

**Focused Management and  
Operations Audit of  
East Kentucky Power Cooperative, Inc.**

**FINAL REPORT**

Presented to:  
**The Kentucky Public Service Commission**

By:



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## I. Introduction

### A. Engagement Background

The Kentucky Public Service Commission (Commission) issued a request for proposals seeking the conduct of a focused management and operations audit of East Kentucky Power Cooperative, Inc. (EKPC), a not-for-profit generation and transmission cooperative, headquartered in Winchester, Kentucky and owned by 16 member distribution cooperatives. EKPC and its more than 600 employees supply electric power to these 16 members and to non-member utilities as well. These 16 members serve over 500,000 member-consumers in eighty-seven Kentucky counties.

The Liberty Consulting Group (Liberty) responded to the Commission's request. Based in part upon EKPC's input, the Commission selected Liberty to perform the audit. Liberty is a management and technical consulting firm that specializes in the energy and telecommunications industries, in which the firm has operated for 23 years. Liberty has performed comprehensive and focused management audits, fuel and energy procurement and management audits, reviews of corporate governance in utility holding company structures, focused reviews of construction program expenditures and results, reliability assessments, and other consulting engagements for two-thirds of the country's state public service commissions and a number in Canada. Liberty's team for this audit included three very senior persons, who combine governance, management, financial, and operating backgrounds, and whose experience extends across a wide range of private and publicly owned power supply entities.

This report documents the results of Liberty's study, which it performed in accordance with the requirements of the request for proposals, as addressed in Liberty's proposal of April 3, 2009.

### B. Recent EKPC Conditions and Circumstances

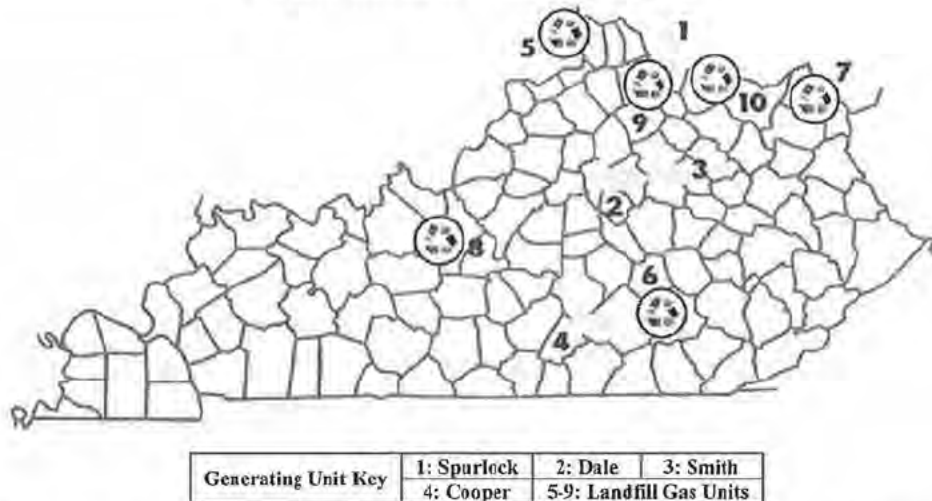
EKPC owns and operates 2,851 megawatts of electricity generating capacity, which it operates to provide capacity and energy to its 16 members. This capacity consists of:

- Three baseload coal-fired generating stations:
  - H.L. Spurlock Power Station (near Maysville)
  - John Sherman Cooper Power Station (near Somerset)
  - William C. Dale Power Station (near Winchester)
- Dual fuel peaking (natural gas and fuel-oil) combustion turbines (CTs) (at the J.K. Smith Power Station in Trapp, near Winchester). These facilities serve peak electric demand on the member systems.

EKPC also obtains about 170 megawatts of hydropower through arrangements with Laurel and Wolf Creek dams and the federal Southeastern Power Administration. In 2008, EKPC's 2008 winter peak reached 3,149 MW; its summer peak was 2,265 MW. EKPC owns and operates about 2,755 miles of high-voltage transmission lines required to deliver electricity to its 16 members. EKPC's most recent annual report listed total assets of about \$2.8 billion.

Figure I.1 depicts EKPC's generation and transmission infrastructure and the retail area served by its members.

Figure I.1: EKPC Serving Region



The past five years have presented a number of changes and problems, which have challenged EKPC management and its board of directors, and which have illuminated many important aspects about EKPC's governance and the relationship that exists between senior management and the board.

Two major financial and operating problems occurred in 2004:

- A notice of violation that eventually led to a January 2006 EPA lawsuit against EKPC, alleging a violation of Acid-Rain environmental requirements at the cooperative's Dale generating station.
- A July 2004 forced outage at Spurlock #1, which caused EKPC to incur significant added costs (about \$38 million) for repairs and to secure power to replace lost generation.

Late 2004 and early 2005 brought other significant changes to EKPC's power portfolio and increases in the financing required to support it. EKPC filed in October 2004 for a certificate of public convenience and necessity (CPCN) for a fourth unit at Spurlock (Case No. 2004-00423). Soon thereafter, in January of 2005, a CPCN application followed for Smith #1 and Combustion Turbines #8 through #12 (Case No. 2005-00053). The Commission granted the Spurlock #4 CPCN, recognizing the additional load EKPC would be serving as a result of the earlier addition of Warren Rural Electric Cooperative to those already being served by EKPC. Spurlock #3 (the Gilbert unit) became operational in April 2005. EKPC did not file a rate case to recover either the capital costs or operations and maintenance costs associated with the Gilbert facility.

These factors required significant new liquidity and short-term financing. In September 2005, EKPC entered into a \$650 million unsecured line of credit (brokered by the National Rural Utilities' Cooperative Finance Corporation (CFC)) involving a group of 17 state, national, and international credit sources. Increased infrastructure needs continued. In October 2005, EKPC filed for a CPCN to install scrubbers at Spurlock #2 at an estimated cost of \$142 million (Case No. 2005-00417). The 2005 year ended with the creation of a \$32 million reserve by EKPC, at the request of its outside auditors, to address the potential environmental liability at Dale.

EKPC filed in January 2006 a CPCN application for a scrubber at Spurlock #1 (Case No. 2006-00132). The Commission approved the Spurlock #2 scrubber application in April, and later

approved the Spurlock #1 scrubber in August. The Commission also granted in August 2006 the requested CPCN for Smith #1 and CTs #8 - #12, in anticipation of load growth in the member systems served by EKPC.

EKPC thus found itself, as 2006 progressed, facing large capital needs, not only for new sources of power, but also for environmental compliance at existing stations. These already large capital needs came with other major, potential consumers of EKPC's financial resources: the forced outage expenses and potential penalties from EPA.

Recognizing the severe strain of these events on EKPC's finances, the Commission initiated on October 27, 2006 a Financial Condition Investigation (Case No. 2006-00455), stating:

*East Kentucky Power files monthly and annual financial reports with the Commission. A review of these reports indicates that East Kentucky Power's operations are producing negative net income since the last quarter of 2004. Based on the Commission's statutory authority under KRS 278.250 to "investigate and examine the condition of any utility subject to its jurisdiction," the Commission finds that an investigation should be initiated to review the financial condition of East Kentucky Power.*

In November 2006, EKPC gave notice of its intention to file a rate case seeking \$50-60 million in rate relief and announced the impending retirement of its CEO. EKPC named a new, interim CEO in December 2006. That same month, Warren Rural Electric Cooperative cancelled plans to become a member owner of EKPC. The Commission responded with an investigation of the adequacy of EKPC's generating capacity (Case No. 2006-00564).

EKPC did make its planned rate filing in January 2007 (Case No. 2006-00472), seeking \$43.3 million in additional revenues. The filing also demonstrated the seriousness of EKPC's financial situation by seeking emergency rate relief and by noting the deferral of already past-due maintenance on Spurlock #2 and Dale #3. Further demonstrating EKPC's financial situation was the testimony of a CFC executive that EKPC would not qualify for an investment grade credit rating. The Commission granted EKPC \$19 million in interim rate relief on April 1, 2007, stating:

*As a general matter, prudently managed utilities will not willingly place themselves in a position where interim rate relief during the suspension period is necessary to avoid a material impairment of the utility's credit or operations. This is especially true of rural electric cooperative corporations. KRS 278.095 provides that a cooperative "shall be operated on a nonprofit basis for the mutual benefit of its members and patrons." While low rates are desirable, this must be balanced against the necessity that a cooperative remain financially and operationally viable. With the shadow of Big Rivers Electric Corporation's bankruptcy only recently receding in the memory of Kentucky utility jurisprudence, all directors and officers of jurisdictional utilities should take note that the extraordinary relief authorized under KRS 278.190(2) is just that – extraordinary.*

Meanwhile, the investigation of EKPC's plan to construct additional generating units in light of Warren RECC's cancellation continued. EKPC would later (in May 2007) surrender the Commission-granted CPCN for Smith CTs #10 - #12. The Commission determined that the remaining generation additions should proceed.

Shortly after replacing his predecessor, the new, interim EKPC CEO commissioned a study of management and governance by the National Consulting Group, a business unit of the National Rural Electric Cooperative Association. The April 2007 report of this NRECA unit (NCG) was critical of executive management and the board. The interim CEO provided the NRECA report to board leadership, but did not share the report with the rest of EKPC's board.

Later in the year (June 2007), the Commission closed out the financial investigation, given the continuing nature of the rate proceeding. The Commission eventually awarded EKPC \$19.0 million in permanent rate relief in December 2007. The Commission did not award EKPC any rate relief beyond the initial interim \$19 million, finding that the cooperative did not meet its burden of proof to justify additional funds.

By September 2008, EKPC's summary of expected, five-year needs and financing underscored the growing significance of its financial stress. Estimates of total capital needs across this period had reached \$1.5 billion: \$900 million for the new Smith Unit #1, \$300 million for the Cooper scrubber, \$100 million for various transmission projects, and \$200 million for miscellaneous projects. EKPC stated that it planned to secure the \$900 million for Smith from private (*i.e.*, non-RUS supported) markets (the RUS moratorium on financing baseload plants was in existence), and that it had drawn \$615 million against its \$650 million CFC-syndicated credit facility.

In October 2008, EKPC filed an application to establish a regulatory asset for forced outage costs incurred during the first part of 2008 (Case No. 2008-00436). In a 2-1 decision, the Commission authorized establishment of the regulatory asset, but only after noting that:

*Without the establishment of a regulatory asset for purchased power costs arising from forced outages, East Kentucky's financial viability is questionable. We find that East Kentucky's request to establish a regulatory asset to account for non-FAC-recoverable purchased power costs arising from forced outages is for a lawful purpose and reasonable in light of its precarious financial condition. This will afford East Kentucky more time to resolve its long-term financial problems.*

The Commission was unanimous, however, in finding that a management audit of EKPC was necessary, stating:

*It is altogether unclear that East Kentucky has, as of yet, arrested the deterioration of its financial condition. That question will be thoroughly addressed in the context of East Kentucky's pending general rate case. The larger question is whether East Kentucky is fully committed to reversing its weakening financial condition. Ultimately, the responsibility for East Kentucky's*

*viability lies firmly within the province of its board of directors, who have a fiduciary duty to safeguard the financial and operational viability of the cooperative. The Commission cannot and should not usurp the directors' duty to make business judgments, but as the statutorily created regulatory authority, it also cannot and should not turn a blind eye to a situation which does not appear to be getting better.*

Three weeks after filing its application to establish a regulatory asset, EKPC filed an application to increase its base rates by \$67.9 million and to establish a regulatory asset for the amount of rate relief lost due to a delay in filing the application. EKPC followed these filings with a November CPCN application (Case No. 2008-000472) for Cooper #2 Scrubber and SCR projects estimated to cost \$324 million (granted in May 2009). On March 31, 2009, EKPC received \$59.5 million (87.6%) of the \$67.9 million in rate relief it had requested. In April 2009, Spurlock #4 went into commercial operation. In June 2009, the interim CEO was replaced by his new, permanent successor.

Credit issues have existed at EKPC throughout this period. Since September 2005, EKPC has obtained unsecured, short-term financing through a private credit facility arranged through CFC, a not-for-profit entity owned by rural electric cooperatives across the country. EKPC has obtained long-term financing through RUS, secured by a mortgage on its properties. EKPC's long-term debt totaled over \$2.4 billion at the end of 2008. EKPC's financial difficulties resulted in a technical default on its RUS debt at the end of 2006.

An extended period of time transpired between the preparation of the November 2009 draft of this report and the receipt in February 2010 of EKPC's comments on its factual accuracy. Those comments stated that, as of December 31, 2009, EKPC has procured financing for all of these facilities, and needs Commission approval of its pending Smith financing request before the Commission to complete its funding of ongoing projects. EKPC also reported that it has paid down its Credit Facility to \$325,000,000.

### **C. Near-Term Challenges Imposed by the Smith Plant**

Smith continues to present major challenges for EKPC from a financial, cost, regulatory, and litigation perspectives. LG&E and KU, for example, serve over 915,000 Kentucky customers, as compared with the 511,000 served by EKPC's members. According to the most recent available staff reports, EKPC, despite serving a base that is about 55 percent of the customers served by LG&E and KU, plans to make capacity additions (in the range of 1,500 MW) that are roughly equal to those of LG&E and KU through 2020. This proportionately much greater level of construction may put significantly greater pressure on the gap that already exists between EKPC rates and those of neighboring suppliers against whom it must compete for new load and against whom members can compare price performance.

The cost estimate for the 278 MW Smith project was \$533 million in mid-2006; it has grown by 54 percent to a current estimate of \$819 million. EKPC is currently seeking Commission approval of an even higher amount (\$921 million), citing uncertainties affecting the current estimate. Those uncertainties remain substantial, including:



- The significant passage of time since issuance of the CPCN, first issued in August 2006 and confirmed later in May 2007 by the Commission
- The significant financial, economic, and environmental disruptions and changes since then, which have caused major changes and uncertainties across the country in forecasted load, loan availability and rates, and the future of carbon-producing activities
- The existence of litigation involving Smith project construction and the current expectation that environmental approvals remain at least a year from being secured
- Whether EKPC is capable, as this audit has found, of carefully and thoughtfully creating, examining, and executing its mission in a manner that will optimize the interests of those who consume the electricity it produces
- An apparently still widening gap between its costs and those of others who produce and procure power in surrounding areas.

EKPC has stated that it does not intend, even upon receiving approval in the current financing proceeding, to pursue Smith before it undertakes a full reassessment of the fit between the project and EKPC's mission and goals, considering the kinds of analyses that Liberty believes are necessary, but have not been performed adequately. The financing application, states that construction expenditures will not take place, but that maintenance activities (of a magnitude that is not specified) will continue. It also states that the contingency affecting resumption of construction is not a reassessment of Smith, but rather is the receipt of required environmental permits. EKPC has received a draft, but not final, required air permit from the Kentucky Division of Air Quality and EKPC has been sued by the Sierra Club in several venues. Moreover, EKPC has objected to the relevance of intervenor data requests that ask questions that are central to a "de novo" examination of Smith's long-term fit into a well-designed portfolio.

#### **D. Prior Reviews of EKPC**

Liberty's prior management audit of EKPC for the commission was completed in 2001. That audit identified key risks then facing EKPC as:

- A major outage, especially at the Spurlock Generating Station
- EKPC's low equity
- Future environmental standards
- Deregulation
- Material changes involving RUS
- Cultural changes needed in a competitive marketplace.

Deregulation of Kentucky's electricity market (which some coops including EKPC have since advocated) has not occurred. However, the other risks have materialized. More significantly, they have, as the preceding discussion of recent events shows, combined to produce a significant adverse impact on EKPC's financial condition, which has become a major source of concern at the Commission. As the NRECA's NCG report noted in April 2007, these issues were "never addressed." The degree to which the risks remain relevant today, and the steps EKPC has taken to address them form an important part of the story that this report will tell, and will make clear that EKPC's ability to confront long-standing issues directly and effectively is a critical factor in its ability to operate in an environment where risks continue to change and increase.

## E. Audit Objectives and Scope

### 1. Objectives

The audit had three primary objectives.

**First Primary Objective:** Determine the independence, duties (fiduciary and otherwise), reasonableness, and effectiveness of the EKPC board of directors. This objective included the identification of any inherent conflicts of interest between:

1. The EKPC board's duties and responsibilities to EKPC
2. The duties and responsibilities owed to the Distribution Cooperatives (Should any conflicts be found, the audit's role was then to examine whether EKPC's interests have been subordinated in any way damaging to EKPC)

**Second Primary Objective:** Examine the involvement of the EKPC board in short-term and long-range strategic planning, including an assessment of the board's role and activities in the following areas:

1. Participation in developing EKPC's strategy for meeting its Distribution Cooperatives' energy needs
2. Development of EKPC's short- and long-term budgets and forecasts of capital and O&M expenditures
3. Decisions regarding the reasonableness of rates and adequacy of service

**Third Primary Objective:** Evaluate the reasonableness and effectiveness of EKPC's Executive Management interaction with the EKPC board, including:

1. Functions and processes, organizational structure, duties and responsibilities of EKPC's Executive Management
2. Business strategies
3. Financial systems, including risk assessment, to track and maintain EKPC's financial integrity and accountability
4. Business and operating policies and procedures.

### 2. Scope

The scope of the audit included:

1. *Evaluate all aspects, functions, and effectiveness of the EKPC board*
  - a. How the interests of EKPC as a separate generation and transmission cooperative corporation align with the Distribution Cooperative owning entities
  - b. Independence of the EKPC board
    - i. Whether conflicts of interest or fiduciary responsibility exist
    - ii. How they are resolved
  - c. Role of Distribution Cooperative governing authorities in the overall EKPC board decision-making process
  - d. Adequacy of communication by EKPC and the EKPC board to the member Distribution Cooperatives and their members
  - e. Adequacy of information presented to the EKPC board
  - f. Steps taken by the EKPC board to independently verify that information
  - g. Nature and extent of the EKPC board's financial, technical and managerial expertise

- h. Existence of any organizational impediments preventing EKPC executive management or its board from diligently directing EKPC
    - i. Extent to which the EKPC board has delegated an appropriate level of discretion to executive management
  2. *Evaluate all aspects, functions and effectiveness of the EKPC board*
    - a. Composition of the EKPC board and all sub-units
    - b. Member selection and assignment to sub-units
    - c. Specific role of each sub-unit
    - d. How each sub-unit functions
    - e. How each sub-unit interacts with executive management and the board as a whole
    - f. Effectiveness of each sub-unit in completing assigned tasks and influencing board decisions
  3. *Evaluate the effectiveness of the EKPC board's participation in the overall long-term and short-term strategic planning processes*
    - a. Participation in EKPC's financial management and planning processes
    - b. Participation in capital planning and capital budgeting processes in terms of maintaining EKPC's financial integrity
    - c. Determination of when to request a rate increase
    - d. Determining if and when to construct or acquire new plant, transmission and equipment to meet load growth
    - e. Responding to regulatory actions or unforeseen events
    - f. Timeliness of EKPC board actions
  4. *Evaluate the effectiveness of executive management*
    - a. Interaction with the board
    - b. Organizational structure
    - c. Duties and responsibilities
  5. *Conduct interviews with all key personnel*
    - a. EKPC board members
    - b. EKPC board chairman
    - c. EKPC board vice chairman
    - d. EKPC board secretary-treasurer
    - e. President /chief executive officer /general manager of the distribution cooperatives
    - f. Each member of executive management
    - g. Such other distribution cooperative directors as necessary
  6. *Develop findings and make appropriate recommendations*
    - a. Address specifically all areas with potential for improvement
    - b. Deliver report to the Commission by September 30, 2009
  7. *Develop action plans and implementation steps*
    - a. Work with EKPC
    - b. Address all recommendations.

## II. Strategic Planning

### A. Background

EKPC does not engage in a regular, structured, and consistent strategic planning process. Management also does not regularly prepare a “strategic plan” document for board input and review, nor is such a document made available to employees for use in guiding their activities. EKPC prepared a strategic plan document in June 2002. It set forth a vision statement and a set of “assumptions” that express very general goals and objectives, such as:

- The primary purpose of EKPC capital assets (existing and planned) is to serve the member cooperatives’ needs
- EKPC will continue to look to RUS and to the CFC for financing, but will need to develop the ability to raise capital in the public/private investment markets
- EKPC will pursue opportunities to reduce capital risk by partnering with other entities for power supply.

A corporate scorecard identified several key performance measures; however, Liberty could find no follow-up documents indicating that this general plan became a source of guidance, reference, and measurement in substantial ways.

Management did undertake during the “financial troubles” of 2005-2007 efforts to identify areas where EKPC needed broadly to improve. These efforts included some examinations of matters that were strategic, as opposed to merely tactical, in nature. EKPC used three external reviews during this period; each review had different purposes. These three reviews, which provide the best written expressions of strategic thinking at EKPC, included:

- A 2006 report from consultant Richard Byrne
- A 2007 report from the National Consulting Group, a business unit of the National Rural Electric Cooperative Association (NRECA)
- An in-depth 2007 strategic planning effort with MCR Performance Solutions.

Focusing on the processes and documents produced by these three efforts provides the best means for assessing EKPC’s “thinking” during the time when its financial difficulties exposed the need for examination of its strategic direction.

### B. Findings

#### 1. *The Byrne Report*

In 2006, consultant Richard Byrne produced for EKPC a brief report identifying high-level issues, forming conclusions, and offering recommendations. This consultant also presented several brief “white papers” analyzing some of the strategic issues facing the cooperative. The recommendations of this consultant included:

- Revisit the “build and operate” approach to power supply
- Partner with investor-owned utilities or coal companies to develop more efficient and economic power generation plants than EKPC could establish under self-build options
- Partner with other major investor-owned electric producers to combine purchased power and coal supply efforts

- Partner with local gas suppliers to obtain firm gas supplies through displacement and storage
- Improve coal-price hedging
- Study the benefits of RTO/ISO membership with external market experts (the consultant expected EKPC staff's vigorous opposition to this recommendation)
- Increase board of directors' knowledge of transmission bottlenecks, and monitoring of operating budgets, capital costs, and variances.

This consultant, who was personally acquainted with the EKPC CEO, provided his recommendations at a time when the CEO was under great board pressure to reduce costs. EKPC announced the pending resignation of this CEO, who had held the position for many years, in November 2006. That same month, EKPC declared its intention to seek a \$50-60 million rate increase; *i.e.*, an increase that the cost reduction efforts had been intended to forestall. A number of the consultant's recommendations presented squarely strategic approaches and options central to forming a long-term strategy for EKPC. However, none of them received significant attention following the change in CEOs. This consultant's input was generally dismissed following the appointment of an interim CEO at the beginning of 2007.

## 2. *National Rural Electric Cooperative Association Report*

A first act by the new, interim CEO was to retain the National Consulting Group (NCG), a business unit of the NRECA to perform an organizational assessment of EKPC. Working in conjunction with Stone and Webster Consulting, NCG provided a report of its findings in April 2007. The CEO's purpose in commissioning this work was to produce a "straight story," hard-hitting conclusions, and frank evaluations of EKPC management personnel. NCG later sought and was given permission to expand the scope of the assessment to include governance issues. NCG produced a highly critical assessment of EKPC's governance, organization, and management, and it benchmarked performance in numerous areas. For example, the report made the following observations related to the organization's strategic power supply (emphasis added):

*EKPC is struggling with the increased demands and complexities associated with supplying electricity in today's changing marketplace. The approaches and techniques that have served EKPC and its members well in the past are no longer sufficient to guarantee future success. The risk exposure associated with environmental planning, construction management and supply planning is increasing. ...*

*... (Supply planning) efforts were very limited in the scope of alternatives considered. The effort appeared to be focused on the determination of "how much" and "when" but did very little to determine what technology would best meet EKPC requirements for low cost, minimal environmental impact and risk tolerance. Transmission as an alternative to new supply received little if any consideration. ...*

*... Renewable and demand-side alternatives also received limited consideration. Retirements of existing facilities were not considered. The result was a supply*

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*plan comprised solely of combustion turbines and circulating fluidized bed (CFB) coal units. ...the current system's strong dependence on the EKPC generation sources during periods of peak demand or system disturbances creates an unbalanced risk exposure to unit outages that could otherwise have been minimized by expanded transmission inter-tie capability and constraint relief measures.*

The factors that NCG found lacking in EKPC's planning must form core considerations for any power supplier's strategy formation to be considered effective. NCG used a number of benchmarks to compare EKPC to both generation and transmission cooperatives (G&Ts) and to more general national averages. This benchmarking exercise revealed a number of troubling trends, with the more significant ones including:

- Starting in about 2003, EKPC's trends in fuel cost and operations costs per kWh began to show increases greatly above national averages
- EKPC's maintenance costs also rose at rates significantly higher than national averages per kWh starting in 2003
- Administrative and general expenses per kWh began to outpace the G&T group even earlier, starting in 2000
- EKPC equity as a percentage of capital has been and remains far below the G&T group, especially since 2004.

NCG was particularly critical of the EKPC finance organization, especially with regard to the following issues:

- Lack of leadership to emphasize required financial strength and to increase equity levels and capital market access
- The CFO and finance organization were not held accountable for the financial problems and debt covenant violations that started with the 2004 Spurlock outage
- Rate relief was not requested to help solve the financial problems
- Internal controls were lacking, as was oversight and legal review of major purchases
- The planning and budgeting processes are weak
- EKPC lacked a financial contingency plan for major generating unit outages
- Cost containment initiatives are not tracked, nor were progress and variances from goals reported.

NCG was also critical of the EKPC power supply functions:

- EKPC's transmission system was not robust enough for effective energy transfers, and current plans do not eliminate these concerns
- EKPC lacked a robust integrated resource planning process
- EKPC's approach, objectivity, and rigor in evaluation of generation bids from outside sources were matters of concern

- Risk management was not well organized or coordinated, and EKPC did not follow a hedging strategy proposed by the Alliance for Cooperative Energy Services (ACES or ACES Power Marketing)
- EKPC had no operating contingency plan for the loss of a baseload unit
- Spot market purchasing of natural gas for peaking generation needed to be reevaluated
- EKPC needed to adjust its organization to align more closely with a significantly changed marketplace
- EKPC needed to validate and implement fuel blending system-wide.

The interim CEO shared some NCG report findings with executive staff. He reported that he described key issues to the board of directors, but did not provide the consulting report to them. The NCG report discussed personnel changes, but otherwise did not offer specific plans or actions to remedy the large number of areas where it made important conclusions. EKPC made changes in two vice presidential positions, (for power production and human resources) but did not follow remaining personnel change recommendations, on the grounds that continuity was required, given the financial uncertainties facing EKPC at the time. Executive management also removed the construction, fuel supply, and generation dispatch areas from under the control of the power production organization.

### *3. MCR Strategic Planning Process*

EKPC contracted with MCR Performance Solutions in February 2007 to facilitate an extensive and thorough strategic planning process. This process began in February 2007, and concluded with a final presentation dated November 8, 2007. It represents the only comprehensive strategic planning process that EKPC management recalls as having occurred. The development of a strategic plan was intended to:

- Address current issues and anticipate future issues or challenges
- Provide a vehicle for the new interim CEO to establish expectations for the management team in conjunction with the board
- Provide the management team an opportunity to interact and gain consensus on key strategies going forward
- Chart the long-term course for the cooperative.

MCR's work included:

- Identification of key issues and strategic imperatives
- Two board of directors' workshops
- Development of a strategic plan
- "NorthStar" cost reduction initiative
- Imperatives for issue resolution
- Action plans.

The plan resulting from this process remains the one against which EKPC tracked progress through 2009. One of the outcomes of the MCR process was the identification of many of the

strategic issues that remain crucial and relevant, now several years later. Another was the designation of the “KU Gap” as the most important objective and corporate performance measure, and the development of the NorthStar cost cutting program as the primary means for reducing this gap.

*a. The KU Gap*

The MCR-led process defines the KU Gap as the difference between the EKPC rate to its co-ops and the Kentucky Utilities municipal rate; *i.e.*, the respective wholesale rates charged to distribution entities. The wholesale rate rather than the retail rate forms the benchmark, because retail rates vary for many reasons not related to wholesale-supplier costs. The percentage difference between EKPC and KU rates emerged as the key measure for the EKPC “senior team” because EKPC and KU operate adjacently in so many areas. Member cooperatives thus commonly find KU rates to be the measuring stick when their member-customers and when businesses considering location decisions assess EKPC rates. The long-term and sizeable gap between the two rates has been a major concern of the EKPC members over many years. Other wholesale power producers operate in areas adjacent to EKPC member serving areas, but there are no structured comparisons made to the rates of these other producers.

The focus of EKPC management and the board on the KU Gap as measured on the bottom line (dollars per megawatt hour) is clear, strong, and continuous, but the same level of attention has not been paid to the specific factors that drive it. Such understanding is necessary to permit well-directed efforts to address the gap. EKPC could not produce analyses of the specific, categorical contributors to the gap, which makes understandable, but not appropriate, its failure to have specific plans to address the root causes.

The MCR-led strategic planning process measured the KU Gap at about 24 percent, or \$10 per megawatt hour in 2006. Starting from this already large disparity, the gap was expected to worsen, reaching over 30 percent by 2010. This 2010 estimate, moreover, assumed a continuation of the “bare-bones” planning level of 1.10 for EKPC’s times interest earned (TIER) target ratio. Using a more reasonable level of 1.25 times would cause the gap to grow by an additional 3 to 4 percent. The discussion of targeted rate gaps among board members and the senior executive team formed a focal point of the strategic planning process. Discussions centered on analyses targeting gaps of 18, 20, and 24 percent. The senior team recommended a target rate gap of 24 percent; some board members expressed a desire to close the gap to 20 percent by 2011.

*b. NorthStar Initiative*

The NorthStar initiative emerged as the top priority and focal point emerging from the MCR-led planning process. NorthStar was designed as a cost cutting program that would define and implement the cost savings levels required to reduce the KU Gap by the targeted amount. EKPC’s organization uses 20 “budget managers.” Each had to present to the senior executive departmental cost and staff reductions showing how to achieve NorthStar cost-cutting targets for 2008-2011. Updated fuel forecasts for both the company and KU were also factored into the goal-setting process. The process calculated final NorthStar savings targets compared to a baseline. The 2007 budget and financial forecast, prepared in late 2006, formed this baseline. The baseline included the 2008-2011 cost estimates from the 2007 document, but updated them



with current fuel cost estimates. The initiative set targeted annual levels for 2008 through 2011. The end target of cost savings for 2011 became the most important objective of the MCR process. These savings levels were projected to reduce the wholesale rate gap with KU. These targets included an EKPC TIER target of 1.20 times, thus overstating the targeted savings.

*c. Strategic Imperatives*

The final MCR report established strategic imperatives for six EKPC functional disciplines. The strategic imperatives addressed the issues facing EKPC, and each would require multiple strategies to address them. Each strategic imperative included from 7 to 10 supporting strategies (or “objectives”). The six high-level strategic imperatives consisted of:

1. **Financial Stability** - Increase the financial stability of EKPC while maintaining rate competitiveness with surrounding utilities
2. **Generation Expansion** - Optimize generation expansion plans consistent with EKPC's defined risk tolerance and environmental requirements
3. **Growth** - Manage growth in the most cost effective manner
4. **Rate Predictability** - Provide more predictable rates by proactively managing key risks in business
5. **Environmental Compliance** - Comply with environmental/regulatory requirements in the most efficient manner
6. **Transmission System** - Meet transmission reliability requirements and capitalize on transmission expansion opportunities.

EKPC expressed these strategic imperatives at a high-level; this makes them less definitive. The supporting strategies and their background statements provide much more insight into the strategic issues and their effect on EKPC. The plan was to track strategies, specific action plans, and their status in a designed spreadsheet format. Specific executives undertook primary responsibility for developing action plans for each of the six imperatives, with assistance from an assigned, secondary executive. MCR designed a simple tracking and monitoring tool to facilitate review and discussion of progress, shortfalls, and plan alterations among senior managers and with the board.

The strategies and action plans that Liberty considers the most important from a strategic viewpoint are those addressing financial stability, generation expansion, rate predictability, and transmission expansion imperatives. In the following sections of this report, Liberty will evaluate history, status and, performance regarding EKPC's financial health and financial management, performance management, strategic asset mix, and utilization of power market resources.

**C. Conclusions**

1. **The NorthStar initiative has inappropriately focused EKPC on cost cutting as the primary and most important strategic program.**

The NorthStar initiative was the highest priority “plan” that emerged from the 2007 MCR strategy process. Cost control is important, but NorthStar has diverted management's focus and limited resources from more critical strategic issues, such as EKPC's financial health and performance, its lack of access to power markets, and its unbalanced power supply portfolio.

Over the past two years, the KU Gap has become a counterproductive focus. Overemphasis on it has obscured the need for other important factors to become drivers of plans and actions. The failure to identify the specific factors that cause the gap increases the concern Liberty has with EKPC's pursuit of it. Lack of such understanding creates the very real risk that actions to address it will become increasingly arbitrary, resulting in the elimination of key activities, processes, or organizations, (e.g., internal audit) that are critical to long-term EKPC health and performance.

Its lack of effective direction is not, however, even the major concern Liberty has with the NorthStar initiative's cost cutting efforts. Even if targets were realistically attainable, they would at best make only a small reduction in the gap. EKPC has performed no clear, convincing analysis that a reduction of one-fifth of the gap (from 25 to 20 percent) would make a material difference in the minds of the stakeholders that the member cooperatives fear are focusing so much attention on it. It makes little sense, in the absence of sound knowledge that small improvements will make a real difference to structure cost-control efforts around this pursuit. It would be far better to generate benchmarks that provide meaningful targets, and therefore do not create the risk of making cuts that in the long run will be counterproductive. Moreover, it is crucial that those benchmarks not, for reasons described below, sacrifice the long-term EKPC financial health that is already and will become more vital to serving member interests in a dynamic power supply marketplace that has already undergone major change in recent years, and can in no way be described as predictable now.

## **2. The MCR-led 2007 strategic planning process identified many key issues and actions required to improve EKPC's strategic direction and position.**

The MCR process represents the only comprehensive strategic planning process that EKPC has undertaken for at least the last several years. That in itself demonstrates a significant weakness in EKPC's approach. Strategic planning needs to remain a dynamic, continuous process to be effective in rapidly changing environments. It deserves far more than a periodic "look" at multi-year intervals.

Nevertheless, the MCR process succeeded in defining some of the most important issues facing EKPC and it spotlighted a number of weaknesses or gaps that exist in EKPC's ability to address those issues effectively. Its focus on constructing action plans as an end product of the process provided both a structure and an opportunity for real improvement to occur. The tracking of progress against the strategic imperatives and action plans was continuing in 2009.

Despite the improved foundation laid by the MRC-led effort, there remains a substantial risk that real change will not, however, occur. Management has not put a sufficient priority on "making the plan happen." Liberty's interviews with EKPC management personnel did not reveal the necessary sense of urgency to complete action plans called for by the planning effort. There has been significant turmoil and distraction over recent years, not the least of which is the need for management to adapt to three different CEOs. Nevertheless, a focus on making and executing action plans remains critical. It is important that attention return to the need to assure that plans and strategies that are now already getting stale get updated, that action plans become established to address revised strategies, that accountability for executing plans be clear and enforced, that progress be tracked, and that there be a process for continually re-evaluating strategies and plans in light of what one can expect to be continued change and development in the power supply world in which EKPC must operate and compete successfully. Moreover, attitude and effort

reorientation must eliminate the pre-occupation that EKPC has had with the KU Gap and the NorthStar initiative, which have served to dilute focus on more important strategic planning issues and activities.

**3. EKPC has pursued some of the MCR strategies and action plans, but has made insufficient progress on several seminal issues that should drive future direction.**

EKPC has completed only a portion of the strategies and action plans that were established by the strategic planning process. After almost two years, approximately one-half of the action plans had been completed in the finance, generation expansion, and rate predictability categories.<sup>1</sup>

In the finance area, EKPC has established higher target TIER ratios, and has factored them into the 2008 rate increase request and financial forecasts. The key performance report, NorthStar report, and member rate report each now exist. On the other hand, action plans regarding the performance to the NorthStar initiative and improving performance to the construction budget, which were the responsibility of finance, fell far short of the plans.

In power supply, EKPC has improved the integrated resource planning process and results. It has also improved its economic dispatch to include more market options, and purchased power has replaced higher-cost combustion turbines more often than in the past. However, EKPC has not yet evaluated crucial issues regarding major transmission investments and ISO membership and whether the benefits from market power transactions override the costs involved. Comments to the draft of this report state that EKPC “is currently working with both PJM and MISO to conduct cost/benefit assessments to determine if joining a market is advantageous.”

Liberty believes that the action items mentioned above as “not accomplished” represent very high impact items. They should be among EKPC’s highest priorities.

**4. EKPC did not take significant action or make improvements as a result of outside conclusions and recommendations made in the past three years.**

EKPC did not follow up or take significant action on the recommendations of either the Byrne report or the NCG report, effectively burying them. The lack of response to the Byrne report is perhaps more understandable, with the report coming from a consultant brought in by a CEO who left shortly thereafter. It is far less clear why the report from NCG of NRECA appears to have had so little impact. Its inconsequentiality casts some doubt on management’s ability to recognize and deal with its own shortcomings. If the report got the answers wrong (which is by no means apparent from Liberty’s examination of EKPC), then it at least raised major questions that should have been pursued some other way. Making two executive changes cannot be considered a sufficient response to the issues that the report addressed.

The NCG report on the EKPC organization observed significant gaps and needs in many areas, provided a long list of “observations” and recommendations, and took a tone that was (and appropriately so in Liberty’s judgment) more critical than one would expect, were the consultant commenting on an organization it already found to be fundamentally sound across the board. Moreover, Liberty would expect NCG to have a high degree of credibility with EKPC, given its

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<sup>1</sup> EKPC’s comments on Liberty’s draft report observed that some action plan completion dates were beyond the period of Liberty’s review.

exposure to the G&T business and the roles it serves for members. Liberty thus found it striking that interviews with EKPC management revealed little knowledge of NCG's specific recommendations of the report. Those interviews also disclosed no instructions from the interim CEO to carry out any of the recommendations. EKPC requested a straight, unvarnished story from NCG, which is what was delivered. Management's reaction to the candid statement of shortcomings demonstrates a culture whose strengths have not included acceptance of constructive criticism and effectiveness in making decisive change. Liberty's views about EKPC's lack of response would be the same even if our team's observations on similar issues were substantially different. However, the consistency between Liberty's views (recognizing that our scope was not as broad as NRECA's) on the subjects common to both examinations, underscores the concern about EKPC's lack of responsiveness.

**5. EKPC has not focused on strategic planning as a continuous exercise, which means that the plan now in place is stale.**

The strategic plan is now over two years old. Some of the strategies and action plans have been accomplished, some need to be revisited or revised, and some may no longer be a priority. A strategic plan has a shelf life of no more than one or two years. Even during this short period, it is necessary to apply some process to assure that it remains in each of its many respects completely consistent with current views of management and the board. The accomplishments and failures of the MCR-led process should be recognized, and the company should embark on a new and improved process.

Management addressed many times in interviews with the Liberty team the view that it is "time to do the plan again" or "It needs to be updated." The NorthStar targets, for instance, are no longer meaningful, given the tendency of fuel cost volatility to override all other expenses. It is also true that the original targets did not get the fullness of consideration that usually takes place in planning by similar entities.

EKPC recently brought in a new, permanent CEO, whose mission appeared to be (and certainly needed to be) to chart a new course for the entity. This factor adds to the already extant need for a re-examination of EKPC's strategic direction, plans, objectives, execution activities, and monitoring. Moreover, the establishment of a new strategic plan should not, as past practice would suggest has been the case, bring a sense of relief that focused and structured strategic thinking can once again be put off for several years. EKPC needs to begin to view strategic planning as a continuous exercise, and to create a culture and adopt methods that will allow it to act in ways that permit adjustments to be made on an informed, risk-sensitive, and timely basis. Understanding that such changes will be inevitable and unpredictable must lead to the collective mind-set and to supportive processes that will make such change the most responsive and effective.

### III. Finance and Performance Management

#### A. Background

EKPC has encountered significant financial difficulties in the past five years. Two major financial events in particular contributed to a significant decline in financial health, which deteriorated to critical levels. The first event, a major 2004 outage at the Spurlock plant, caused approximately \$20 million in additional purchased power expense, and accelerated about \$18 million of additional maintenance expense for work that had been planned for 2006. Then, a notice of environmental violation (NOV) from the EPA and resulting lawsuit settlement required that EKPC accrue a loss of about \$49 million, realized in 2005. These events magnified a growing financial weakness caused by the failure to file rate increase requests to recover the costs of major construction projects, such as the Gilbert unit completed in April 2005. Figure III.1 shows the company's summarized results for 2003-2008.

**Figure III.1: EKPC 2003-2008 Financial Results Summary (\$x1, 000)**

Item	2003	2004	2005	2006	2007	2008
Net Margin (Deficit)	29,398	(27,267)	(46,077)	11,174	44,493	27,872
TIER	1.66	0.49	0.34	1.13	1.43	1.25
DSC	1.35	0.72	0.66	0.98	1.17	1.04
Equity Ratio	12.61%	9.10%	5.69%	5.28%	6.97%	6.75%

*TIER: Times Interest Earned Ratio (RUS)*

*DSC: Debt Service Coverage (RUS)*

*Equity Ratio: Equity/Total Assets (RUS)*

#### B. Findings

##### 1. EKPC Financial and Rate Case Actions

EKPC has received most of its long-term funding from the Rural Utilities Service (RUS) and from supplemental lenders CFC and the Federal Financing Bank ("FFB"). Congress created the FFB as a government corporation in 1973 to centralize and reduce federal borrowing and federally-assisted borrowing costs, among other purposes. The FFB may purchase any obligation issued, sold, or guaranteed by a federal agency to ensure financing efficiency. EKPC also established a \$650 million private credit facility in September 2005, primarily to provide funding flexibility for the "lag" in receiving loan proceeds from the RUS to fund its large capital program.

EKPC management considered filing a general rate case in early 2006. Management prepared an analysis of the need for rate relief. This analysis assumed: (a) the use of a historical 2005 test year, and (b) outage costs, EPA legal fees, and penalties would not be recoverable in rates. These assumptions produced a conclusion that EKPC could not justify a general rate increase. Management believed that the fuel adjustment clause and environmental surcharge would mitigate the need for a base rate increase.

EKPC's RUS mortgage agreement includes financial covenants requiring that the average: (a) TIER be at least 1.05 to 1.00 for the best two out of the last three calendar years, and (b) DSC ratio not be less than 1.00 for the best two out of the last three calendar years. The unsecured

credit facility also contains these covenants. Additionally, the unsecured credit facility contains a financial covenant that requires the equity to total assets ratio be at least 3 percent at the end of any quarter. EKPC found itself in technical default of the RUS TIER and DSC covenants as of the end of 2006. However, the RUS did not declare EKPC to be in default under its mortgage agreement, nor did RUS enforce default actions. EKPC also faced in 2006 a potential default condition on its private credit facility. EKPC negotiated an amendment to the facility (for additional consideration) to prevent such default.

As these conditions existed, the Kentucky Public Service Commission opened in October 2006 an investigation into the financial condition of the company. The Commission found that:

- Beginning with the unplanned outage of the Spurlock No. 1 unit in July 2004, EKPC's financial condition had steadily and consistently deteriorated and showed no immediate signs of improvement
- Due to a significant capital construction program, EKPC had incurred increasing levels of interest expense at a time when it was least able to absorb increasing costs
- EKPC's credit worthiness had deteriorated to the point that its credit score would likely fall into a sub-investment grade category
- But for the willingness of RUS to forebear from making any declaration of default under the mortgage agreement, which would also trigger the cross-default provisions of the credit facility, EKPC would be insolvent.

In response to the Commission's examination of EKPC's financial condition, EKPC filed a general rate case proceeding in January 2007. This filing requested a rate increase of \$43.4 million annually, and sought approval to place interim rates into effect immediately. The Commission concluded that the credit of EKPC would be materially impaired or damaged in the absence of a portion of the rate increase being awarded on an interim basis. EKPC also asserted that a failure to grant interim rate relief would likely require it to defer maintenance on generation and transmission assets and to reduce hiring, with the consequence being potential degradation of system reliability. The Commission approved an interim \$19.0 million rate increase commencing April 1, 2007.

EKPC noted that it filed in March 2008 to amend its environmental surcharge compliance plan. EKPC requested and the Commission approved change to a current return on CWIP from AFUDC accounting. The Spurlock Units 1 and 2 scrubbers and the pollution control portion of Spurlock 4 formed part of this compliance-plan amendment.

EKPC filed another general rate case on October 31, 2008, but, at the time, was also seeking resolution of more immediate financial issues. EKPC had requested on October 9, 2008 that unrecovered 2008 replacement power costs of \$12.3 million be treated as a regulatory asset to be amortized and recovered over three years. EKPC asserted that such regulatory treatment was required to permit it to have sufficient net margins for calendar year 2008 to meet debt service coverage covenants on its \$650 million private credit facility. A default would allow creditors to treat all outstanding loans as immediately due and payable. EKPC expected a negotiated waiver of the default to require an increase in interest rates of 3 to 5 percent and triple facility commitment fees, given the extreme turmoil that existed nationwide in credit markets at that

time. The Commission granted the company's request for a regulatory asset. The Commission also granted in 2009 a general rate increase of \$59.5 million, which has in the short-term improved the EKPC's financial health substantially.

## 2. The Capital Program

Despite its financial difficulties, EKPC has continued to plan for and receive approval from its board of directors for an extremely large capital expenditure program to meet the expected electric needs of its members. As each calendar year is beginning, the board approves a capital budget for the next three years as well as a two-year operating budget. The magnitude of the approved capital expenditures is shown by Figure III.2.

**Figure III.2: EKPC 3-Year Capital Budgets (without AFUDC; \$x1million)**

Budget	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
January 2003	292.1	151.7	102.9							546.6
January 2004		269.3	65.5	127.0						461.8
January 2005			309.1	427.3	358.5					1,094.9
January 2006				566.5	650.2	289.1				1,505.9
January 2007					615.8	508.7	292.9			1,417.4
January 2008						583.1	306.8	180.6		1,070.6
January 2009							222.3	355.1	475.0	1,052.4

New generating units (Gilbert, Spurlock 4, and Smith #1), pollution control equipment for existing units (Spurlock and Cooper), combustion turbines, and transmission facilities have comprised the primary drivers of planned capital expenditures. Had EKPC spent the full amounts of these budgets, it would have faced greater requirements for rate increases through both the environmental surcharge and through base rates. However, EKPC did not make capital expenditures at near the budget-approved levels, which will be discussed further later in this chapter.

As far back as Liberty's 2001 management audit, concern about the relationship between a low equity ratio and an ambitious generation capacity building program was raised: "EKPC's equity ratio of 7-8 percent is very low and represents a major financial risk to the future, especially in light of plans to build additional generating capacity." This issue remains a critical one.

## 3. Financial Forecasts

EKPC uses a 20-year financial forecast for planning purposes. The forecast uses approved capital and operating expense budgets for immediate outer years and it applies a rough estimate of capital expenditures for the remaining part of the 20-year period. EKPC uses this forecast to prepare 20 years of annual projected income statements, balance sheets, and cash flow statements. The revenue required in future years results from selecting a targeted TIER level that represents the required bottom line result. EKPC assumes that increased environmental surcharges will go into effect as it completes planned pollution control facilities. Forecasting assumes that rate cases occur either on completion of major facilities, or when the forecasted TIER level drops below a minimum level.

Liberty reviewed EKPC's 20-year financial forecasts prepared from recent years. Through the 2007 forecast, EKPC used the TIER result of between 1.05 and 1.18 times in each of its recent

annual forecasts. EKPC has increased its historically forecasted annual TIER of about 1.1 times for 2008 and 2009, in recognition of prior financial challenges and of the need to increase equity levels over time so that financing availability from private capital markets can be supported. The projected TIER levels for the 2008 and 2009 forecasts range from 1.16 to 1.40 times. In addition, the company's 2008 rate case filing assumed the revenue levels required to achieve a 1.45 TIER. The latest 20 year forecasts increase the targeted equity ratio to 12.5 percent by about 2015. EKPC believes that ratio provides the minimum equity level consistent with an investment grade credit rating. In 2007, MCR reported that its reference group of 15 G&Ts with BBB+ to A+ credit ratings had an average equity ratio of about 16 percent.

#### 4. Budgeting

Budgeting and budget performance are crucial to the effective financial management of a power supplier such as EKPC. The extremely large ongoing capital budget makes performance to budget a large determinant of needed rate increases, required levels of funding and liquidity, the timing of such funding, and the ability to forecast related operating expenses such as interest expense and depreciation. The MCR-led strategic planning process cited “manage construction costs to budget” and “improve liquidity through improvements in forecasted spending” as goals required for supporting financial stability.

Capital expenditure projects and programs originate primarily through the generation production plants and transmission operations, with input from central engineering. Approximately 20 managers have responsibility for capital budgeting, which they support by estimating and managing the cost of projects and programs. The 3-year capital expenditure budget requires annual executive management and board of directors approval. Reports on capital spending versus budget are provided to responsible managers, executive management and the board of directors on a monthly basis. Detailed spreadsheets summarize expenditures on major projects, and provide detailed variance information. Company financial managers note that a primary cause of large variances in the capital budget is under-spending that results from delays in receiving various required permits, right of ways, and equipment. The timing of expenditures on projects tends to slip from year to year, routinely causing large under-spends from the approved capital budget. The financial managers also noted that the board generally does not consider under-spending the budget to be a problem. Figure III.3 shows EKPC’s capital expenditures versus budget for 2005-2008.

**Figure III.3: EKPC Capital Expenditures vs. Budget**  
(with AFUDC; \$x1 million)

Year	Approved	Actual	Variance	
			Amount	Percentage
2005	313.9	159.1	(154.8)	(49.3)%
2006	579.3	291.9	(287.4)	(49.6)%
2007	632.5	419.6	(212.4)	(33.7)%
2008	594.2	381.4	(212.8)	(35.8)%

#### 5. Other Performance Reports

The 2007 NRECA report concluded that EKPC, as an organization, lacked accountability, had poor performance standards, and needed to improve planning. Management created a position in the finance organization to establish performance measures and to develop performance reports. Three primary reports have been developed as a result of this effort:

- Key Performance Report



- NorthStar Tracking Report
- Cost to Member Systems Report.

The Key Performance Report operates as a corporate scorecard and performance measurement tool, monthly for management and quarterly for the board of directors. The report provides five corporate measures considered to represent the highest-level key criteria; a one-page summary scorecard presents the results of those measurements. The measures include a safety index, cost to member systems, cash flow interest coverage, weighted equivalent availability factor for coal plants and start reliability for combustion turbines, and system average interruption index. The report also includes numerous other performance measures for each of five functional areas: finance, production operations, power delivery, power supply and corporate services. Each functional area has several performance measures. For example, the production benchmarks include net value of available capacity, weighted equivalent availability factor, cost of non-fuel O&M, and cost of station service. EKPC tracks these performance measures and year-to-date for each plant, and compares them to target performance levels established. Those levels comprise: threshold (minimum), target, and stretch (superior performance). EKPC tracks its performance compared to benchmarks or market information where available. Examples include: (a) EKPC coal cost versus a 19-company benchmark, and (b) power purchases versus regional market and ISO prices. The Key Performance Report also includes a one-page summary of NorthStar initiative savings performance.

The NorthStar report tracks performance against the NorthStar budget targets established in 2007. This monthly report tracks performance for business unit-specific operating costs other than labor. Each major operating expense category, including fuel, is also tracked against the NorthStar targets. Each of six business units was also asked to make commitments for savings on individual line items over which the managers have more control. These “declared manager commitments” form a subset of the total business unit expenses. For the calendar year 2008, the first year of NorthStar, actual total cost savings were \$33.7 million, as compared to a target of \$73.7 million. EKPC has noted that a principal reason was the fact that purchase-power costs exceeded the NorthStar target substantially.

The *Cost to Member Systems Report* is also issued monthly. It tracks EKPC current member charges per MWh on a monthly and year-to-date basis. The report compares these charges to threshold, target, and stretch performance levels. The report provides breakdowns and analysis of rate components such as base rates, fuel cost adjustment, and environmental surcharge. The report also estimates end-of-the year costs including actual results to date.

## 6. *Financing Sources*

EKPC has historically received funding for its long-term asset base from RUS at low rates not available in corporate capital markets. The relationship of RUS with EKPC and other G&T co-ops has been strong, with RUS providing required funding when needed. RUS has imposed only low financial-strength hurdles on its financing. Moreover, as was the case with EKPC recently, RUS has not pursued action in the face of violations of its debt covenants.

RUS has, however, announced that it has halted financing for baseload generating plants to be constructed by G&T cooperatives. RUS will continue to provide debt financing for other assets,



financing in a manner that produces a net lower revenue requirement than does traditional debt financing. The key to reducing revenue requirements is to capture economic gains on the sale of utility assets at prices that exceed book value. Asset owners, like EKPC, who have weak financial ratios can also benefit from the increased debt coverage ratios and equity-to-asset ratios that such transactions can bring for assets already in service.

Curiously, Liberty's work with management and the board did not generate significant mention of this alternative as a means for improving financial strength. Discussions tended almost universally to focus on rate increases as the sole means for increasing financial ratios. Liberty's request for EKPC's analysis of these alternatives generated the response that the cooperative does not perform its own analysis on financing proposals such as sale/leasebacks. In commenting on a draft of this report, EKPC stated that it does perform its own review and analysis of all financing proposals initiated by and received from outside parties.

### *7. Outage Insurance*

The NCG report found significant weakness in EKPC's planning for addressing the consequences of generating unit outages. EKPC had an outage insurance policy in 2004, but it did not pay unless replacement power reached at least \$75 per megawatt hour. The 2004 Spurlock outage therefore did not produce any insurance company payments to EKPC. The cooperative does not currently have outage insurance. EKPC financial management's analysis of such coverage determined that it was too expensive to be economically beneficial. Liberty's request for the analyses produced evaluations by ACES Power Marketing of 2007 and 2008 insurance policies offered to EKPC. ACES concluded that both policies offered economical pricing, and recommended their purchase. EKPC declined to purchase the insurance for both years.

EKPC is one of the founders and remains one of 17 power-supply cooperative owners of ACES Power Marketing. A number of G&Ts formed this alliance in 1999, in order to provide wholesale energy trading and risk management services. ACES has 17 owners (including EKPC), and serves nearly 50 clients in the wholesale energy industry. Those clients include independent power producers, investor-owned utilities, financial institutions, municipal utilities, industrial enterprises, renewable energy providers, and other industry participants.

## **C. Conclusions**

### **1. Financial strength has had too low a priority at EKPC, and has been sacrificed to the overriding priority of keeping member rates down.**

EKPC targeted low margins and low TIER and DSC coverages in its financial planning and consideration of rate increases until 2008. The target TIER ratio used in financial forecasts before 2008 ran only to the "bare bones" level of 1.1 times. This approach produced low net margins and poor debt coverage ratios. Managing to such thin margins did help keep members at minimum levels for the short run, but did so at the expense of building financial strength and viability necessary to long run economy in the dynamic marketplace where EKPC must operate. Overly aggressive financial management foreclosed the potential for growing equity capital to a level that provided an adequate cushion against the large financial losses eventually experienced



higher net margins and financial covenant coverages that will result provide a foundation for building financial strength. It must be emphasized, however, that a failure to build on this foundation, which recent history at EKPC suggests is a very real and likely risk, will make the laying of this foundation, in the long run a futile gesture that simply postpones future adversity.

EKPC's comments on a draft of this report stated that it is currently evaluating the need for a rate increase that would become effective in 2011, or sooner than appeared to be anticipated when audit field work took place. Should it determine that such a need exists, EKPC will file for a base rate increase using a fully-forecasted test year with a TIER request of 1.45 (the level sought in the previous rate case.) Additionally, recovery for those projects contained in the environmental surcharge compliance plan amendment became effective in November 2008. EKPC is seeking another amendment to its environmental surcharge compliance plan. This matter was reportedly on the EKPC Board's February 2010 agenda.

### **3. EKPC's poor response to the 2004-2007 financial difficulties contributed to additional financial "mishaps" through 2008.**

EKPC did not act sufficiently to build its financial strength following the events of 2004 and 2005. It did not file a rate case to relieve its financial stress in 2005 or 2006. EKPC's interim CEO (who served from 2007 through the middle of 2009) now views, with hindsight, the decision not to request rate relief earlier as a "poor" one. EKPC slid into financial distress and technical default on its RUS debt at the end of 2006. Liberty takes a broader view of the matter than rate cases, observing that EKPC also failed to give due consideration to other sources of financial improvement, such as sales of assets or sale/leaseback options that may have allowed it to avoid default and strengthen its equity position and debt coverage ratios.

The company's reluctance to take positive action to reverse the financial deterioration caused a continuing financial crisis from 2006 – 2008. The following negative incidents occurred as a result of EKPC's continuing weak financial condition:

- Technical defaults on the RUS mortgage agreement arising from the failure to meet financial covenants
- Forced amendment of the \$650 million credit facility covenants with private lenders to prevent a default
- The Commission financial investigation, which expressed concerns regarding EKPC's financial viability
- EKPC's request for emergency interim rate relief in 2007 to avoid additional defaults on loan agreements
- EKPC's October 2008 request for the treatment of forced outage costs as a regulatory asset to avoid yet another potential default on the private credit facility.

### **4. The RUS financing moratorium and looming capital market requirements have forced EKPC to pursue increased financial strength and performance.**

EKPC's ability to rely on RUS financing in the past appears to have created an environment that undervalues strong financial management and performance at EKPC. The RUS has applied very low requirements for financial performance to its mortgage agreements. The RUS debt-covenant requirement that EKPC need only average a TIER ratio of only 1.05 in the "best two of three

years” sets a very low hurdle and one not appropriate for financial planning. Moreover, EKPC is aware that the RUS has a history of failing to enforce debt covenant violations rigorously. This “well of forgiveness” also extends to the EPA fines that EKPC ended up paying. The EPA linked the fines imposed by the Consent Decrees entered into with EKPC to future earnings. Likewise, EKPC has benefitted from extraordinary rate and accounting relief from the Commission when requested. Liberty considers it manifest that EKPC has historically functioned as if it will not be allowed to fail. Its aggressive financial strategy and operations and its failure to consider contingencies robustly reflect that attitude. EKPC did not in the past exhibit significant concern about its ability to obtain financing for a huge capital program that would be difficult in corporate financial markets, especially with EKPC’s poor financial performance. Even were RUS and other sources of “forgiveness” to be presumed to continue in the future, this approach simply does not conform to the challenges of the multibillion dollar enterprise that EKPC has become. EKPC has the burden to protect its current resources, find a way to expand them to serve growing needs, and identify, assess, and manage the intensely magnified risks unavoidable in the business it is charged to carry out makes the issue more than one of good stewardship - - the matter is one of assuring long-term survival in a recognizable and useful form.

The RUS moratorium on providing financing for baseload generation will require a completely different and more disciplined approach to financial management for EKPC. EKPC will be required to continually prove its financial strength, financial planning, and performance to capital markets that will require higher margins, interest and debt coverages, and equity capital before they will provide debt financing. The contrast in dealing with corporate capital markets versus the RUS will be stark; EKPC will not find the safety nets there that it has counted on to date. EKPC must continue to improve its financial performance, increase its equity levels and perform to approved budgets in order to qualify for the solid investment grade credit rating required to obtain market capital.

**5. EKPC accepts poor capital expenditure budgeting and performance without apparent accountability and reaction.**

EKPC has under-spent its approved capital budget by 34 to 50 percent in each of the last four years. This poor performance indicates deficiencies in both capital planning and in management accountability for budget variances. The large budget variances cause problems in estimating liquidity and financing needs, in projecting revenue requirements and rate levels, and in power supply planning. The large variances also cause the operating budget to be inaccurate, as budgeted levels of capital-related expenses such as interest expense and depreciation are not realized.

Poor capital budget performance was noted in both the NRECA report and MCR strategic plan. However, even with recent management emphasis on improving capital budget performance, unacceptably large variances have continued. The CFO says that he “expects that only half of the capital budget will be spent” in order to roughly plan for funding and liquidity requirements. Reasons for the variances are blamed on “permitting or siting delays.” All utilities and power suppliers must plan for such contingencies; good practice among them does not allow such levels of “float” in budgets. Capital budget variances of more than 5 percent should be considered unacceptable when regularly repeated. Capital budget accountability has not yet been

established at EKPC. Liberty believes it will take a great effort to overcome the cultural resistance that is a barrier to using such budgets effectively.

The EKPC board of directors approves a three-year capital budget annually. In an extremely capital intensive company such as EKPC, capital budget oversight is one of the board's most important responsibilities. However, even though capital budget variance reports are provided to the board every month, little or no feedback is received, as "the board does not get upset with under-spending."

**6. EKPC has improved its measurement and reporting of performance companywide through new reports and analysis.**

EKPC established a performance management position in 2007, in order to begin developing and producing performance reports. The "key performance report" provides management with monthly updates on the most important performance metrics in each functional area. The performance measures and presentation are comprehensive, and are supplemented by analysis of the metrics and what they represent. This report provides a good tool for executive management to monitor performance on the most important metrics, as well as provide a format for improving accountability for performance at the management and executive levels.

EKPC has also established reports for member co-ops to explain and analyze components of rates, target levels, and performance to these goals. The NorthStar performance report has also been established to provide management with information regarding actual performance versus the cost-cutting targets.

**7. Performance on the NorthStar cost-cutting initiative has been poor.**

The company's NorthStar initiative to reduce operating costs was a primary focus of the MCR strategic planning process. EKPC has placed a great deal of emphasis on the initiative as the vehicle for reducing the rate gap with Kentucky Utilities and generally controlling the increase in member rates. However, the company's performance to the NorthStar targets has been poor through mid-2009.

EKPC achieved only about \$33 million of its \$73 million total cost saving target for the 2008 calendar year. It notes that the savings target and actual results include fuel and purchased power costs, which are more difficult for managers to control. On the other hand, EKPC managers also identified items that are more controllable, and made commitments to savings levels of \$46 million on these 2008 expenses. Only \$7 million of savings on these "more controllable" expenses was realized, with each of five functional areas falling short of its commitment. The interim CEO was "very disappointed" in the NorthStar results for 2008. The NorthStar reports for January-May 2009 indicate a somewhat better savings performance in this period, with \$19 million of a \$32 million target for more controllable expenses being realized. It remains the case, however, that the significant and continuing mismatch between targets and results demonstrates the creation of misleading goals and lack of performance in achieving them.

## IV. Asset Mix and Power Supply

### A. Background

EKPC has provided power supply for its members primarily by building, owning, and operating coal-fired baseload generating plants, and more recently, gas-fired combustion turbines. This strategy has proven successful for decades, as EKPC and other regional power suppliers have taken advantage of low-cost coal supplies in the region. The strategy has therefore also been in accord with local economic interests. Apart from the question of fuel source, EKPC and its members have concentrated on a build/own/operate strategy, and, again, a strategy that has served members well in the past. This build/own/operate strategy, however, is now viewed as significantly more risky in recent years, as portfolio diversification has become an increasingly important value to power suppliers. Tightening environmental requirements generally, more volatile coal pricing as the commodity's pricing has become more intertwined with international markets, and the looming potential for carbon penalties or CO<sub>2</sub> limits make over-reliance on the build/own/operate alternative even more risky as an EKPC strategy.

### B. Findings

#### 1. *Asset Mix Risk*

The ownership of assets that have 40-year lives and cost hundreds of millions of dollars bring to EKPC significant exposure to changes in the power supply industry. Should major changes occur in generation technology, access to capital, fuel and power markets, transmission technology, regulatory formats or other current industry standards and practices, EKPC's traditional business model may not prove sufficiently robust. EKPC has also used the circulating fluidized bed technology for its recent coal plants. This technology is relatively new and less proven technology than pulverized coal or combined cycle natural gas plants, which may add risk as well. Placing not one, but essentially all of EKPC's 40-year business "bets" on owning power plants becomes increasingly risky as the industry changes at an accelerating rate.

EKPC plans to continue its same approach, intending to self-build its next baseload generating unit. This Smith #1 unit will use a circulating fluidized bed (CFB) technology. The board of directors initially approved Smith #1 over five years ago, in 2004. The in-service date for the plant has been delayed a number of times; it is currently projected to come on line late in 2013 or in 2014.

EKPC has considered Smith #1 plant to be "embedded" (*i.e.*, already assumed to come into existence) for purpose of examining new power resources (following Spurlock 4) for several years. EKPC includes Smith #1 in the 2009 integrated resource plan (IRP). EKPC, until the last few years, considered building its own coal-fired generating plants to be its only option. Historically, EKPC's power-supply resource lay with the production organization, which displayed an overwhelming preference for building its own plants. Management consistently gave the board of directors the message that EKPC "must" build its own coal plants until the naming of the interim CEO at the end of 2006.

This dogmatic approach did not lend itself to a robust consideration of the alternatives for acquiring power supply resources through partnering with other power producers or other



industry participants. Such arrangements can take the form of joint plant ownership or a commitment to purchase a portion of the plant output, for example. Partnering with other enterprises (*e.g.*, investor-owned utilities or other G&Ts) may allow larger and more efficient generating units that lower capacity and energy costs for all participants. Partnerships can also spread the ownership risks among the participants, mitigate some portions of risk through purchase power agreements, and permit optimal choices from among those who can best serve design, construction, and operations roles. A key component to partnering is spreading the ownership of risk among financially stable partners. Partnering arrangements require financial strength among the counterparties so that ownership and operating risk is not replaced by counterparty financial risk.

EKPC has considered to some degree the potential for partnering arrangements for power supply resources that will follow Smith #1. Thus far, none have progressed beyond the discussion stage.

## 2. Ownership Alternatives

EKPC builds, owns, and operates generating plants and transmission facilities. Another tenet of the strategy and culture is that EKPC will continue to own and operate its assets until they reach the end of their useful or economic lives. EKPC management considers its facilities, especially generating plants, to be “our plants,” and that a “for sale” sign would indicate a failure, or create some other negative image. EKPC, like any other participant in this business, should be able to ask itself questions like:

- Would it be advantageous *not to own* and operate this asset/facility
- Why should the answer depend on how and when it came into our possession
- Would the sale of this asset/facility at a favorable price and its replacement with a substitute resource be more economic
- Would such a transaction cause a lower revenue requirement or solve a financial problem?

Liberty found a culture that discourages, if not precludes, frank consideration of such questions. The executives interviewed did not demonstrate acceptance of such inquiries as both a natural and necessary means of continuing to examine its risks and opportunities holistically. It was difficult to see that the interviewees could get past the question of, “Why would a sale be financially favorable? That plant produces power for \$22 per MWh!” Another common reaction was that cooperatives by definition must be able to own and operate less expensively because they have lower debt costs, do not need to satisfy equity owners, and do not pay income taxes.

Interestingly, an appendix to the MCR strategic plan presentation did pose two hypothetical asset sales alternatives. EKPC’s sample analyses of these theoretical transactions were, however, flawed. It reached the conclusion that it is unlikely that such transactions could be economically beneficial. EKPC assumed that assets could be sold only for book value, despite the fact that some produce energy at costs well below the market. These assumptions are self evidently inconsistent; plants producing below-market power would realize a premium price based on its expected cash flow generation, which would certainly be far above the plant’s depreciated book value. The sale of certain assets would generate cash and taxable gains, because the assets have been fully depreciated. Equity levels or the equity ratio would increase, depending on the

application of the net proceeds. This transaction could nevertheless also prove economic, depending on the sale price and the price of replacement power.

Theoretical comparisons in any event are not an “acid test.” The important consideration is that the marketplace will determine the sale price of assets and the cost of replacement power. Ownership retention may or may not be the best option, “depending on the price.”

### ***3. EKPC 2009 IRP***

The EKPC integrated resource planning process evolved and improved between the 2006 and 2009 versions. The 2006 plan did not consider a variety of power supply options. Even though the Byrne Report questioned whether EKPC was “acting prudently by depending so heavily on CFB technology,” supply-side capacity additions for the future were limited to CFB units for required baseload additions, combustion turbines for peaking additions, and the option for RFPs to evaluate purchased power. The Commission suggested that EKPC expand its universe of supply-side options in preparing its next IRP.

The 2009 IRP included several additional supply-side alternatives to meet future power supply requirements. The CFB coal units and combustion turbines were included, but the alternatives were expanded to include combined cycle gas units and renewable resources (wind, solar, biomass and hydro). Various power purchase and partnering alternatives as well as demand-side options were also considered as resources. The Smith #1 CFB was included in the IRP is the company's next baseload resource (now expected to be on line in late 2013 or in 2014). All other supply options fill baseload needs after 2020 and peaking requirements starting in 2010.

EKPC uses the “RT Sim resource optimizer” model to support the analysis conducted as part of the IRP process. This model includes the assets, operating characteristics, and dispatch of existing EKPC units and the Smith #1 addition, selecting the most favorable mix of plans for future power-resource additions. The model runs numerous simulations to determine the top five plans, based on economics. It includes environmental costs for SO<sub>2</sub>, NO<sub>x</sub> and CO<sub>2</sub> in determining the most economic choices. The 2009 IRP included demand-side management (DSM) as a resource, growing its contribution to 300 MW over 15 years. A 200 MW block of seasonal purchases also forms part of the plan, as do additional combustion turbines. Purchase power contracts did not form a large part of the future plan, because the assumed cost of this option exceeded other alternatives. EKPC engaged an industry consultant, who reviewed and recommended small changes in the assumptions used in the IRP analysis.

### ***4. Transmission Constraints***

EKPC has historically designed and built its transmission system to provide members power supply through owned and operated generation, and to provide system reliability. It has not focused on the promotion of economical exchanges of power with its neighboring system. Management reported that it is not well interconnected to its utility neighbors and to ISO markets for the purpose of making such exchanges. EKPC has added some 345 kV transmission capability to its system in recent years, again, for the stated principal reason of improving reliability. EKPC shares with most other Kentucky providers (KU, LG&E, and Big Rivers) the historical roots that produced generally weaker transmission-system interconnections, especially with other states, than one finds in many other regions. This situation contributes to a lack of

firm transmission availability, as the executive vice president for power supply reported to Liberty several times, limits EKPC's ability to import or export power.

EKPC is interconnected to E.ON (Kentucky Utilities and LG&E) at numerous locations, but the power transfer capability with these neighboring utilities is nearly zero. EKPC cites difficulty exchanging any power with E.ON, primarily due to the lower voltage EKPC system and interconnections. EKPC, however, is short of capacity during its winter peak season, which increases the benefits of connections to E.ON (which is long on capacity at the same time) for power transfers. EKPC is currently jointly building a new connection with E.ON; EKPC will bear its costs.

EKPC's power generation is concentrated at the Spurlock plant site, which comprises a 1,500 MW baseload generating complex. Transmission stability in this area had been problematic. EKPC reports that, recognizing its 345 kV expansion in central Kentucky, there have not been line overloads at Spurlock for several years. The cooperative is also currently building interconnections with Duke Power and Kentucky Power, which EKPC believes will also allow more pure economic dispatch and bilateral power exchanges.

The Spurlock plant is the site of EKPC's most consistent interconnection that has available firm transmission access to out-of-state power markets. This point connects to the PJM market, where the least-cost regional power purchases may be made. EKPC is currently able to import up to 466 megawatts of energy year-around from PJM with available firm, point-to-point transmission capacity contracts. However, the EKPC export capability at the same point is near zero year-round. Firm transmission availability to the MISO market, in which EKPC was a member from 1998 to 2001, is very weak. There exists less than 100 MW of import capability in all but one month, and no export capability. EKPC's southern tie with TVA has firm transmission capacity allowing large exports and imports only during certain months and zero in others. Transfers other than spot purchases in this area are thus difficult, according to what the manager for power supply operations told Liberty. EKPC has reported that it was able to make some imports at its 2009 winter peak, but year-round capability is far less.

EKPC arranges its firm transmission, power purchases and sales through ACES Power Marketing. All of the transactions are on a bilateral basis, because EKPC is not a member of MISO or PJM.

#### ***5. EKPC Power Market Utilization***

Prior to 2007, the EKPC production organization built power plants, bought their fuel, operated them, and dispatched them. There existed a deeply embedded cultural bias to generate its own power whenever possible. The "economic dispatch" of the EKPC system did not regularly include power supply from outside sources. The market "was not considered" as a viable provider of power supply resources until recently. The power supply organization now dispatches the power resources and regularly purchases power that displaces more expensive EKPC combustion turbines.

Several potential categories of benefits can come with greater market access for EKPC. "Market access" does not necessarily mean becoming a member of an ISO. It may be as simple as

improving interconnections and seeking beneficial exchange agreements with neighboring power suppliers, including E.ON. Greater market access would allow EKPC to pursue joint dispatch opportunities with surrounding utilities. EKPC could also pursue agreements with regional power suppliers to provide back-up capacity to each other to mitigate the risk of unplanned unit outages. Since Liberty's field work, EKPC reports that, following completion of audit field work, it has recently begun a reserve sharing agreement with E.ON and TVA. Greater market access may also allow EKPC to increase significantly its surplus power sales, and increase its margins.

Greater access to neighboring utilities may also allow EKPC to develop seasonal and load diversity exchanges. The cooperative finds itself in the unique (and potentially very beneficial) position of having a winter peak while being surrounded by neighbors whose load peaks in the summer. This situation provides the opportunity for EKPC and a summer-peaking neighbor to exchange off-peak generation seasonally, providing each with a less expensive power supply resource during the peak season. Such exchanges may be arranged via bi-lateral agreements or market transactions. EKPC has had only extremely small seasonal exchanges with TVA in past years. Weak interconnections with E.ON will not yet allow such exchanges, but EKPC reports that exchange potential exists with Duke Energy-Ohio and potentially other partners.

EKPC was a member of MISO from 1998 to 2001, but withdrew from the ISO before it was fully developed. EKPC believes that the benefits of being a member of this ISO may be greater now than they were earlier, because EKPC is buying more firm transmission from the market. The benefits of membership may now exceed the costs; therefore, EKPC should place a high priority on performing an evaluation as soon as possible. EKPC reported in comments on the draft of this report that it has since begun an analysis of joining PJM, and that it is beginning a similar study regarding MISO.

### **C. Conclusions**

#### **I. EKPC's traditional power supply strategy of build/own/operate baseload and combustion turbine plants has become increasingly risky.**

EKPC has provided power supply for its members by building, owning, and operating coal-fired baseload generating plants, and gas-fired combustion turbines, supplemented by renewable generation and limited wholesale market purchases. This strategy has become significantly more risky in recent years, and the consensus is that it will become more so in the near future. Cost overruns present one material risk that EKPC bears as a result of its predominant reliance on constructing its own units. EKPC acts as its own construction contractor for many projects.

Every company has the opportunity to determine an optimal power supply portfolio that contains a mix of owned generation assets with different fuel supplies as well as purchased-power contracts and spot market purchases. The optimal portfolio considers load requirements, owned generating assets, ownership options, markets and supply sources, renewable energy requirements, and transmission capabilities. The construction of an optimal portfolio also considers "additions to supply" that can be obtained through Demand-Side Management programs and energy efficiency programs. Throughout the optimization process, technology, fuel, environmental, regulatory and financing risks must be considered. An integrated resource

plan (IRP) attempts to optimize the future portfolio by balancing the costs of various supply resource options with appropriate risk levels.

The existing EKPC asset mix includes only owned generation assets, with no long-term power contracts. This asset mix entails higher levels of risk due to its lack of diversity.

**2. EKPC has not sufficiently pursued alternatives to self-building the planned Smith #1 plant such as partnerships or turn-key construction contracts.**

EKPC has not pursued partnerships, turn-key construction contracts, or other alternatives to the self-build and own option for Smith #1 until very recently. While stating that it is “open to such alternatives,” the existence of an in-house construction group (particularly given EKPC’s culture) causes an institutional bias toward self-building. Bidding turn-key construction contracts (or construction, ownership, and operation of the plant) in the market may not only provide a reduced price, but more importantly remove the risk of cost overruns, which the company has identified as a major business risk.

EKPC’s senior vice president for power supply reports that he recently has visited several regional utilities and G&Ts to determine if there was any interest in partnering on Smith #1, but that none of the companies require a power resource in the 2014 time frame. Discussions about post-Smith options have not progressed beyond the discussion stage.

**3. EKPC has not sufficiently considered ownership alternatives for its existing asset base.**

EKPC should be able to ask itself the series of self-examination questions set forth in the preceding section (*2. Ownership Alternatives*) if it is to assure itself that its consideration of alternatives is sufficiently robust. Good business practice requires executives of all companies, especially capital-intensive power suppliers, to know the approximate value of each of their major facilities or asset classes. Management should also know if assets may be more advantageously utilized by specific outside parties, making them more valuable to others. Finally, company management should know how the proceeds of any sale would be applied, an important factor in valuation.

This openness to alternatives does not mean necessarily that EKPC should change its asset mix or sell assets. It does, however, require that EKPC candidly, objectively, thoroughly, quantitatively, and analytically consider such alternatives (and to repeat the process periodically) to assure that it is maximizing value for its members. A sale/leaseback is another alternative ownership transaction that can be economically beneficial, as well as provide up-front proceeds to improve the equity level or ratio. This alternative is discussed further in the *Finance and Performance Management* section of this report.

**4. EKPC has moved toward substantial power supply alternatives in its 2009 IRP, but they are in the distant future.**

EKPC has expanded the types of supply side options considered in its 2009 IRP. The inclusion and modeling of these alternatives demonstrates a step forward, as EKPC is now considering other power resources for the future. However, the IRP cannot change the power supply portfolio significantly for many years. The Smith #1 unit in 2014 is the only sizable baseload addition required until 2021. The IRP plan includes 200 MW of combustion turbines and a 200

MW seasonal purchase in 2010, and additional peaking resources of 100 MW in 2012 and 50 MW in 2015.

EKPC is including other supply-side resources in the IRP, but their implementation is in the distant future. The total EKPC power supply portfolio as defined in the 2009 IRP will not change the current resource mix significantly through 2020.

**5. EKPC has not been well interconnected to neighboring utilities and ISO markets, limiting the potential for beneficial power transactions.**

EKPC's inability to transfer power with its neighbors or regional markets and its acknowledged lack of analysis of economies that can be gained through increasing transfer capability has been an issue of long standing. An EKPC internal, inter-discipline study team concluded in 2005:

- *EKPC has transmission constraints that create the need to run combustion turbines*
- *EKPC dispatches its CT's different from its competitors*
- *EKPC has no long-term purchased power contracts*
- *EKPC has no affiliated company to rely on for purchased power.*

The same document stated that:

*...The absence of adequate transmission facilities and its impact on overall fuel costs has become evident to the team. Until EKPC can reduce its dependence on combustion turbines, fuel costs will remain high.*

Liberty asked EKPC to provide its analysis addressing the alternative of investing in and strengthening the transmission system to allow for additional purchased power or exchanges as power supply resources. When asked about investing in and strengthening the transmission system to allow for additional purchased power or exchanges, EKPC noted that there had not been in the last five years any requests of the transmission planning staff to analyze transmission system capability "for specific power imports into the EKPC System." EKPC's response went on to explain transmission design criteria for replacing power for the outage of its largest generating unit. The response was that it has only recently initiated an effort to study designing the EKPC transmission system to allow economic imports in place of dispatching combustion turbines.

EKPC has made 345kV additions based on improving reliability. Liberty concluded that, through the present, EKPC efforts to strengthen its transmission system have focused on reliability, without appropriately considering economy. Investing significant amounts in the transmission system to facilitate beneficial power purchases, sales and exchanges, through either bilateral agreements or an ISO, has not yet been pursued with sufficient vigor, candor, or analytical rigor.

**6. EKPC's limited utilization of power markets restricts its ability to pursue beneficial transactions such as seasonal exchange agreements.**

Greater market access would allow EKPC to pursue joint dispatch opportunities with surrounding utilities. The company also could pursue agreements with regional power suppliers to provide back-up capacity to each other to mitigate the risk of unplanned unit outages. EKPC may also be able to significantly increase its surplus power sales and increase its margins.

Greater access to neighboring utilities may also allow EKPC to develop seasonal and load diversity exchanges. EKPC is in the unique (and potentially very beneficial) position of being a winter peaking system that is surrounded by neighbors whose load peaks in the summer. This situation provides the opportunity for EKPC and a summer-peaking neighbor to exchange off-peak generation seasonally, providing each with a much less expensive power supply resource during the peak season. Such exchanges may be arranged in bi-lateral agreements or through market transactions.

The benefits of greater access to neighbors and markets may be further enhanced if EKPC joins either the MISO or PJM ISO. EKPC believes that the benefits of being a member of an ISO may be greater now than previously, because the company is buying more firm transmission from the market. The benefits of membership may now exceed the costs, and the company should perform an evaluation as soon as possible.

#### **7. EKPC has not vigorously pursued agreements and exchanges with IOUs.**

EKPC has demonstrated a long-standing resistance to engaging in partnerships, joint operations, or exchange-type type agreements with investor-owned utilities. EKPC appears to favor dealing with fellow cooperatives rather than IOUs. The historical roots of an aversion to dealing with IOUs may be understandable; it nevertheless creates a barrier to maximizing economy.

The weak interconnection with E.ON/KU demonstrates this bias. The two systems are adjacent and connected at numerous points, yet no significant transfer capability exists. Each system has been built to be self-sufficient. However, the two systems may be able to benefit from joint dispatch, shared back-up capacity, or diversity exchanges. It is possible that KU may be the “best fit” among regional power supplies to enter into such arrangements with the company. However, EKPC does not appear to consider KU other than as a competitor, and, moreover, one whose rate gap is a source of frustration to the member cooperatives. This situation may suggest that joining an ISO rather than dealing directly with individual IOUs may have more chance of coming to fruition in the short run. The benefits of seasonal exchanges may be monetized in the market, thereby distributing the counterparty benefit among several parties.

## V. Governance

### A. Background

Liberty performed a review of the board, including its structure, practices, members, capabilities, and processes. Liberty's review of the board was all-inclusive, and paid particular attention to seven specific questions that the RFP asked to be specifically addressed:

1. Whether, and to what extent, the EKPC board faces conflicts of interest arising from the fiduciary duty owed to both EKPC and their respective distribution cooperative. If such conflicts exist, how are they resolved?
2. Whether, and to what extent, the actions of the EKPC board are influenced by the respective distribution cooperatives' governing authorities (i.e., is the EKPC board sufficiently independent to diligently pursue the best interests of EKPC?)
3. Whether the distribution cooperatives and their members are adequately and appropriately informed of issues confronting EKPC and the EKPC board's decisions.
4. Whether the EKPC board is adequately and appropriately informed of issues confronting EKPC and what steps are taken by the EKPC board to independently verify that information.
5. Whether the EKPC board possesses the financial, technical and managerial expertise to diligently pursue EKPC's best interest and what steps are taken, if any, to ensure that the EKPC board's expertise is kept current.
6. Whether there are any organizational impediments preventing EKPC or the EKPC board from diligently directing the affairs of EKPC.
7. Whether, and to what extent, the EKPC board has delegated an appropriate level of discretion to EKPC's Executive Management to perform the day-to-day operations of EKPC.

Liberty's review included extensive examination of documentation, including board and committee minutes, and 45 interviews of every EKPC director, distribution cooperative board chair and distribution cooperative CEO (EKPC board alternate). Liberty carried out this review in close coordination with the review of management, which the preceding chapters of this report addressed. A review of governance must focus attention on the planning, finance, and strategy issues that those preceding chapters discuss. The extensive description of the circumstances, challenges, and opportunities that have engaged senior EKPC management provides in large measure the same backdrop against which Liberty performed its review of governance. Moreover, the interrelationship between senior management and the board forms a critical element in successful board performance. Thus, the board's role in overseeing management's conduct in the areas and on the matters discussed in the preceding chapters is also important.

Thus, those preceding chapters provide much of the background for assessing EKPC board structure, composition, and performance. Those chapters essentially seek to answer the question of how well management has performed in the areas Liberty examined. This chapter focuses on how well the board has performed in giving management what it needs to act effectively and in ensuring that management has acted effectively.



Liberty reviewed a great deal of documentation in the performance of its governance review. Nevertheless, as is customary in our prior reviews of governance, interviews proved the most critical sources of information bearing on the questions to which the RFP sought answers. EKPC's board is a large one, even before considering that each voting member: (a) has an alternate on the EKPC board, and (b) comes from an EKPC owner that has its own governance structure led by its own chair. This structure required Liberty to conduct the 45 interviews needed to secure input from the very large leadership body that guides EKPC. Liberty would expect such a large group to exhibit significant diversity of thought, priorities, views, and concerns.

Such diversity, however, did not emerge from the interviews. They were revealing much more for the consistency in words and tone that Liberty observed. The study team found a generally common set of observations and opinions. Some individuals offered different perspectives, but not at a level that would prevent Liberty from offering a single, coordinated set of conclusions that can comfortably be described as predominant among the EKPC board. In summary, while Liberty found some differing views, the more important observation is that the EKPC board members define the board's role and carry it out in a highly consistent manner overall. The merits of that means of exercising board functions formed a central part of Liberty's governance examination.

The lack of substantial variance in the responses obtained through interviews does not and should not necessarily reflect favorably on board performance. It does, however, increase the confidence one can have in the conclusions reached about how the EKPC board conducts its business and meets its responsibilities. For example, almost none of the directors could articulate elements of the strategic plan at a significant level of detail. Liberty used that common level of "distance" from plan knowledge to conclude that members, despite attendance at planning "retreats" did not engage sufficiently to make the board a meaningful part of that initiative. Liberty has typically found varying levels of director recall of and "ownership" of strategic plan elements. Where that is the case, it can be difficult to form conclusions about the real matter at hand; *i.e.*, not judgments about individual board members, but judgments about how well the board as a group operates. The commonality Liberty found among the EKPC members, however, (on strategic planning specifically, and the remainder of the agenda addressed at interviews generally) made the formulation of conclusions about the board as a whole much more straightforward than would generally be expected. Such a conclusion would not be possible if several directors had proved knowledgeable about the strategic plan. Liberty did observe some differences between the voting members and the alternates (who consist of the CEOs of the 16 member local cooperatives), but found those differences, particularly given what the study team learned about how they influence voting members, not to be at a level that warrants differentiation in the overall conclusions formed about the board as a group.

## **B. Findings**

### ***I. Governance Standards***

The role of directors in American enterprises has grown considerably in recent years, driven in major part by a series of financial catastrophes at large corporations (for example, Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom) and responses to them. The adoption

of The Sarbanes-Oxley Act (SOX) in 2002 and the adoption of major guideline reforms by the stock exchanges exemplify those responses. Concern continues today in the wake of the 2008 financial meltdown that ended up causing economic downturns throughout the world. While significant, the resulting changes have not had a direct impact on most consumer-owned utilities, although financial fallout for those who must secure financing in the marketplace have certainly suffered, as the preceding chapters discuss. The direct impacts of regulatory and exchange-listing transformation fall primarily on how the Audit, Finance, Nominating and Governance, and Compensation Committees of the boards of publicly owned corporations function. EKPC is not publicly owned, and has only one corresponding committee; *i.e.*, Audit.

The culture of accountability that began with landmarks such as SOX has, however, spread beyond those enterprises directly affected. Moreover, the current national climate indicates that even greater degrees of accountability and transparency may be coming. It would, therefore, be short-sighted to ignore the benefits (to the public, and, in the case of EKPC, members as well) that come from increased accountability, merely on the grounds that still emerging public requirements have yet to extend to the realm in which other types of entities (*i.e.*, non-investor owned) serving what are essentially business purposes operate.

The changes that have come and that clearly will continue to come in American enterprise governance have generally focused on promoting a much more active form of oversight and stronger independence among members of the board or other top-level governance authority that applies. Not only exchange-listed enterprises, but others as well have become more aggressive in developing and applying more structured governance standards and in expanding the scope of governing body engagement. The degree to which such changes apply to every enterprise may be debated; what is not open to question, however, is the need for a well-defined and structured approach to good governance.

A belief that the public, acting through its legislative and regulatory bodies, will indefinitely extend to other enterprises the discretion that is steadily being eroded among investor-owned counterparts seems clearly to be misplaced. Progress by entities not now specifically required to comply with SOX, exchange listing guidelines, and other governance standards reflects the rejection of this belief as a criterion for future planning. That progress also demonstrates that a commitment to continuous improvement compels all entities to consider carefully that at least some of what others must do under compulsion, they should do by choice.

The distribution cooperative approach to governance has traditionally centered on community ownership, direction and oversight. Liberty takes no issue with the great benefits that the rich history of cooperative growth in America has provided. Nevertheless, even full acceptance of the wisdom and virtue of what has brought the cooperative movement generally, and EKPC specifically, to today still begs the question of what approach will carry EKPC's success forward indefinitely into the future. Answering that question depends not on what EKPC was when it began, or even what it was as little as a decade ago. The correct framework for examining the future is the recognition that EKPC has become a multi-billion dollar power-supply enterprise that operates in a time of perhaps unprecedented levels of uncertainty and risk.

It simply will not do to distinguish EKPC from other businesses that operate in this environment. EKPC's risks and opportunities are certainly not identical to investor-owned counterparts. Those risks and opportunities are, however, sufficiently common to conclude that EKPC needs to operate like the business it is, and that doing so requires governance that can provide the

oversight necessary to steer carefully in waters that are far less known, in “weather” that is much rougher, and on a course that is more difficult to chart. How and how well EKPC’s directors adjust that traditional approach logically to provide effective governance at a multi-billion dollar power supply enterprise thus becomes, in Liberty’s view, the central question for the board to answer. Times have been changing rapidly, both in the nature of power supply complexities and risks, and in escalating demands on enterprise governors in this country in general. The public power community has recognized this. Some have adopted Sarbanes-Oxley principles and others are re-examining their governance practices in the wake of major problems at places like Pedernales Electric and Cobb EMC.

Pedernales Electric is a private electric utility owned by the members it serves, consisting of more than 231,000 meters throughout 8,100 square miles in Central Texas. Cobb Electric Membership Corporation is a not-for-profit cooperative that serves approximately 195,000 members in approximately 1,434 square mile area in North Metro Atlanta area and Randolph, Calhoun, Quitman and Clay counties in southwest Georgia. There were highly publicized scandals at both of these cooperatives in the last few years involving alleged malfeasance by certain directors and management. The notion that “it can’t happen here” was too recurring a theme from Liberty’s interviews with EKPC directors. Even without such events at other cooperatives, this view should have been seen as short-sighted. In the wake of such events, such a view falls nothing short of courting disaster.

Notwithstanding the growing efforts by other non-investor owned enterprises, there remains no uniformly accepted set of governance principles for power supply cooperatives. There was some motion in Washington to establish standards for cooperatives in general. Hearings took place in 2008, but there does not seem to be an active effort at this point, as Congress faces substantial other priorities. In any event, it would seem to be in the best interests of the cooperative community to develop such standards before federal or state regulators take steps to fill the void.

This audit, therefore, can begin with no authoritative set of standards from which to measure the EKPC board. Liberty crafted a set of standards for EKPC that was intended to establish minimum requirements. These standards should not be read as establishing “best practices,” but instead represent common-sense expectations for a board of directors engaged in the business activities that EKPC is charged with executing. Liberty’s standards require that the board:

- Set strategic direction
  - Articulate a compelling vision
  - Define the mission and objectives
  - Set standards of performance within the strategic framework
- Assure financial health
- Assure adequate controls and the overall integrity of the cooperative
- Provide oversight and direction of management
- Assure that problems and issues brought to its attention are satisfactorily resolved
- Assure the board has the attributes to accomplish the above
  - Qualified and act to enhance those qualifications
  - Committed – spend the necessary time and effort

- Loyal – protect the G&T Cooperative’s interests above all others;’ *i.e.*, including the Distribution Cooperatives’
- Self-policing – hold each other accountable
- Collegial – do not allow domination by one person or a small group.

## 2. *Organization and Structure*

EKPC is owned by 16 distribution cooperatives. The board of directors consists of one director selected and assigned by each of the 16 owners. In addition, the CEO of each distribution cooperative serves as an alternate on the board. Directors are generally compensated at \$400 per meeting with a minimum of \$800 per month. Officers and committee chairs received added compensation. Directors also receive a severance payment tied to their years of service as a director. This latter benefit, established by board resolution, gives directors an amount equal to the current annual minimum monthly per diem (\$800) times years of service up to 20 years. This program appears unique to EKPC; management reported finding “no other G&T with such a program.” The severance program was eliminated as part of the board’s cost-cutting contribution to the NorthStar initiative in 2008, but was reinstated four months later.

The board conducts much of its work through: (a) three standing committees, (b) the Audit Committee and, from time to time, (c) ad hoc committees focused on special assignments (such as CEO selection). In summary, the overarching responsibility of the committees is to bring recommendations to the full board for its disposition. At present there are four active committees:

- Operations, Services and Support (OS&S)
- Fuel and Power Supply (F&PS)
- Power Delivery (PD)
- Audit.

The Operations, Services and Support Committee (OS&S) has responsibility for financial and operational aspects of EKPC, such as annual budgets and work plans, bylaw and policy changes, HR matters, strategic planning, member services, public affairs, economic development, marketing, and pricing. It generally meets monthly before the board meeting and its meetings generally run about a half hour.

The Fuel and Power Supply Committee (F&PS) has responsibility for fuel procurement, power supply planning, and other matters relating to fuel, generation, and power supply. It generally meets each month before the board meeting and its meetings generally last about an hour. F&PS meetings tend to be longer than others due to their responsibility to review and approve procurement documents on a regular basis, such responsibility flowing in part from RUS requirements.

The Power Delivery Committee (PD) has responsibility for all elements of transmission including planning and reliability, communications, telecommunications, information transfers, and all other elements of power delivery. It too meets monthly before the board meeting and it appears to be the least active committee. Its meetings last less than a half hour on average.

The three standing committees are comprised of both directors and alternates, with the goal being to divide membership equally between them. No member may serve on any one committee for more than three consecutive years.

The Audit Committee consists of four members: the Chairman and one member from each of the standing committees. This produces to two directors and two alternates as committee members. The Audit Committee is required to meet at least twice per year. It met five times between April 2008 and April 2009. The Audit Committee, unlike the other committees, has specified qualifications for its members. The Chairman must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience which results in “financial sophistication.” Each member should be able to read and understand fundamental financial statements.

### 3. Governance Policies

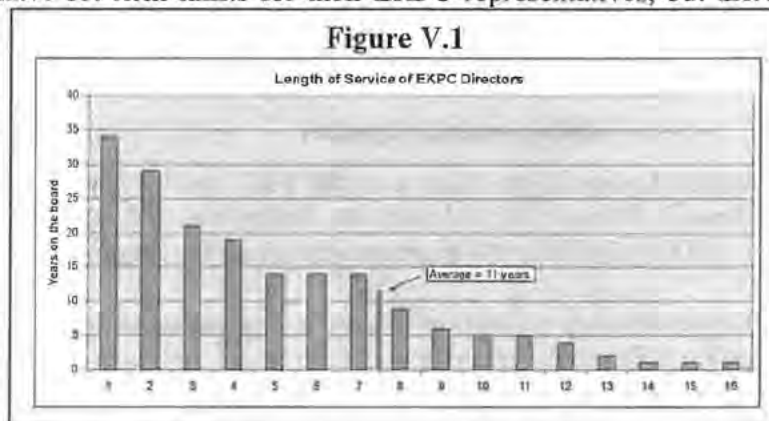
The board maintains a series of formal policy statements, which currently numbers 13. The practices required by the policies seem to have been embedded for a long time; therefore, the literal policies themselves do not necessarily play a significant day-to-day role. Some of the statements are more than five-years old, which suggests that the policies have generally not kept pace with the many changes in governance that have occurred elsewhere in recent years.

One notable omission, which has previously been called to the board’s attention by the NRECA team, is a “whistleblower policy.” Virtually all firms now see the need for a vehicle that allows direct communication with the board on perceived irregularities. EKPC has repeatedly rejected such a policy and, in fact, its Policy No. 104 seems to forbid such communications.<sup>2</sup>

### 4. Qualifications and Selection of Directors

The process of EKPC director selection varies among the distribution cooperatives, which elect them, but generally involves annual nomination and vote by the directors of the distribution cooperative. A few of the distribution cooperatives have established minimum requirements to serve as an EKPC director, but most require only that the selected director be a distribution cooperative director. A few also have set term limits for their EKPC representatives, but there are no such limits for most of the directors. Figure V.1 shows the length of service of each current EKPC director. The average is 11 years and nearly half of the current directors have been on the board for at least 14 years.

NRECA provides various training for directors. All distribution cooperative directors are expected to become certified



<sup>2</sup> EKPC comments on the draft of this report state that the board has since approved a “whistleblower policy,” and intends to expand it later in 2010.

via that NRECA process. There is no such training for power supply cooperatives in particular. EKPC's directors become educated in the G&T's business via orientation provided by EKPC and on-the-job training.

### *5. Communications*

The flow of information between management and the board, and between board leadership and the board, is critical in allowing the board to accomplish its responsibilities. The uniform feedback from board members was that such communications are excellent. Directors cited the wealth of information that is provided to them each month, along with a stream of e-mail that serves to keep them informed, and which helps them provide valuable information back to their distribution cooperatives. There was not a single complaint over the quality of this information, although there were some concerns about the ability to handle such a large volume.

Liberty's observation of management status reports found them professional and valuable, although the tendency to provide numbers without explanatory analyses geared to the directors' level is a weakness. The directors have an open path for questions. Most claim to avail themselves of that path, but the level of understanding evidenced in interviews suggests problems with the process.

Management embarked on a 2007 strategic planning initiative, and seems to have tried to engage the board in that effort. This may have been a response to the NRECA team's review of EKPC; that report was withheld from the board by board leadership for unknown reasons. Most directors generally recall the nature of the effort, but few recall or were conversant with any outcomes.

The NRECA report, described extensively in the preceding chapters of this report, displays a low point in communications between management and the board. The then-CEO defined the report as "operational," which is both incorrect and irrelevant. The report included important board-related findings and its "operational" findings were at a level that demanded board awareness, attention and prompt action. Yet there is no evidence that any board member, other than perhaps the officers, knew that the report was critically important to EKPC, the appropriate board committees, and the board as a whole. Although this incident stands out as a major communications failure, Liberty saw no reason to conclude that such inappropriate withholding of information from the board by management was customary.

### *6. Management Delegation*

The board places high reliance on the CEO and his support team. The delegation to the CEO is defined in Policies No. 103 and 104. Policy No. 103 is more properly a position description for the CEO. Policy No. 104 is aimed at defining the relationship between the board and the CEO.

Relationships are a function of people and personalities, probably more so than of policies. A capable CEO will generate a higher level of trust and reliance than one of questionable performance. But it is nonetheless wrong to entrust an excessive level of delegation, regardless of the CEO's credibility and capability. The risk in doing so was demonstrated at Pedernales, as reported:

*The board appears to have placed almost complete reliance on the former General Manager . . . to establish the strategic direction for the Cooperative, to set the policies and procedures by which it was governed, and to provide the benchmarks for how the Cooperative's performance was to be measured and evaluated.*

*A critical factor that contributed significantly to the board's acceptance of (the GM's) role was the board's general consensus that (he) was a talented manager who had presided successfully over years of significant growth of the Cooperative.*

Good governance requires that adequate controls, including well-defined delegations that maintain board direction and oversight, are essential, regardless of the attributes a CEO may possess. There is no suggestion here that the situation at EKPC is, or has been, at a level similar to Pedernales. Rather, Pedernales is a lesson that should be learned.

Liberty's interviews painted a consistent picture that both the board and management are satisfied with their relationship. The board believes that it exerts a suitable level of oversight and direction, although Liberty takes issue with this belief, as the following Conclusions section describes.

Management similarly is generally comfortable with its board relationship. Interviews also suggested that board and committee agendas, while prepared by management, follow input from directors.

### **7. Prior Assessments**

At least two reports by independent consultants in the last several years addressed governance at EKPC. In 2006, Richard Byrne was retained by EKPC to review operations. As Mr. Byrne described that work:

*The EKPC board has requested the Consultant to review its general practices and recommend modifications that could be made for it to perform its duties more thoroughly and effectively. It has also been requested that key strategic issues be identified that the board should focus on during its deliberations.*

The resulting recommendations on governance can be summarized as follows:

- *"As you all know the board should spend the vast majority of its time analyzing, debating (and even arguing about) issues that affect the overall strategic direction of the cooperative"*.
- *"The Board Standing Committees meet just prior to the board each month. This schedule leaves very little time for in depth review of matters that come before them."*
- *Board Policy No. 102 encourages quarterly Manager meetings. The board should "emphasize this policy to assure it is being followed and highly encourage Managers to attend."*
- *The staff should "meet with RUS to develop a new approval authority matrix that permits the Committees or the CEO to sign off on RUS certifications."*

Liberty found no indication of any acceptance or subsequent action on these or other recommendations. Liberty's interviews disclosed that board members were not familiar with the consultant's findings and recommendations. Some board members did, however, have a recollection sufficient to allow them to dismiss the report and criticize its quality. The implication that this was an initiative of the then-CEO and had no backing from the board was clear from these interviews. This therefore leaves open the question of the statement quoted above that the board requested the governance review.

The second external review was conducted by a team from NRECA, through its National Consulting Group (NCG) business unit in April 2007. The interim CEO commissioned this review soon after he became CEO. His action reflected a sound step to develop promptly an understanding of the challenges facing EKPC. On the other hand, such broadly based work by a new CEO presented the potential for major surprises, which NRECA's work certainly presented.

The findings of the NRECA team can be described as very critical of EKPC, including the board, many senior managers, and their organizations. Recommendations were substantive and, if fully implemented, would have had major impacts on the organization and its people. The following list of recommendations addressed the board (this chapter addresses later some of the other key recommendations):

1. *"All board members, regular and alternate, should participate in a ... strategic planning retreat (already scheduled). Strategic thinking opportunities should be included on every agenda."*

The retreat did occur with board participation. However, it did not resonate with directors enough to make them conversant with it today. More importantly, the work was viewed as a "once and done" activity, which was contrary to the NRECA team's intent.

2. *"Board should consider a board evaluation."*

The board conducted a self-evaluation in October 2007. The evaluation can better be characterized as an opinion survey, however, and not the critical self-assessment NRECA presumably recommended and which many boards now undertake annually.

3. *"Review board committee structure and focus to ensure that committees are addressing governance issues and not operational topics."*

The board decided that no action was appropriate.

4. *"Develop a 'whistleblower' policy."*

It does not appear that the board had considered this recommendation by the close of field work on this audit.<sup>3</sup> It seems to have been rejected by the interim CEO on the grounds that EKPC did not fall under Sarbanes-Oxley requirements and that it had not been an issue at EKPC.

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<sup>3</sup> EKPC reported in comments to the November 16, 2009 draft of this report that the board did consider and approve such a policy in November 2009.



5. *Include directors in the sexual harassment policy.*

This recommendation appears to have been accepted.

6. *“Ensure that the cooperative has established and maintains an effective and comprehensive compliance and internal controls program.” Include a formal internal audit function.*

At the time of the report EKPC had an internal audit function, but later eliminated it.<sup>4</sup>

7. *“Review legal ethical obligations of the role of General Counsel versus a board Attorney.” “Separate board counsel should not be necessary under normal corporate conditions.”*

There is no indication of action and the board continues to retain its own, separate attorney.

8. *“Engage in a discussion regarding the legal distinction between directors and alternate directors.”*

There is no indication that any actions were taken.

Liberty discovered that the NRECA report was not made generally available to the board. In early 2009, in apparent preparation for this audit, the board’s attorney requested information on the governance recommendations. This request came nearly two years after the report’s issuance. In response, the interim CEO provided a summary of the recommendations and their disposition to the board’s attorney and to its chairman. Based on subsequent interviews, it appears that even this belated summary was not shared with the rest of the board.<sup>5</sup>

Liberty found from the responses to both the Byrne and NRECA reports that the board did not learn of the recommendations made and the underlying issues that were raised. This lack of attention to external criticism is discussed further later in this report. The apparent failure of board leadership to share this information is of course a mitigating factor and a matter of significant concern.

## C. Conclusions

Liberty has examined the performance of the EKPC board in the context of the six minimum standards described above. In addition we evaluated the overall conduct of the board’s business, the qualifications of directors and the adherence of the board to its own policies. It was noted earlier that the responses to our governance questions by the board members and others were remarkably consistent and give us confidence that the conclusions that inevitably emerged from such consistency are accurate.

### 1. **Governance standards and expectations have escalated sharply in recent years, but the EKPC board has not kept up with changing times.**

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<sup>4</sup> EKPC comments on the draft of this report state that the internal audit function was subsequently reinstated.

<sup>5</sup> EKPC comments on the draft of this report state that the report was shared with the full board shortly after receipt of the draft of this report.

Members of the board are in some cases aware of the changing nature of governance expectations and the factors driving those changes; yet the board does not see a connection between them and its role in overseeing EKPC. Liberty's review of board and committee minutes and more than 45 governance-related interviews found no evidence that SOX, Pedernales, Cobb, or other developments have had a substantial impact on the thinking of directors. The feeling shared largely by directors and executive management seems to be that such problems have not and cannot happen at EKPC. That attitude does not comport with even traditional views of corporate stewardship, let alone the advances that have occurred in the wake of the much publicized disasters of more recent vintage.

The fact that governance issues have dominated industrial news for quite some time and that EKPC was specifically cautioned in this regard by several advisors, including Crowe Chizek (discussed below), NRECA and Byrne, is troubling. Liberty found no reason for the board's failure to address these issues other than the strength of the underlying belief that EKPC is immune to similar, bad things. This rational demonstrates a weakness that goes to the heart of good governance.

**2. The board has moved away from the minimum standards for acceptable governance and it presently does not meet those standards.**

Liberty provided above a set of six minimum criteria for a board such as EKPC. At a summary level, Liberty found material weaknesses with respect to all six. Liberty underscores this conclusion to avoid any ambiguity about the urgent need for direct, substantial, and prompt improvement. The board has received similar input in the past, although not as bluntly and to a smaller audience. That EKPC has not responded substantially to that "news" emphasizes the need for vigor in making a call for strong and immediate action. The following conclusions address each of the six criteria in turn.

**3. The board, including the responsible OS&S committee, does not provide meaningful strategic direction or guidance, is not meaningfully involved in strategic processes, and is generally unaware of the strategies currently in place at EKPC.**

Nearly every board member was unable to articulate the current strategy of EKPC, the results of the 2007 planning retreat, any status information on "the plan," or to offer any insights on strategy other than very general recollections of having attended the retreat, or of having a conflict that prevented their attendance. It is clear that strategy has not been a board focus for at least the last two years.

*The board should set strategic direction.*

The 2007 strategic planning effort, facilitated by MCR Consulting (MCR), appears on paper to be an extensive and properly designed effort. It produced a series of objectives for which implementation plans were developed to be carried out by the appropriate organizations. One outgrowth was the NorthStar initiative, which put in motion an aggressive program of cost reduction. The board was indeed aware of this effort, and some directors defined the NorthStar subset of initiatives as "the strategy." Board minutes state that NorthStar's objective was to lessen the rate gap with KU, but there was no indication of discussion at the board, any linkage to financial goals or any decisions by the board on NorthStar, including the setting or approval of reduction targets. This may be an oversight in the minutes. The November 8, 2007 "EKPC

Strategic Plan” reports that “The Senior Team presented the savings opportunities to the board and with a couple of exceptions, the board approved the NorthStar savings opportunities and the \$42 million in projected savings.”

The board’s failure to confront its responsibilities for strategic planning was the subject of recommendations by Byrne and NRECA. Liberty’s examination found that the problem remains. In addition, the OS&S committee, whose charter specifically includes strategic planning, has not acted in a visible way to fulfill this duty. The strategies chosen by EKPC will affect the distribution cooperatives’ customer-owners for the next 40-50 years. Commitments made today carry risks and obligations that will be borne by the end-use consumer for a long time. A board must expend considerable effort if it is to show due diligence in defining and carrying out a well-designed long-term strategy. This fundamental obligation is too serious to turn over to management without suitable oversight and direction.

**4. The board has practiced a biased priority for low rates, even at the expense of EKPC’s financial health.**

Earlier chapters of this report addressed the subject financial management and the overall health of EKPC. The board’s role in assuring a healthy and prosperous power supply company and particular how such an obligation is balanced against rates is the focus here. The distribution cooperatives want their rates to be as low as possible without damaging their investment in and commitment to EKPC.

*The board should assure financial health.*

A critical question asked in designing this audit was the degree of conflict that may exist between directors’ obligations to their cooperatives and to EKPC. Directors were well prepared to respond to this question, which very many of them in interviews did with a consistency that was so similar in substance and presentation as to suggest structured preparation. One director even offered to articulate the response, even though he was never asked the question.<sup>6</sup>

The prevailing answer from directors was essentially that what is good for EKPC is good for the distribution cooperative owners. Directors correctly conclude that, as the owners of EKPC, they and their customers have the most to lose from EKPC financial weakness and potential collapse. This argument theoretically suggests that directors would aggressively exercise fiduciary duties and insist on a strong financial base for EKPC. In practice, however, other factors have overridden this perspective. Those factors have negated “balance” between low rates and financial health irrelevant, with low rates having become the overriding consideration.

**Figure V.2: The KU GAP and Closure Targets**

Gap at end of 2006 (baseline for plan)	24%
2011 target recommended by mgt.	24%
2011 target established for NorthStar	20%
Actual at end of 2008	32%

This prevalent principle lies squarely at odds with the “no conflict” responses of the directors. The conflict requires consideration of the reasons why directors would compromise financial health when they are fully aware of their obligation to protect that health and the wisdom in doing so. Liberty believes this contradiction flows from a number of realities, which arise principally from unrealistic expectations about the “KU Gap,” shown in Figure V.2.

<sup>6</sup> EKPC’s comments on a draft of this report cites director familiarity with the issue given its inclusion in two prior rate orders, as opposed to preparation for this audit, as the cause of the similarity in responses.

This gap (the difference in EKPC's rates versus the wholesale rates of KU) is and has for some time been extremely important to the cooperatives. Some cooperative customers live very close to KU customers, yet pay considerably higher rates. In addition, the cooperatives are at a major disadvantage for new economic development and accompanying industrial load when KU is the competitor. To some extent, the board seems preoccupied with the gap and views it as the single most important strategic imperative. The gap was a prime topic in the MCR strategic planning effort, and considerable analysis was included in the MCR work. The gap was chosen as the "NorthStar metric."

MCR cautioned that "Despite the emphasis on rate disparity with KU, it is very important to also recognize that EKPC's very low equity ratio is not sustainable." MCR suggested a number of ways to build equity other than the two obvious ones: cutting costs and raising rates. MCR's suggestions included managing growth and delaying the need for new generation, increasing generation and transmission access to markets for surplus sales, and lowering new construction costs per kW through partnerships. Liberty's interviews indicated that most directors do not accept and in many cases are not even conversant with other options. Their rejection is based on an unawareness of those other options and/or a perception that such options are impractical. As a result, with cost cutting a given and already in place, the only way to build equity is through rates.

Despite numerous inquiries, Liberty was unable to find any analysis at EKPC that defines the reasons for the KU Gap. EKPC has confirmed that no such analyses are available. It is not clear how effective goals can be set for the gap in the absence of knowledge of its underlying causes.

The overriding focus on this gap puts EKPC in the unfortunate position of chasing something it cannot catch without putting forth a serious effort to probe its drivers at a sufficiently detailed level. The singular "strategy" became "cutting costs," which has a necessary but unstated corollary: no rate increases. Management seems sensitive to the need to increase equity at the same time, but the board does not appear to share this priority, thereby consigning the rate increase question to resolution by implication, rather than by directly confronting it. This chain of events leads to the answer to the Commission's question about the existence of an inherent conflict.

EKPC comments on the draft of this report asserted that the board has approved two base-rate increase filings in the last five years, thus establishing that "directors have indicated an obvious willingness to place the interests of EKPC above those of their local cooperatives." Liberty's conclusion that such actions are only undertaken as a last resort, is not contradicted by these actions, but rather finds support in them.

**5. The board's overriding focus on narrowing the KU rate gap and its direct impact on the financial strength and resources of EKPC lead directly to a real, continuing, and hazardous conflict.**

This conclusion deliberately avoids the term "inherent conflict." That term would suggest a fundamental flaw in EKPC's governance structure that precludes directors from fulfilling their fiduciary responsibility to EKPC under any circumstances or with any improvements. Herein lies

a key distinction that will have far-reaching consequences; *i.e.*, whether the conflict at EKPC arises from conscious choices by the directors (which may be addressable) or from a fundamental flaw in the governance structure (which does not allow for the possibility of change short of addressing that structure). Liberty considers the former to be more likely the case, but believes that the only meaningful answer can come from the board itself. It is the board that must decide if it can define and enforce upon itself a discipline that places the interests of EKPC above others. If directors are not able to do this, then the conflict either is “inherent,” or it does not matter if it is not, for major structural change becomes the necessary answer in either case.

Selected directors in any entity are often chosen for their ability to bring the point of view of an outside group, whether that be consumers, a labor union, or any other stakeholder group. In all such cases, however, the director’s role is to assure an understanding of the represented group – it is not to advocate for that group against the interests of the enterprise the directors serve. The director’s loyalty must be to that enterprise, and he or she should resign if unable to exercise the fullest degree of loyalty.

The board as a whole and directors individually face an important and immediate need to decide if they are willing and able to formally make the health of EKPC their top priority, to enforce that commitment and to include that priority effectively in all their decision-making; if not, then major structural change is required.

**6. EKPC’s board has not been effectively identifying and analyzing risk in ways that conform to current business thought.**

Liberty observed three material gaps in how the board applies current thinking about risk in its oversight of EKPC:

- The board does not adequately consider the risks facing EKPC on a structured basis and does not require a management program of risk assessment and mitigation
- The board does not adequately consider risk in its decision-making processes
- The audit committee, although formally charged with acting as “the Risk Oversight Committee,” has taken no actions relating to this responsibility or the consideration and management of risk in general.

An important element of financial health is the effective consideration and management of risk. Risk has two different applications that matter in this context. First, the board and management must possess and apply on a continuing basis a sophisticated understanding of the risks involved in the business. That understanding must lead to programs and systems that permit management of those risks.

Second, risks must be factored into the decision-making process. It is simply inadequate to make a decision solely on the basis of economics without also considering risk. For example, a given power plant option may be superior based on current and projected costs, but high risks might forbid that choice. This is especially critical when such risks might expose the customer-owners for decades.

It will be noted that the new CEO and his staff seem to be making risk management a priority.

**7. The lack of an internal audit function is unacceptable in an organization like EKPC.**

Enron, and the many governance-related responses to that disaster, raised the bar on expectations for the board in assuring adequate controls and maintenance of a high level of integrity. EKPC has controls in place, but there are notable gaps in the board's creation of and support for an overall program and culture.

*The board should assure adequate controls and the overall integrity of the cooperative.*

First, EKPC eliminated the internal audit function in an apparent cost cutting move. The lack of this function in an organization like EKPC represents a serious and unacceptable deficiency, yet management and the board continued to seek to justify it through the course of field work on this audit. Several directors have suitable current governance experience that should have caused them to reject this unacceptable situation, but none acted to do so.

Second, the Audit Committee is not sufficiently involved and active. The committee met only five times in the last year. Applicable policies require the committee to meet only twice per year, which makes not only its performance insufficient, but demonstrates that the expectations regarding that performance are also too low.

Third, the board failed to deal appropriately with the Crowe Chizek deficiency discussed below, failed to promulgate a whistleblower policy, and has failed to consider "lessons learned" from relevant cases elsewhere (Pedernales and Cobb), reflecting the unsound premise that "it can't happen here."

**8. The degree of delegation afforded to management by the board taken as a whole is overly generous and the degree of oversight is less than required.**

This is not intended as a criticism of management, or as an implication that such delegation has been abused. There is no evidence to support such a claim. Rather, strong oversight is a critical governance attribute and the intention is to prevent the appearance or possibility of such abuse.

Both the board and management are generally comfortable with the existing relationship. That relationship was established by the long-term CEO, who left in late 2006, and the interim CEO, who left in mid-2009. There is reason to believe that the chair of the board does exert significant personal influence, but that should not be considered an appropriate alternative to performance of this role by the board as a whole.

*The board should provide oversight and direction of management.*

Liberty could not find substantial indicators that the board is providing substantial direction, oversight, guidance, input, or testing of management. This conclusion is supported by the following observations resulting from interviews:

- Board and committee agendas are defined by management. Although directors state that they have input to this process, there is no indication that such input is substantive or that directors play a meaningful role in the process. It is clear that management (not the board) sets the agenda, defines what will be discussed, and controls the process.

- The board, in making decisions, is rarely given options by management. In effect, management reports to the board decisions it has already made, and gives no other choices to a board that asks for none. A quote during one of the interviews with management summed this point up in a manner consistent with what Liberty found: “The board’s job is to ratify the CEO’s decisions.” This of course should not be “the board’s job,” and a governance relationship that fosters such thinking requires significant change.
- Liberty found no indicators that management is routinely and analytically held accountable for its performance in tangible and meaningful ways. As discussed elsewhere in this report, there have been significant performance failures, including those related to NorthStar and the capital budget, and such failings have not attracted apparent board attention.

The nature of the policies defining the relationship between the board and management carry a tone that management should be, and is, in charge. Policy No. 104 could be characterized as a general warning to the board to keep its place. This characterization is based on:

- Paragraph D that warns directors against commitments made in “private conversations”
- Paragraph E that forbids directors from discussing personnel issues with employees
- Paragraph F that warns everything must flow through the CEO
- Paragraph G that gives the CEO “latitude to exercise independent judgment in executing policies of the board.”

Each of these directives is innocent in itself, yet the tone and content of Policy No. 104 seems to be constructed fully from the viewpoint of the CEO. In fact, in the responsibility section of the Policy, the CEO is given no responsibility for its implementation and adherence, suggesting that it limits the board, not him. On the other hand, the board chairman is given the responsibility “for inviting the attention of board members to (their own) non-adherence to this policy,” or, in other words, keeping the board in line. This policy, which was drafted many years ago, seems to nonetheless still set a tone for the relationship between the board and the CEO.

**9. Continuing leadership inaction to deal with previously reported trends of less-than-acceptable governance standards is unacceptable.**

There were at least three cases in the last three years in which outside experts retained by EKPC presented critical governance related findings and recommendations. Two of those, Byrne and NRECA, were discussed earlier. Byrne’s report as a whole appears to have been dismissed by the board, with no actions taken. The NRECA report was not made available to the board, but it appears to have been provided to board leadership, both when originally issued in April 2007 and in response to inquiries by board counsel in January 2009. The recommendations and cautions of NRECA were ignored on both occasions, and were not shared with other directors and alternates. This does not fully excuse directors, because they were made aware of the report in April 2007 and were promised a briefing, which apparently never took place.

*The board should assure that problems and issues brought to its attention are satisfactorily resolved.*

The third external warning that was ignored by the board came in 2008 from EKPC's auditor, Crowe Chizek. A deficiency in fraud risk management was specifically identified for the board's attention. Liberty's interviews demonstrated that directors, including those on the Audit Committee, were unaware of this deficiency and if it was resolved. In fact, management issued a response to Crowe Chizek which promised formation of a task force to deal with this issue. That promise remains to be fulfilled. Further, and ironically, in its response to Crowe Chizek, management took credit for the internal audit function as an applicable managerial control over fraud but then terminated the internal audit function shortly thereafter.

In summary, the board and its leadership have failed to deal with critical governance issues that have been identified for its benefit.

**10. The EKPC board has not taken substantial actions to police or to improve itself.**

Interviews with the board's members and its officers elicited the sense that all take the board's current state, for better or worse, as a "given." Even board leadership seems convinced that the board is powerless to change its membership or to police its own operations. They freely state that each cooperative selects a director, regardless of that director's capabilities, commitment or contribution. There was not even a suggestion that unofficial "jawboning" could be called upon to encourage member engagement, self-improvement, or other attributes required for providing effective oversight.

*The board should assure it has the attributes to accomplish its duties.*

The notion of a board that has neither the license nor desire to police itself is not logical; the board should take very seriously this responsibility. A board requires certain attributes to function properly, and the board should be proactive and assertive in assuring that those attributes are in place and are adequately maintained and developed. The EKPC board clearly does not see things this way, however, and in fact, has been, at the best, passive in response to suggestions for change.

**11. The EKPC board has defined no qualifications for directors and does not require any minimum skills or experience for that role.**

The qualifications of individual directors are of course a key question on any board. Reasonable people can and will differ on what those qualifications should be; however, few would deny the need to define some set of minimum qualifications, established as guidelines, if not enforced as requirements. There are no defined qualifications for directors and no statement of desired skill or experience attributes at EKPC. The single requirement is selection by the distribution cooperative.

Beyond the question of skills and experience, there remain two other minimum qualifications for directors and the board as a whole: engagement and commitment. The EKPC board also does not see for itself a role in ensuring that members exhibit these qualifications either.

**12. The board is not sufficiently engaged in the business of EKPC.**

This conclusion follows in major part from many of the observations already offered in this report. The board's lack of involvement in strategic matters, its delegation to management, its

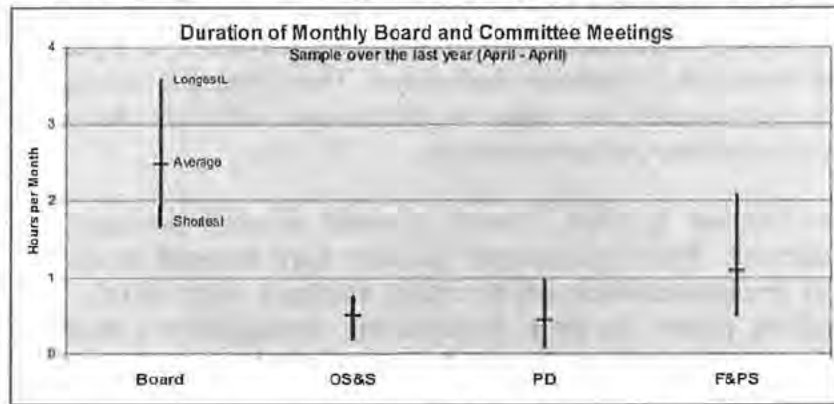


lack of awareness of performance status and issues and its lack of familiarity with key reports and conclusions indicates an insufficient level of interest and engagement. The NRECA review hit upon the same issue, including its observation that the “board (is) viewed by some employees as not fully engaged.” Similarly, Byrne suggested the same, although in more carefully guarded language: Committee schedules leave “very little time for in depth review.” The Byrne report was characterized by “carefully guarded language,” at times offering somewhat complimentary observations, only to be followed by critical details that demand a contrary conclusion.

A lack of engagement often is linked to a lack of commitment, which Liberty found to be the case at EKPC.

**13. The board does not exhibit a comforting level of commitment to meeting its governance responsibilities.**

Directors generally refer to the committee structure as a strength, and observe that matters are discussed at a more detailed level before recommendations are brought forth to the board as a whole. They also cite the added capabilities of the cooperative CEOs, who share equally in committee assignments with the directors. The stage they believe is therefore set for a meaningful committee role that should serve the board well in its decision-making.



On the surface, this scenario should be true; in reality, it is not. A more accurate characterization would be that the committees spend some small amount of time on administrative duties and that represents the full scope of their commitment. The chart illustrates the time spent in meetings. Given the administrative chores that any board must complete, and the special administrative chores mandated by EKPC’s lenders,<sup>7</sup> it becomes clear that the board and its committees are not spending meaningful amounts of time on substantive issues.

The directors, however, unanimously agree that EKPC is a complex business, and that understanding all of the matters that should be considered by the board presents real challenges. Directors can articulate the fact that the challenge is large, but it is equally clear that they have not been spent the time it takes to meet that challenge. This recognizes that all directors surely spend added time with “homework” and that scheduled meeting times do not reflect the full amount of their time commitment. Nevertheless, it is simply not possible to fulfill the board’s obligations in the meeting times noted.

<sup>7</sup> F&PS is especially burdened with such administrative chores.

## VI. Recommendations

### A. Efforts to Promote EKPC Change-Agenda “Ownership”

This audit has taken a course that differs from the normal one that such work typically takes. That course changed following the completion of the initial draft of this report in mid-November 2009. An expression of general agreement with the need for substantial changes in the issues addressed by Liberty led to the belief that it would be preferable for EKPC to prepare the first draft of recommendations for accomplishing those changes. Because the changes Liberty was prepared to recommend were so broad and fundamental, it seemed logical to conclude that the prospects for encouraging their rapid deployment would be improved substantially by a process that instilled a sense of EKPC “ownership” of the agenda for change. This modified audit process produced considerable effort on the part of EKPC to respond, and it has understandably, albeit unfortunately, extended the time for completion of this audit substantially.

### B. Liberty’s Initial Recommendations

Liberty did share summary descriptions of the types of changes it considered to be appropriate at the time of the November draft report. They formed a starting point for a number of key steps that subsequently took place in the dialogue between Liberty and EKPC in addressing audit conclusions and recommendations.

On October 7, 2009, Liberty provided separate presentations to management and board leadership. These “roundtable” sessions were designed to share Liberty’s preliminary findings and recommendations and to obtain feedback from EKPC. The following charts present the “talking points” for these presentations. Management’s reaction to the presentation about its needs was generally supportive of Liberty’s conclusions, and evidenced a commitment to move ahead with management recommendations immediately. The board’s officers reacted very differently to Liberty’s presentation of governance findings. They clearly stated that they did not agree, but that they recognized that moderate (meaning not costly) changes might be prudent, recognizing the authority of the Commission over EKPC.

## Management Improvement Areas

- ✓ Determine the EKPC risks and risk tolerance levels
- ✓ Obtain market determinations of the value and alternatives for major assets
- ✓ Determine the optimal mix of power supply resources under various conditions
- ✓ Diversify existing power supply portfolio by pursuing economically favorable transactions
- ✓ Evaluate the benefits of accelerating transmission upgrades and improving connections to better access markets
- ✓ Hire an independent power market expert to evaluate joining an ISO
- ✓ Utilize the ISO/markets to improve economic dispatch, diversity exchanges and wholesale sales
- ✓ Set and implement a strategic capital structure and financial targets with board concurrence
- ✓ Evaluate and implement economically favorable market alternatives such as sale/leasebacks to reach capital structure targets
- ✓ Improve performance to the capital budget and link to performance evaluations
- ✓ Strengthen board oversight and information on financial/rate plans and budget performance
- ✓ Pursue market alternatives to B/O/O for Smith 1, such as partnerships or vendor build options
- ✓ Reevaluate and update the NorthStar targets to be obtainable and meaningful
- ✓ Reevaluate the focus on KU rates and determine more meaningful targets
- ✓ Fill the internal auditor position

## Board Improvement Areas

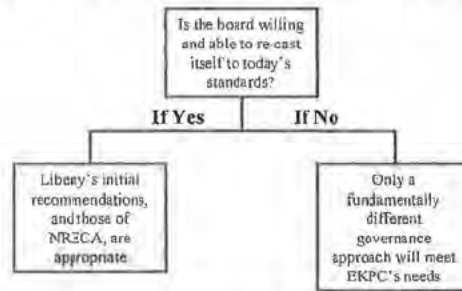
(Within the Existing Construct)

- ✓ Redefine the role of the board and expectations for its performance
- ✓ Fix the committees
  - Required mission versus vague options
  - Define clear objectives
  - Committee sets agenda
  - Increase level of commitment
- ✓ Upgrade the Audit Committee and implement an internal audit function
- ✓ Focus on strategic planning and the setting of policy
- ✓ Upgrade the quality of directors
  - Minimum requirements and expectations
  - Continuous education and training
- ✓ Upgrade the commitment of directors
- ✓ Increase external support for the board
- ✓ Implement an issues management program assuring recommendations are not ignored
- ✓ Challenge RUS administrative requirements that unnecessarily tie up the board
- ✓ Require options from management
- ✓ Elevate the priority of financial strength and the board's sensitivity to it
- ✓ Conduct meaningful self-evaluations of board performance
- ✓ Deal with the conflict issue
- ✓ Bring risk analysis and risk management into the decision-making process
- ✓ Implement a whistle-blower policy allowing access to the board
- ✓ Implement recommended fraud deterrent programs

On November 2, 2009, at EKPC's request, Liberty made a formal presentation to the full board on the report's initial conclusions and recommendations. Almost immediately thereafter, on November 4, 2009, the board chairman, acting upon direction of the board, advised Liberty and the Commission that, "*Liberty's initial recommendations are generally appropriate and should be immediately addressed.*" Liberty's talking points for that presentation are set forth below.

## Recommendations

- Liberty has developed specific preliminary recommendations
- We have shared with you a draft of them
- A major question needs answering to move them along:



1

## Recommendations

Under the "Yes" scenario (i.e., no inherent conflict)

- |   |   |
|---|---|
| <ul style="list-style-type: none"> <li>✓ Redefine the role of the board and expectations for its performance</li> <li>✓ Elevate the priority of financial strength and the board's sensitivity to it</li> <li>✓ Deal with the conflict issue</li> <li>✓ Focus on strategic planning and the setting of policy</li> <li>✓ Upgrade the performance of directors               <ul style="list-style-type: none"> <li>□ Minimum requirements and expectations</li> <li>□ Continuous education and training</li> </ul> </li> <li>✓ Upgrade the commitment of directors</li> <li>✓ Conduct meaningful self-evaluations of board performance</li> <li>✓ Upgrade the Audit Committee and implement an internal audit function</li> </ul> | <ul style="list-style-type: none"> <li>✓ Fix the committees               <ul style="list-style-type: none"> <li>□ Required mission versus vague options</li> <li>□ Define clear objectives</li> <li>□ Committee sets agenda</li> <li>□ Increase level of commitment</li> </ul> </li> <li>✓ Implement an issues management program assuring recommendations are not ignored</li> <li>✓ Increase external support for the board</li> <li>✓ Require options from management</li> <li>✓ Bring risk analysis and risk management into the decision-making process</li> <li>✓ Challenge RUS administrative requirements that unnecessarily tie up the board</li> <li>✓ Implement a whistle-blower policy allowing access to the board</li> <li>✓ Implement recommended fraud deterrent programs</li> </ul> |
|---|---|

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### C. Liberty's Initial Recommendations

The following recommendations reflect what Liberty was prepared to recommend last November, under the assumptions that: (a) management was in general accord with the conclusions summarized above and (b) the board accepted the need for fundamental change. As this report will describe later, the dialogue that has taken place with EKPC since that time no longer allows us to place substantial confidence in the ability of these recommendations to make needed changes at EKPC (in either management or the board) on a basis that is commensurate with the needs that the enterprise faces. Liberty presents them here to establish with more specificity the kinds of changes contemplated by the summary information shown above.

### *1. November-Vintage Recommendations – Management*

- 1. Develop and implement strategic plans that address the company’s critical existing and forward-looking issues: asset mix and ownership, the optimum power supply portfolio including market power supply resources, appropriate financial strength and capital market access, and rate trajectory and competitive issues.** *(Conclusions 1 and 2, Strategy)*

The NorthStar initiative was the highest priority “plan” that emerged from the 2007 MCR strategy process. Management (and the Board’s) strategic focus should be on more critical core directional issues, such as the ownership (or sale) of assets, EKPC’s financial health and performance, the lack of access to power markets and unbalanced power supply portfolio, and the rate impact of its huge capital program.

EKPC must address the question of “where it is going” with respect to these core strategic areas, which have not been sufficiently addressed individually and holistically so far. The focus of any future strategic planning processes must directly address and evaluate these key issues, and form clear and measurable action plans.

- 2. Make the attainment of strategic goals its top priority, with effective upper management follow-through, strategic plan updating and Board monitoring.** *(Conclusion 3, 4, and 5, Strategy)*

The MCR process succeeded in defining some of the most important issues facing EKPC and it spotlighted a number of weaknesses or gaps that exist in EKPC’s ability to address those issues effectively. However, EKPC has completed only a portion of the strategies and action plans that were established by the strategic planning process. Management has not put a sufficient priority on “making the plan happen.”

A focus on developing and executing action plans and making them top priorities remains critical. The strategic plans should also regularly be updated, action plans should be established to address revised strategies, accountability for executing plans be clear and enforced, progress should be tracked, and that there be a process for continually re-evaluating strategies and plans in light of continuing change in the power supply business. EKPC needs to begin to view strategic planning as a continuous exercise, and to create a culture and to adopt methods that will allow it to act in ways that permit adjustments to be made.

EKPC did not follow up or take significant action on the recommendations of either the Byrne report or the NCG report, effectively burying them. Management must be held more accountable for effectively making changes recommended by external entities that the Board and management agree are important to strengthening EKPC operations, performance and rate competitiveness.

- 3. Adopt Board capital structure and financial performance targets that ensure financial strength and access to capital markets.** *(Conclusions 1 and 3, Finance)*

EKPC’s too-aggressive approach to financial management has historically produced low levels of debt coverage, equity capital levels, and cushion to protect the company if unexpected financial challenges arise. Managing to such thin margins was designed to keep member rates at

minimum levels for the short run, but did so at the expense of building the financial strength and viability necessary to address unexpected financial incidents. This strength is required to optimizing rates over the long term, particularly as contingencies occur. However, EKPC steadfastly refused to set equity level targets that support adequate financial strength.

EKPC management should immediately evaluate and establish optimal equity level target and credit rating goals that plan for an end to the company's "boom and bust" cycles. Equity levels should be increased to 20 percent or more to establish the more adequate equity levels maintained by most other G&T companies that provide increased protection and attractiveness to capital markets.

Outage insurance is a tool that can form part of a sound financial portfolio by mitigating the risk of one of a power supplier's major contingencies. While such outage insurance is expensive, EKPC should have such coverage until its equity capital reaches much higher levels. Its reliance on what it believes others do is misplaced in failing to consider that what others do is a function of financial conditions that do not apply at EKPC. The technical defaults on RUS debt in 2006 demonstrate the lack of financial strength necessary to weather major contingencies, such as generation outages, with its thin capital structure.

**4. Define the levels and trajectory of future rates with its planned capital expenditures, power portfolio and appropriate financial targets, and report the results to the Commission. (Conclusions 2, 3, and 4 Finance)**

EKPC's rates have grown to levels that are a burden to its members and far out of line with neighboring utility Kentucky Utilities. High capital expenditures have contributed and may significantly contribute to this phenomenon. However, EKPC and its board do not have an adequate grasp of the reasons for its high rate levels, especially in comparison to neighboring utilities. The cooperative must determine the specific quantitative reasons for its current rate levels and provide explanations for key differences with neighboring utilities.

EKPC should also provide a projection of its future rate levels at the wholesale and distribution levels, including its planned capital program and operations. An analysis of the economic impact of the projected rate increases should also be conducted. The analyses should be immediately prepared for review by the Commission.

**5. Obtain independent analysis and recommendations for financing alternatives such as sale/leasebacks to more effectively fund capital expenditures and reach capital structure targets. (Conclusion 4, Finance)**

The RUS moratorium on providing financing for base load generation will require a different approach to financial management for EKPC. While EKPC has been exploring private capital markets, it has not adequately investigated or implemented alternative means of financing its asset base and requirements. EKPC has inappropriately dismissed alternatives such as sale-leasebacks or asset sales as not being viable, without performing the comprehensive and unbiased analysis that should underlie such decisions.

EKPC should have independent market experts provide analysis of various financing techniques and present them to both the company and the Commission.

**6. Greatly improve capital budget performance and Board understanding and monitoring of such spending and resulting rate levels. (Conclusion 5, Finance)**

EKPC has under-spent its approved capital budget by 34 to 50 percent in each of the last four years, indicating deficiencies in both capital planning and in management accountability for budget variances. Such huge variances also denote deficiencies in the Board's capital budget oversight, one of its most important responsibilities.

EKPC should immediately make capital budget performance the most important measure affecting the compensation of the CFO and all managers with budget responsibility. The entire capital budget process should be evaluated and restructured as soon as possible to improve this crucial performance area.

**7. Replace the NorthStar initiative with effective operating expense budgeting plans and oversight linked to manager's performance evaluations. (Conclusion 7, Finance)**

EKPC's performance to the NorthStar plan was inadequate through mid-2009, indicating performance problems with operating expense budgets that are similar to those of the capital budget. EKPC should make operating budget performance an important measure affecting the compensation of the CEO, CFO, and all managers with budget responsibility. The entire expense budget process should be evaluated and restructured as soon as possible to improve performance in this area.

**8. Hire an independent consultant to determine EKPC's optimal power supply portfolio, considering the possible sale of existing assets and more extensive use of purchased power. (Conclusion 1, Power Supply)**

EKPC has provided power supply for its members under an approach that far overfocuses on building, owning, and operating generation resources. EKPC has not adequately pursued longer-term power contracts. This strategy has become significantly more risky in recent years; it requires immediate re-evaluation.

EKPC should hire independent experts to assist in determining an optimal power supply portfolio that may contain a mix of owned generation assets with different fuel supplies as well as purchased power contracts and spot market purchases. The optimal portfolio would consider load requirements, owned generating assets, ownership options, markets and supply sources, renewable energy requirements, and transmission capabilities. In contrast with how EKPC has approached integrated resource planning, an optimum portfolio would consider options related to changing the company's existing asset base through beneficial sales or ownership options. Independence criteria should preclude reliance upon entities with which EKPC has had long and close relationship in enabling its current approach to funding supply assets and its market alternatives.

The independent consultant should provide its report and conclusions to both EKPC and the Commission.

**9. Obtain an independent evaluation of the market value of EKPC's major assets. Diversify the existing EKPC power supply portfolio by evaluating and pursuing economically favorable transactions. (Conclusions 2 and 3, Power Supply)**

EKPC has not adequately pursued partnerships, turn-key construction contracts, asset sales or other alternatives to the self-build and own option for Smith #1. Good business practice requires executives of all entities, especially capital-intensive power suppliers, to know the approximate value of each of their major facilities or asset classes. Management should also know if assets may be more advantageously utilized by specific outside parties, making them more valuable to others.

EKPC should engage independent advisors to determine the market value of its major assets (including the Smith 1 site) and the economics of the potential sale of such assets. The independent consultant should provide its report, analysis and recommendations to both the company and the Commission. EKPC should pursue transactions that provide net economic benefits and improve the company's capital structure or financial strength. Again, independence precludes the use of those with whom EKPC has worked in close business or advisory relationships in the past.

**10. Determine whether investments in the transmission system to improve access to power supply alternatives are economically justified. (Conclusion 5, Power Supply)**

The inability to effectively transfer power with its neighbors or regional markets causes higher fuel and power supply costs. However, EKPC has not yet analyzed the alternative of investing in and strengthening the transmission system specifically to allow for additional purchased power or exchanges as power supply resources. EKPC's efforts to strengthen its transmission system have focused on reliability, without appropriately considering power supply economy. EKPC should immediately evaluate the economic impacts of such targeted transmission investments and report the results to the Commission.

**11. Hire independent market experts to evaluate the costs and benefits of joining an ISO. (Conclusions 6 and 7, Power Supply)**

Greater market access would allow EKPC to pursue joint dispatch opportunities with surrounding utilities, expand reserve capacity, develop seasonal and load diversity exchanges and increase its surplus power sales and increase its margins.

The benefits of greater access to neighbors and markets may be enhanced if EKPC joins either the MISO or PJM ISO. EKPC should hire an independent consultant to determine the costs and benefits of ISO membership. The independent consultant should provide its report and recommendations to both the company and the Commission. Again, independence precludes the use of those with whom EKPC has worked in close business or advisory relationships in the past.

**12. Conduct an immediate and comprehensive assessment of senior executive management's ability to chart an appropriate future course for EKPC. (Management and Governance Conclusions generally)**



Management has for years been given input that should allow it to understand the needs for change that confront EKPC. That change involves not only approaches, values, and techniques. It has also included candid assessments of senior managers.

EKPC has declined many “invitations” to undertake changes like those identified in the preceding recommendations. Even now, its basic approach to key issues involving power supply and finance, for example, is to bring in new consultants. Moreover, they are consultants who have already been unsuccessful in getting EKPC to change its viewpoints and approaches, and in some cases its management. Either senior management responsible for these areas continues to be a barrier to change, or lacks the ability to overcome barriers imposed by the board. Whatever the reasons, management’s inability to offer more than another round of consultant study reinforces the conclusion that EKPC needs not only to examine the issues it faces, but also to examine those who have not brought change and still have either no empowerment to make change or, alternatively, a clear sense of where it is needed.

It is true that the CEO, who bears (or should) direct responsibility for power supply and financial matters has been at EKPC for less than a year. He certainly came to EKPC in the middle of 2009 expressing a commitment to change and declaring himself its leader. Recent actions and Liberty interactions with management and the board, however, do not give confidence that he continues to be a true champion of change. Whether this is because he does not have the board to do so is not clear.

Whether the inability to create more momentum for change is a function of management’s approach to the challenges or how board leadership has allowed management to approach them is fast losing consequence. Whatever the source of the barriers, EKPC cannot long continue on its current course. Therefore, the required assessment of management should exclude no senior executive responsible for power supply and financial matters.

## *2. November-Vintage Recommendations - Governance*

### **1. Develop and subscribe to a set of governance standards consistent with modern practice and the needs of the power supply cooperative. (Conclusion 1)**

EKPC has many options here, including starting with the minimal standards suggested by Liberty; retention of a consultant to develop a more definitive set of standards; or perhaps working with others in the cooperative community, including NRECA, to develop a more generally applicable set of standards. The key is that any standards should be consistent with the new demands for oversight and transparency that have emerged in recent years.

### **2. Complete a formal analysis, incorporating Liberty and NRECA governance observations, of the degree of compliance with the new standards developed above in Recommendation #1 and including a program for achieving compliance. (Conclusion 2)**

The recommended analysis is intended to define gaps that EKPC needs to fill, including those already identified by Liberty and NRECA. Presumably, many of the recommendations that follow in this report will also be appropriate for this analysis.

### **3. Redefine the role of the board and expectations for its performance. (Conclusion 2)**

Many of the conclusions in this report relate to the fundamental role of the board and expectations for the performance of individual directors and the board as a whole. A key element of reforming governance at EKPC must therefore be a reexamination of the board's role in the business of EKPC.

**4. Elevate the priority of strategic planning as a board function and become heavily involved in providing strategic direction to management. (Conclusion 3)**

The MCR effort brought a sound beginning to the kind of strategic thinking that the board should embrace on a continuing basis. But it is clear that the initial work was not sustained at the board level, and most board members remain unaware of its conclusions and subsequent results. The board needs to do far more in both formulation of strategies as well as implementation and continuous testing and monitoring of strategies.

Reports against a strategic baseline should be provided regularly, and to some extent they already are. But they are clearly ineffective at the board level. Formulation of plans needs to be a periodic board task and status of implementation needs to be a monthly topic. Further, these tasks need to be discussed at length, and not just dismissed with the issuance of a management report.

**5. Elevate the priority of EKPC's financial health and the board's sensitivity to it. (Conclusion 4)**

The financial health of EKPC is not given sufficient attention by the board. Targets for TIER and equity should be established and managed, with the board exhibiting a long-term commitment and understanding of what constitutes adequate financial health. Again, the first part (targets) are to a large extent already in place. But the thinking behind those targets at the board level and an understanding of the adequacy of long-term targets is lacking.

**6. Reconcile the conflict of interest immediately in favor of EKPC. (Conclusions 5 and 6)**

Liberty has concluded that a de facto conflict does indeed exist and it is real, continuing and dangerous. The conflict forces a philosophy of low rates at the expense of all else and hence influences all of the board's actions in key areas, including financial health, rate strategies, and strategic planning. It manifests itself most directly in the balancing of financial health, as expressed in targets for TIER and equity, against the goal of lower rates.

Since this recommendation calls for a change in underlying philosophy, there is a tendency to see the required fixes as intangible, but that is not true. A fundamental change in thinking is necessary, but that must be accomplished along with numerous tangible actions.

The board must articulate a new, EKPC-centric way of thinking and acknowledge that, while the consumer's voice must be heard, a role of consumer advocate is not acceptable for directors. Further the board needs to commit to enforcing this notion on a continuing basis, with specific measures for the removal of directors who sacrifice EKPC's interests for others, including the interests of the distribution cooperatives.

Liberty acknowledges that this long-held philosophy may be too hard to break, and that directors may continue to feel compelled to function as “consumer advocates.” In that case, the conflict is “inherent,” and an alternate governance scheme is necessary.

**7. Greatly expand knowledge and understanding of the “KU gap” and reevaluate its use of that parameter as a strategic imperative and “the NorthStar metric.” (Conclusion 5)**

Despite the prominent role of the “KU gap” in its strategies, EKPC does not have a firm grasp on the underlying reasons for the gap. Perhaps such knowledge is not necessary to gauge the consequences of the gap, but they surely are required to understand how to narrow the gap going forward.

Further, the ability to fully understand the gap will allow directors and management to put it in a proper perspective; *i.e.*, what gap makes sense given the realities behind KU’s and EKPC’s businesses.

**8. Require a structured program of risk management, including identification and management of continuing business risks and expansion of economic evaluation practices to incorporate risk. (Conclusions 8 and 9)**

**9. Greatly expand audit committee activities to be more compatible with modern audit committee duties and commitments. (Conclusions 10, 11 and 12)**

Expanded efforts should include (a) more frequent meetings; (b) expanded risk capabilities; (c) implementation of its risk duties as defined in its charter and as may be modified by Recommendation #8 above; (d) implementation of an internal audit program; (e) greater focus on internal controls; (f) review of lessons learned from other cooperatives; (g) development and implementation of a whistle-blower policy; and (h) implementation of the fraud deterrent programs suggested by Crowe Chizek.

**10. Increase oversight of management, its expectations for management performance and its requirements for management reporting and analysis. (Conclusion 13)**

It is the role of the board to provide guidance, direction and oversight and not, as suggested by some, merely to ratify the CEO’s desires. A good start here would be for the board to require options from management, rather than a singular “take it or leave it” solution. This should of course be accompanied by positive discussion of the options such that the board has a thorough knowledge of the possible outcomes and can make a decision with a strong foundation.

A second improvement would be a requirement that management provide analysis in addition to “numbers.” Charts and graphs showing traditional measures may be interesting, but they give the board no insight. The addition of management analysis, highlighting areas of concern and, especially, discussing corrective measures for non-performing areas, will help the board meet its oversight responsibilities.

The role of the board in the management of board and committee meetings should also be expanded. Directors should insist on substantive input to agendas, including the topics and the amount of discussion expected. The present near-total reliance on management is not appropriate.

As a final note, we previously discussed the tone of Policy No. 104 as seeming to be designed to keep the board in its place. This policy should be reviewed and revised as appropriate to define a tone more consistent with an active, involved board.

**11. Implement an issues management program. (Conclusion 14)**

The board's prior failures to deal with important issues brought to its attention suggest the need for a more formal and structured vehicle for tracking and managing issues. As a minimum, an "open issues" list should be maintained and reviewed monthly. This should define all issues brought to the board for action, the plan for closeout and the current status. Items should not be removed from the list without the board's formal approval.

**12. Periodically conduct a meaningful self-assessment of board performance and needs. (Conclusion 15)**

Although this is an existing requirement at EKPC, and an assessment was conducted in 2007, Liberty found the process to be ineffective. The assessment conducted was actually an opinion survey and no follow-up actions took place. An effective self-assessment will provide individual critiques of the board's performance and in particular where it needs improvement. An appropriate action plan, to be implemented by the board, is the final measure of success.

**13. Adopt board responsibility to police itself. (Conclusion 15)**

Liberty found that the board tends to take some of its weaknesses as givens and assumes it is powerless to deal with them. This is an unacceptable way of thinking in that the board has the final say at EKPC. If the board does not assure proper functioning, then the only resort is action by the customer-owners, and that is simply not practical. The board can and must be responsible for assuring its own performance.

**14. Define qualifications required of its directors and assure that those qualifications are met initially and then sustained. (Conclusion 16)**

Reasonable people can debate the nature of such qualifications, but it is not reasonable to have no qualifications defined at all. EKPC is a complex business, and its governance is a real challenge. Minimum standards should be set for the directors' qualifications including types of skills, experiences, level of commitment, ability to engage management and other directors, loyalty to EKPC, willingness to spend the required time and effort and other qualifications as deemed appropriate by the owners.

**15. Create and use the ability to acquire external skills where the board lacks those necessary to provide experience and capability commensurate with the size, scope, and complexity of EKPC's business operations. (Conclusion 16)**

Regardless of the qualifications eventually required of the directors, the need for added skills from time to time is likely. The board needs the flexibility to acquire such skills when and as needed to meet its governance obligations.

**16. Redefine the board's expectations for committees, their roles and their commitment. (Conclusion #17)**

Liberty has concluded that the committees fail on several levels to engage in the business of EKPC. The committees should be the front line contact with management, eliminating the need for an unacceptable level of detailed discussion at a 32 member board meeting. But the committees fail in this regard. The short duration of their meetings, their requirements for administrative resolutions and their failure to meet the responsibilities of their charters all serve to make their role ineffective.

It is presumed that the overall structure of committees will be modified as part of the changes in the board's role. It will be important to also transform the committees' roles. The current issue is not structure or scope, it is a failure to assume a meaningful role, and that is the primary problem to be solved regarding the committees.

As a further part of committee reform, the administrative chores required of the committees, including those supposedly imposed by RUS, should be reexamined.

**17. Substantially increase the time commitment expected of directors.** *(Conclusion 18)*

Liberty found that the length of time spent in board and committee meetings is far less than required of a business of this complexity. Directors must be able and willing to spend far more time on their responsibilities.

**D. Changes in Liberty's Understanding of the Need for Change at EKPC**

On January 21, 2010, EKPC leaders orally presented the approach to and principal components of their proposed action plan. In comments intended to assist EKPC in completing the formal documentation of its plan, Liberty advised that EKPC's plan was comprised principally of further study and did not reflect commitments to actions that should not be deferred pending such study. Liberty expressed the need for EKPC's formal documentation to:

- Provide a statement of specific management actions that would be taken without waiting the six to nine months required to complete "assessments"
- Consider carefully the fact that the consultants selected to assist EKPC had all been there before, and that one was being asked by EKPC in effect to examine objectively the alternatives for providing services that this consultant was currently providing
- Address the fact that EKPC's actions needed to have clear, designated executive responsibility, and to reflect board consensus
- Make clear that internal personnel had clear responsibility for leading improvement efforts, and that consultants could support, but should not lead the process.

EKPC expressed some level of agreement with Liberty's report, but carefully avoided directly addressing any of Liberty's findings. It eventually became apparent that, months after the board's November 4, 2009 direction, EKPC remained divided and undecided. An EKPC representative noted that "the board does not have a consensus on the Liberty findings."

On January 28, 2010, EKPC formally submitted its written, proposed action plan, without clear indications of response to Liberty's identification of needs. Liberty found the plans to be non-responsive to the identified conclusions and issues. It did not make firm commitments (beyond an analysis to determine if any changes were needed) to address the substantive issues. It

demonstrated a very different sense from Liberty's about the severity of EKPC's current situation and fundamental concerns about its future prospects.

On February 8, 2010, EKPC formally submitted its comments to the Liberty report, in response to Liberty's request at the January 21 meeting to provide a clear and comprehensive statement of where EKPC agreed and disagreed with Liberty's statement of underlying needs. Liberty emphasized that such a clear statement was critical in order to allow a determination of whether the open-ended plans presented were at least being pursued with a common understanding of the gaps that needed to be closed.

The response ultimately provided by EKPC has not demonstrated the existence of the clear commitment to necessary change. Rather, it creates a very significant risk of continuing a "business as usual" approach. In essence, EKPC has proposed to undertake again what it has tried many times already; *i.e.*, to have outside consultants look at what weaknesses may exist and to recommend actions to address any that may be found. As our November-vintage recommendations indicate, study is not irrelevant. But the time has passed for study alone (and particularly study by outsiders) to be considered adequate. Prompt action is now the point. Moreover, a commitment by management and the board to an uncompromising, expedited, and self-directed program of action is essential. Instead, EKPC has proposed problem or needs assessments that themselves will take from six to nine months. Additionally, EKPC has done so under circumstances that do not reflect acceptance of the breadth, types, and depth of changes that Liberty considers to be necessary. Under EKPC's approach, one cannot know:

- What problems and needs EKPC will recognize after that time
- What actions it will propose to take
- How long it will take to accomplish them.

This uncertainty makes the EKPC approach unsatisfactory. It is rendered more problematic when one notes that the consultants named to take the lead on the management issues have worked on the same issues for EKPC in the past. It is more than optimistic to hope that a repeat of prior, consultant-led exercises will prove more beneficial than they have on repeated occasions in the past.

The January and February meetings and document exchanges demonstrated that there was actually not a significant level of agreement between EKPC and Liberty, despite the November 4, 2009 letter from the board and verbal assurances from management. Liberty has therefore determined that continuing to seek an EKPC-led creation of an agenda for change would not produce a workable plan and that Liberty's November-vintage recommendations were not likely to be effective either. EKPC's responses made clear that there remains considerable disagreement on the fundamental issues, both on the part of management and the board. Moreover, EKPC's proposed action plan, which consists of a management plan and a governance plan, did not respond substantially to Liberty's conclusions about change needs. It exhibits three gaps that Liberty finds substantial.

First, the management action plan comprises two programs: a process analysis and a risk assessment, each to be spread over nine months. One cannot argue with the value of either, but neither addresses directly the specific issues raised by Liberty. Neither offers reasonable

prospects for timely and responsive change, considering the issues that EKPC faces. In the meantime, the many immediate solutions, identified by Liberty and EKPC's own consultants over the years, remain unaddressed by management. The conclusion that Liberty reached is that management is either unwilling or unable to take the actions necessary to remedy the needs that Liberty has identified.

Second, the governance response represents a "best practices" approach that, again, has merit for any organization seeking to optimize performance. However, it simply is not responsive to the major needs facing EKPC. Some of the recommendations have already been tried at EKPC and have failed; the action plan does not address that barrier. There is no acknowledgement, or even discussion, of prior failures and what will be different this time. The plan does discuss most (if not all in some form) of the categories of governance performance that Liberty's draft report addressed. However, it does so without describing what EKPC does, has done, or falls short in doing in a manner that responds to Liberty's conclusions. Instead it discusses those categories in largely terms of what others do.

Most importantly, Liberty's key question in the preliminary recommendations was "is the board willing and able to re-cast itself to today's standards?" The failure to identify what specifically will be changing at the board compels an answer of "no." Proceeding from any other premise cannot be expected to produce more than marginal change. EKPC's board needs fundamental change in its composition, membership requirements, and functioning.

Third, the responses reflect no sense of urgency by management or the board or recognition of the severity of EKPC's situation and the need for a thorough assessment of its direction. Instead, the response appears more designed to "buy time" and offers no reason to believe that EKPC anticipates a change from "business as usual" over time.

In summary, the February 8, 2010 response makes it clear that EKPC's position in response to Liberty's identification of needs forecloses an effective, EKPC-designed solution. Liberty concludes that the level of disagreement within EKPC management and the board precludes timely and effective response to the Liberty findings. Given the existing board and management team and the lack of acknowledgement of the need for major change and improvement, one should conclude that there is not a significant chance that improvement will come in a way that is either substantial or timely.

## **E. Specific Comments On EKPC's January and February Submissions**

### ***1. EKPC's Action Plan on Management Recommendations***

Page 9 of the EKPC response discusses its "general reaction." This portion of the January 28, 2010 EKPC document contains a number of positive statements. They include an invitation for Commission Staff to sit in on occasional board meetings and classes. But there is no indication in the text that EKPC understands the severity of its current situation and the urgency required to deal with circumstances that already place it at a competitive rate disadvantage that has the clear potential for growing worse.

Any “general reaction” short of an awakening, a call to action, an acknowledgement of the severity of EKPC’s problems and an aggressive commitment to doing what it takes to make corrections does not match the gravity of the situation. EKPC has stated in meetings that the report did serve as a “wake up call,” but that general statement finds no support or confirmation, and (more importantly) amplification in the January 28, 2010 response. That response gives no indication of any sense of immediacy. To the contrary, EKPC has proposed a program that will require many months or years to achieve even intermediate goals. Liberty was struck by the incongruity between the verbal reactions that dialogue with EKPC had engendered and the greatly more muted tone of the written document.

EKPC’s response to the management issues proposes too little (“assessments” of processes and risks) and too late (nine months to complete assessments, with no specification of the schedule for completing changes). This portion of the response confirms that EKPC fails to gauge the importance of the issues it faces. For example, the following needs fall among those that can and should be addressed without any delay.

First, the necessity for changes in certain key personnel was identified years ago (not initially by Liberty). The appropriateness of such moves continues to be apparent.

Second, EKPC’s ability and willingness to optimize power supply costs through its interactions with the regional markets was questioned by both Liberty and prior consultants. EKPC’s response is to retain a firm to perform an “independent” assessment. This firm is the very same firm that has helped craft the EKPC market strategy in the first place, and, perhaps most significantly, it stands to lose (as a vendor and an advisor) if certain changes from the status quo take place. EKPC was one of the initial founders of this cooperative marketing entity. Surprisingly, EKPC finds its long standing relationship with and support for this entity to enhance rather than diminish objectivity. EKPC also proposes to take an excessively long time (nine months) to reach a conclusion.

Third, Liberty has emphasized that the continued commitment to a build/own/operate approach, and the lack of robust consideration of ownership structuring and market-based alternatives to its next proposed new generation fails to recognize both the opportunities and risks of today’s power supply and generation environment. In addition, EKPC’s extremely high level of anticipated expenditures and the large rate disparity it already imposes on distribution cooperative member/customers raise real questions about the costs to ultimate users and about the ability to fund and carry through on its long-standing approach to meeting the needs of the ultimate users that it serves.

Nevertheless, EKPC proposes to continue pursuing Smith 1. During the nine months during which it will undertake “risk assessment,” EKPC proposes to obtain approval of nearly a billion dollars in permanent financing for a project that may be the biggest risk it will face in many years. EKPC’s failure to address this issue, other than as a part of a nine month risk assessment, is a major failing of the EKPC response. Moreover, EKPC has indicated that it is working with the CFC to address this issue. The EKPC board chairman is a director of the CFC and its audit committee’s financial expert. The CFC is a cooperative-owned financing entity that has total gross loans and guarantees outstanding of \$21.5 billion and its owners have invested more than



\$4.3 billion in CFC securities. It too has close and long-standing relationships with EKPC. Relying solely on its support in this activity thus creates very substantial barriers in EKPC's candid examination or pursuit of alternative approaches.

Fourth, Liberty concluded that some critical areas were not being managed properly, with the capital budget and the NorthStar program goals given as two examples. It is not clear why management cannot address such problems immediately. The CEO has tasked the EKPC chief financial officer with addressing these issues since at least 2007.

The fundamental approach by EKPC to dealing with the audit's management findings is two-fold: (a) a process analysis and improvement initiative, and (b) a risk assessment and risk response strategy. Both approaches comprise good business practices, but EKPC has not linked them to the specific findings of the audit, and their ability to deal with the specific threats facing EKPC. Liberty found an absence of definition and specificity in EKPC's cursory descriptions of plans to address the audits' management findings and conclusions. This absence suggests a belief by management that examining the need for a more effective approach to general business management will serve as a "universal solution" to the sizeable list of gaps that Liberty believes to exist at EKPC. Liberty would not agree with such a view. We do not consider the proposed process analysis and risk assessment to be the solution to all of the management and business needs identified. EKPC's failure to propose a more focused confronting of the key issues it faces and the very general and summary-level treatment of the issue is troubling.

EKPC was presented in mid-2009 with a new opportunity in the form of a new CEO. A new CEO can offer a fresh new outlook and an aggressive and visionary plan for the future. A leader new on the scene often brings the advantage of an enhanced ability to see the problems and a license to fix them. In this context, the CEO's selection of consultants for the management issues is questionable. Liberty intends no criticism about the technical capabilities of the consultants. The concern that does exist (apart from difficulties they will face in assuring objectivity) is that they have already addressed similar issues for EKPC under prior top leadership.

Liberty therefore believes that EKPC's response to the management issues identified:

- Does not present a sufficient plan to deal with the issues identified by Liberty and those issues on which EKPC's future success rests
- Establishes that EKPC management and the board do not understand or accept the gravity of the current situation and the need for immediate and effective response
- Relies inappropriately on two general, long-term programs (process analysis and risk assessment) as effective means for dealing with the challenges that confront EKPC
- Presumes that critical regulatory approvals (such as Smith financing and a likely rate filing) should be permitted to take place before EKPC deals directly with the serious and immediate issues it faces.

## ***2. EKPC Action Plan on Governance Recommendations***

EKPC, through its governance consultant NCG, has advanced a learned approach to governance optimization. The presentation in the EKPC response lays out strong governance principles and best practices, as well as good ideas for how to move towards those objectives. In many ways, it

represents a well prepared academic justification for adopting its principles and strategies. It however begs the question of “justification to whom?”

The EKPC board appears to be the audience for NCG’s efforts at justification. The troubling aspect of that observation is why the EKPC board requires persuasion that the principles offered are appropriate for its adoption. There exist serious concerns not only about the board’s willingness, but also its capability to do the things recommended first by Liberty, and then, as structured by NCG.

An overarching concern with the recommendations is the document’s implicit premise that improving performance on top of a sound foundation is the goal. The need is more profound than that; establishing a sound baseline of capability and performance are first necessary. Starting from the premise that the baseline already exists will make it exceedingly difficult, if not impossible, to accomplish real EKPC governance change within a reasonable time frame.

Moving to the document’s specific contents, the Governance section of EKPC’s proposed action plan begins with the voice of “EKPC Leadership,” defined as the executive management team and the 32 directors and alternates. But to assume that this is one voice does not comport with the observations Liberty formed after meetings with essentially all of them. As recently as January 21, 2010 (which follows at least the draft of the document by NCG), it was reported that the board did not have a consensus on the Liberty findings. A major concern developed through our audit work has been the degree to which “the board” means a very small circle of board leaders or the 32 directors and alternates as a whole. That important information has been withheld from the board as a whole in the past forms part of the concern about assuming that there is a substantially greater consensus around the NCG principles than there is around Liberty’s identification of key governance gaps.

The Governance section includes numerous observations and recommendations that have been made or tried before at EKPC, but have failed. The document does not address this important perspective, and thus omits a key feature required to instill confidence in its ability to succeed this time; *i.e.*, what makes this occasion different from prior ones.

It is observed that NCG “has been impressed with the level of engagement of the EKPC board.” This statement stands in stark contrast to Liberty’s conclusion, supported by others, that “the board is not sufficiently engaged.” It is not realistic to believe that such a fundamental change has taken place so quickly, particularly when board leadership cannot respond to the board’s views on Liberty’s key conclusions, because the board has not reached a consensus on them. In short, proceeding from the premises of board commitment and engagement appears to embed an optimism that is not consistent with a long pattern of performance and therefore does not appear designed to overcome serious obstacles that have existed for a long time.

A similar “disconnect” with experience arises in the case of strategic planning. The response indicates that board strategic planning retreats will be held. Such an approach has already been tried, without producing lasting impact, board understanding of its specific elements and initiatives, and structured tracking of performance. In fact, the prior retreat was held at the recommendation of NCG. With only two years passed since the prior retreat, few directors or

alternates remember any of the outcomes of the retreat, nor do they know what, if any, strategic plans had resulted or what the status of those plans is at this time. EKPC now proposes to repeat the process with the same board members, the same management team (other than the CEO) and the same consultant. There is no acknowledgement of the failure of the same effort in the past and there is no discussion of what can and will be done to assure different results this time.

The EKPC response indicates that a Governance Committee will be formed, and that the committee will be charged with overseeing the implementation of the proposed action plan. In the abstract, such a committee makes sense, but a bare recommendation to create one ignores a fundamental barrier to its success at EKPC. Liberty concluded, as have others, that the committee approach at EKPC has not been effective. There are numerous examples of committee failures to follow charters, to exercise duties, and to spend the time needed to conduct their business. Within this context, placing oversight responsibility for this program with a board committee, without fixing the underlying problems that have made committees ineffective at EKPC, cannot be considered sufficient.

The EKPC response discusses a “perceived lack of transparency and trust between the board and past management” and further claims that this may have “led to many of the issues identified in the Liberty report.” Liberty disagrees that such transparency lies at the heart of the issues found during the audit, and considers a focus on transparency to be unconnected with producing material change in either management or governance at EKPC. Liberty did observe one glaring example of important information that was deliberately withheld from the board by management; and that is the NCG report. Liberty reported that such behavior on the part of management did not appear to be customary at EKPC. At this point it is probably more important to consider the degree to which some board members, but not all, had access to the report. This is a board issue, not a management transparency issue.

EKPC’s response confronts a primary issue, conflict of interest, directly. It provides both sides of the story and appropriately makes clear the writer’s opinion of the right answer. A training session, presumably centered on that “right answer,” is proposed as the corrective action. The seriousness of this issue, however, calls for significantly more. First, an expression of NCG’s opinion is not ultimately the point. The real concern is what the board’s decision is on the answer. Board consensus on that answer should already exist; if it does, the document does not address it. The response discusses the “intuitive view of many G&T directors” (not necessarily EKPC directors) that their primary obligation is to their distribution cooperative and, although not stated, it is clear that many EKPC directors are in that camp. Based on our interviews, and the “party line” established at that time, there is a deeper belief that the conflict issue does not even exist and what’s best for the cooperatives is best for EKPC, and vice versa.

This issue was identified by the Commission and included in the audit RFP as a specific area of audit inquiry. It appears that EKPC’s board has not yet dealt with this issue, that internal debates remain to be held sometime in the future, and that a “training” vehicle will serve as their forum. Accordingly, a major concern about governance will remain in place indefinitely and its only avenue for success appears to be optimism that discussion and training among directors who have not “come around” so far will be sufficient. In this light, it is difficult to see how the EKPC response can be considered adequate.

The EKPC response on the Board and CEO relationship is important. With the current condition of EKPC, leadership that is aggressive and visionary is essential. It is clear that, over the last few months, the dynamics at EKPC have constrained the new CEO from reaching his previously stated goals. Specifically, the uncertainties added by this audit, the struggles of board leadership to establish an effective role, the mixed reactions of directors, and a defensiveness on the part of managers to change direction all have served to restrict the CEO. The person holding this position needs to be given the opportunity, freedom, organizational support and board mandate to establish a vision with board concurrence and drive that change. He then needs to demonstrate the vision and leadership to carry out that mandate. Neither of these has happened. The sense of energy and optimism that characterized his approach last summer is not evident now, presumably because of the constraints noted above.

Liberty therefore concludes that EKPC's response to Liberty's governance findings:

- Provides academically and technically strong content, but does not respond to the particular challenges at EKPC, which go well beyond the need to make marginal improvements.
- Provides no evidence of any real change in thinking on the part of board members, particularly given the board's lack of consensus on the real issues.

On November 2, 2009, Liberty posed the question to the assembled directors and alternates: *Is the board willing and able to re-cast itself to today's standards?* Over four months later, EKPC has not demonstrated a positive, convincing response to the question. Liberty concludes that, at this time, the board is neither willing nor able to make the necessary changes.

#### **F. Revisiting the Audit's Conclusions**

The changed audit process, seeking an action plan initiated by EKPC, did not produce the hoped-for benefits. It did, however, serve to underscore the significance and the immediacy of the changes that will be required to place EKPC on a path that will produce sufficient optimism about its ability to meet the future challenges of those who rely most on its success; *i.e.*, the half million Kentucky homes, farms, businesses and industries served by EKPC's owners. It also has made clear the intractability of barriers to change at EKPC. New management leadership has not succeeded in its first eight months in bringing an attitude that embraces change across the organization. There is no perceptible entity-wide commitment to change that is more than cosmetic. The looming question of authorizing a nearly \$1 billion commitment to the Smith project adds to the need for EKPC not to delay fundamental change. Deferring actions that EKPC needs to take until after that commitment is made creates the very real and disturbing potential for greatly diminishing the effectiveness of subsequent change, even if it proves real.

Starting from the audit work leading up to the November 16, 2009 draft report and ending with the subsequent dialogue between Liberty and EKPC, Liberty has arrived at the following foundation for crafting its recommendations for addressing the conclusions of this audit:

- Serious gaps and weaknesses exist at EKPC, and have gone unaddressed for a number of years
- EKPC has been afflicted with a conflict of interest that its board has not been successful in overcoming and is not on a path to overcome in a timely manner

- Neither the board nor management has been willing to accept repeated assessments of the forces and factors underlying serious issues that it has faced for some time and continues to face
- The result is that EKPC has not shown the willingness or the understanding it takes to deal with them effectively
- Liberty does not have confidence that its findings and conclusions have changed EKPC's thinking substantially, other than to have produced a willingness to look at changes that will not have effect (if ever) until after current and expected regulatory proceedings critical to EKPC have run their course
- Liberty's assessment of the current board and management team leads us to conclude that substantive change in any meaningful form is unlikely
- In the meantime, the substantial premium that customers pay to take service from EKPC remains and is at risk of growing further
- The pendency of a \$921 million authorization for Smith 1-related borrowing and the likelihood of looming rate increase requests create an undue risk that opportunities for change delayed will be opportunities irretrievably lost.

Liberty thus ultimately found that the EKPC board has not been able as a group to deal effectively with conflicts of interest in how EKPC is governed and managed. Liberty has also concluded that present governance and management do not make it likely that EKPC will succeed in doing so in a timely and satisfactory manner. We commend the NCG commitment to helping EKPC implement new governance standards and behaviors. However, the contemplated effort, in taking years to complete, just does not promise a response that is commensurate with the needs that exist and the urgency in addressing them.

The concern about leadership here is not a matter of theoretical governance standards or abstract notions about public versus private organizational "models." EKPC acknowledges that its rates act as a major force in the economic health of eighty-seven Kentucky counties. EKPC's need to find a way to govern and manage itself much better ultimately involves fundamental questions of economic development, job retention and the region's competitiveness with others. EKPC has higher electric rates and lower equity than other regulated electric utilities in Kentucky. It proposes to accumulate perhaps \$4 billion dollars or more in debt within just a few years. That debt threatens further decreases in EKPC's equity or (and perhaps and) multiple, significant rate increases.

It is difficult to be more specific than this about how and how well EKPC will prove able to manage sizeable debt increases in a way that makes the costs of the critical services it provides rates a sail and not an anchor for the communities affected. This difficulty arises from more than the direct concerns this report raises about governance and management. It is magnified by EKPC's: (a) lack of analyses or forecasts of its revenue requirements path, and (b) absence of a studied perspective on what continued escalation of its costs will mean for the economies it wants to and believes it can continue to help drive in the coming years. The absence of such information and analysis significantly compounds our concerns about relying on a change program that focuses principally on problem study, and sets a schedule that reflects no sense of urgency.

At the present time, all Americans face a future that presents fewer “certainties,” other than the understanding that difficult choices lie ahead. Kentuckians in the communities EKPC serves are no different, but should understand that meeting energy needs economically is especially critical, given the states’ resources, opportunities, and risks. Meeting energy needs economically has been an important element in making the state strong. It is likely to be all the more so in the future. Liberty has worked hard to convince EKPC board and management of the need for change. We do not believe that we have succeeded.

In any event, it falls to the 16 distribution cooperatives that own EKPC and in turn the half million member/customers who speak through those 16 to take ultimate responsibility for what role EKPC should continue to play, how it should play it, who should govern it and how it needs to be managed. As managers and directors of public enterprises often describe, when the customer is your owner, it isn’t hard to figure out who ultimately wins and loses.

### **G. Addressing Change at a More Fundamental Level**

The stakeholders of EKPC, including the distribution cooperatives, their member/customers and the Commission, find themselves today at a critical crossroads. The board and management have selected a path that essentially will “stay the course,” including major new commitments for generation. It is difficult to envision how that course can be demonstrated to benefit customers in the long-term. In fact, it may well generate an increasing penalty in the form of further diminished rate competitiveness. EKPC has not focused on this issue analytically.

Liberty believes that the time has come for a candid and prompt reappraisal of EKPC’s mission and future (beginning with a fresh look at its reasons for existence, the value it adds when compared to alternatives, and, as appropriate, its nature and roles). That reappraisal needs to be mediated by sources outside current management and the board, which not only have confined their mission to an examination of the need for change, but appear to be doing so in a way that will not challenge all that merits testing at the enterprise.

The distribution cooperatives, in their role as stewards for their customer-owners, should take the initiative now to change direction. The new path should start with a fundamental testing of the mission of EKPC, the outlook for the member/customers it serves, and other alternatives for meeting the needs of ultimate users. What that process will produce Liberty does not presuppose, but we do believe that, to be successful, it must be broad and open-minded enough to challenge the most basic premises and to consider the strongest alternatives, such as whether alternate strategies, up to and including disposition of some or all of EKPC’s assets, would benefit member/customers in the long-term. Liberty also believes that such a review must be self directed and from the member level to be effective. Inviting Commission oversight of the effort, however, would represent a very valuable step in demonstrating the sincerity of the effort and the commitment to change needed to promote the regulatory confidence that EKPC will need if it is to continue in a major power supply role in Kentucky. Should the distribution cooperatives fail to seize the initiative, it is reasonable to expect the Commission to do so.

To the extent that continued operation in some form is appropriate, the next step would be to create (from a bottoms-up approach and giving no preference to incumbency) a revised governance structure and a new board. Then, a restructured and reconstituted board needs to put

into place a senior management team (again from a bottoms-up approach and giving no preference to incumbency) that it objectively finds capable of meeting the challenges that EKPC will face, according to the newly developed view of its future according to management and governance consistent with the needs of such an enterprise.