line savings)

c. Update: Starting June 2, 2017, Cumberland Valley has stopped the use of any construction contractors and is only using CVE employees for construction and retirement work.

3. Reduce Use of IT Contractor
    a. Plan: Reduced the number of days IT contractor engaged from 3 days to 2 days
    b. Estimated Savings: $27,036.00 (annual savings)
4. Temporarily Discontinue Sending Off Reclosers for Repairs
    a. Plan: Delay any future repairs of reclosers until 2018
    b. Estimated Savings: $40,074.85 (one-time savings)
5. Pursue Energy Efficiency Measures at Cumberland Valley's Facilities
    a. Plan: Change out lighting in the Gray main office and warehouse to LEDs
    b. Estimated Savings: $2,963.66 (annual savings)
6. Discontinue Use of Digital Signage Software
    a. Plan: Halt the use of digital signage for displaying information to members and employees
    b. Estimated Savings: $3,528 (annual savings)
7. Reduce Right-of-Way Budget
    a. Plan: Reduce 2017 budget for Right-of-Way expenses to $750,000
    b. Estimated Savings: $469,212.87 (one-time savings)
    c. Update: Cumberland Valley is currently on track to come in below the revised budget while minimizing any safety or reliability risk
8. Evaluate and Address Cumberland Valley's Fleet
    a. Plan: Continually examine whether Cumberland Valley's fleet is appropriately sized and available for service; reduce the number of vehicles in Cumberland Valley's fleet by five, four vehicles will be sold and the remaining vehicle will be used for parts
    b. Estimated Savings: $23,161.03 (annual savings)
9. Other Reductions outside the Committee
    a. Consolidation of Local Telephone Lines
        i. Estimated Savings: $19,325 (annual savings)
    b. Negotiated Phone System Upgrades
        ii. Estimated Savings: $16,995 (one-time savings) and $3,360 (annual savings)
    c. Internet Access
        iii. Estimated Savings: $6,996 (annual savings)
    d. Anti-Virus
        iv. Estimated Savings: $1,200 (annual savings)
    e. Website Hosting
        v. Estimated Savings: $4,000 (one-time savings) and $3,120 (annual savings)
    f. SCADA Telephone Lines
        vi. Estimated Savings: $45,828 (annual savings)
    g. Modification of Cell Phone Plans
        vii. Estimated Savings: $16,596 (annual savings)

III. Consideration of a Merger

Pursuant to the Commission's final Order in Case No. 2016-00169, Cumberland Valley's recent in-depth examination of its expenses and financial health included consideration of "the advantages and disadvantages of a merger between Cumberland Valley and another electric utility, with the ultimate goal of achieving cost savings through economies of scale."[2] As part of this process, Cumberland Valley generally identified certain positive and negative outcomes that may result from a merger, as well as specifically examined the possible implications of a merger with a neighboring utility.

At the outset, Cumberland Valley noted that a merger necessarily falls near or at the end of the continuum of actions it may take to ensure its members continue to receive safe, reliable electric service at fair, just and reasonable rates. Any merger, of course, would necessarily be an extensive and expensive undertaking that presents numerous legal, financial, and operational challenges; Cumberland Valley believes that other efforts (including those related to load growth and retention, expense reduction, and appropriate rate design/rate recovery) should be pursued and exhausted prior to such an endeavor. Of course, Cumberland Valley has taken (and continues to take) significant steps to address its financial health, as evidenced by the record of Case No. 2016-00169 and this Plan and Report.

While the full-scale pursuit of a merger involving Cumberland Valley is premature, it is nonetheless useful and beneficial to explore the advantages and disadvantages that may result from that action. A merger would obviously increase the scale and scope of the involved businesses; while access to capital and credit costs may be expected to improve as a result of the increased size of the resulting entity, such benefits would likely be marginal due to Cumberland Valley's

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[2] *See* Order, at p. 24.

particularly low cost of debt and the financing framework available to cooperatives through lenders like RUS, CFC, and CoBank. Additionally, a merger could be expected to have some impact on equipment procurement/utilization, labor force/personnel costs, and necessary physical facilities (offices, warehouses, fleet, etc.); however, due to the layout and nature of Cumberland Valley's rural, rugged service territory, it is unlikely that substantial cost reduction with respect to district offices or field employees could be realized. Savings resulting from economies of scale with respect to certain leadership and office employees, as well as increased diversity in the load profiles and geographic location of customers, would be expected positive outcomes. Conversely, fewer employment opportunities and the loss, at least to some degree, of local influence and control are negative aspects of a merger.

Of course, the viability of any merger is dependent upon the value proposition for Cumberland Valley and the potential merger candidate. For discussion purposes, Cumberland Valley identified the two (2) rural electric cooperatives it borders, namely Jackson Energy Cooperative Corporation and South Kentucky Rural Electric Cooperative Corporation, as the most plausible candidates with which to merge. Cumberland Valley then performed a high-level inquiry into each of the relevant parties with the intention of preliminarily ascertaining whether Cumberland Valley and its members are positioned to benefit financially (primarily in terms of the rates paid) by pursuing a merger. This analysis included an examination of the parties' statements of operations and balance sheets, trends in historical pricing and, perhaps most notably, the residential rates presently charged by each of the cooperatives, which are reproduced below.

	CVE	South KY	Jackson Energy
Residential Customer Charge	$12.00	$12.82	$16.44
Residential kWh Charge	0.08749	0.08543	0.09849
Residential Base Cost 1000 kWh	$99.49	$98.25	$114.93

Based on the information reviewed, and because Cumberland Valley's existing and anticipated rates and costs are comparable to or substantially less than those of the potential merger candidates, Cumberland Valley has concluded that a merger is likely not an appropriate pursuit under present circumstances.

As is evident from the foregoing discussion, numerous (and sometimes conflicting) considerations must be weighed when exploring the advantages and disadvantages of a merger between Cumberland Valley and another electric utility. While Cumberland Valley does not believe that moving forward with merger pursuits is the proper course at this juncture, it does intend to continue to learn from and work cooperatively with its fellow utilities to ensure it continues to best serve its members.

IV. Conclusion

Beginning in February of 2017, Cumberland Valley's President/Chief Executive Officer tasked a collection of employees to perform a thorough and systematic examination of the cooperative's expenses. Cumberland Valley's Cost Reduction Committee, in conjunction with professionals throughout the cooperative's organization, began compiling and analyzing all relevant data and discussing the strategies that could be employed to reduce costs. The information contained within this filing is the culmination of Cumberland Valley's efforts, which efforts are expected to result in the following cost savings:

Plan/Item	One Time	Recurring
Reduce Right-of-Way Budget	$469,212.87	-
Reduce Use of IT Contractor	-	$27,036.00
Reduce/Eliminate Use of Construction Contractors[3]	-	$882,161.00
Temporarily Discontinue Recloser Repairs	$40,074.85	-
Energy Efficiency at Cumberland Valley Facilities	-	$2,963.66
Discontinue Digital Signage	-	$3,528.00
Evaluate and Address Fleet	-	$23,161.03
Consolidate Local Telephone Lines	-	$19,325.00
Negotiated Phone System Upgrades	$16,995.00	$3,360.00
Switching Anti-Virus	-	$1,200.00
Internet Access	-	$6,996.00
Website Hosting	$4,000.00	$3,120.00
SCADA Telephone Lines	-	$45,828.00
Modify Cell Phone Plans	-	$16,596.00
Medical Insurance[4]	-	$7,232.70 – 17,901.75
Dental Insurance	-	$931.01
Total	$530,282.72	$1,043,438.40

While the foregoing expense reductions are certainly substantial, Cumberland Valley realizes that continuous improvements will need to be made as economic challenges in its service territory continue. This realization is reflected in many of the recommendations currently being pursued, as they outline the need for ongoing evaluation of expenses and the development of plans to streamline operations. Cumberland Valley will continue to strive to meet its mission of providing safe and reliable electricity at the lowest possible cost to its members.

[3] Cumberland Valley's primary construction contractor was Five-C Construction, whose labor was mostly capitalized; therefore the $882,161 herein represented are cash savings and not a direct decrease in annual expenses (only around $70,572 will be a direct reduction in annual expenses). One other factor to be considered is that the reduction in the amount of labor that is capitalized should slow the rate of growth in depreciation expense over time.

[4] Recurring savings will increase over a four-year period based on the gradual increase to employee contributions approved by Cumberland Valley's Board of Directors (*see* Cumberland Valley's post-case compliance filing in Case No. 2016-00169 made April 5, 2017).