COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE ELECTRONIC APPLICATION OF SOUTH KENTUCKY RURAL ELECTRIC COOPERATIVE CORPORATION FOR A GENERAL ADJUSTMENT OF RATES, APPROVAL OF A DEPRECIATION STUDY, AND OTHER GENERAL RELIEF	)))))	**CASE NO. 2021-00407**

SOUTH KENTUCKY RURAL ELECTRIC COOPERATIVE CORPORATION'S BRIEF

Comes now South Kentucky Rural Electric Cooperative Corporation ("South Kentucky" or "Cooperative"), by counsel, pursuant to the May 11, 2022 Order of the Kentucky Public Service Commission ("Commission") setting forth a post-hearing procedural schedule in the above-styled docket, and does hereby tender its Brief in support of the Application for general adjustment of rates ("Application") filed December 14, 2021, and addressing other matters raised during the hearing held before the Commission on May 10, 2022, respectfully stating as follows:

I. INTRODUCTION

This case presents South Kentucky's first full rate case request in over ten years. It is necessitated by substantial increases in general operating expenses coupled with a decline in energy sales. Thanks in part to effective cost-control measures, diligent management and board oversight, and favorable federal policies including the Rural Utilities Service's ("RUS") Cushion of Credit ("CoC") program, South Kentucky's retail base rates[1] have increased by less than $4.000 million over the past approximately ten years. However, in the ensuing years South Kentucky's energy sales have decreased substantially while purchased power and other costs of conducting business have increased in most every portion of its operations. This situation has resulted in a degradation of South Kentucky's financial condition and currently jeopardizes its ability to maintain loan covenants with its lenders, specifically RUS. In order to prevent a further untenable financial situation, the Cooperative's Board of Directors, in conjunction with its management, determined that a general adjustment of retail rates was necessary in order to account for increased costs of conducting day-to-day activities in virtually all sectors of its business. Included in the analysis of the need to file a rate case was a thorough review of South Kentucky's depreciation rates which were set by the Commission in South Kentucky's last rate case in 2011.[2]

South Kentucky's original request sought approval to increase its annual revenues by $8.685 million to achieve a Times Interest Earned Ratio ("TIER") of 2.00.[3] South Kentucky bases its proposed rates on a twelve-month historical test period ending March 31, 2020. In consideration of the dual impact of the COVID-19 pandemic and East Kentucky Power Cooperative, Inc.'s ("EKPC") recent rate increase on its member consumers, South Kentucky proposes to phase in the total revenue increase in two steps by employing an initial revenue increase of approximately $4.334628 million (Phase 1), and then twelve months later, increase

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[1] Excluding pass-through increases resulting from East Kentucky Power Cooperative wholesale rate and surcharge adjustments.

[2] *See* Case No. 2011-00096, *Application of South Kentucky Rural Electric Cooperative Corporation for an Adjustment of Electric Rates* (Ky PSC March 30, 2012, pages 5 through 25).

[3] Following several rounds of case discovery which uncovered inadvertent minor calculation errors South Kentucky revised its revenue request to $8.669257 million, an increase of 7.90% which is provided as Exhibit WSS-3 to the rebuttal testimony of William Steven Seelye filed 4/13/22. For ease of reference Mr. Seelye's Rebuttal Exhibit WSS-3 is attached hereto as Exhibit 1.

revenue by the same amount, an additional $4.334628 million (Phase 2). Included in this approval request is an increase of the monthly residential consumer charge from $13.29 to $24.00. South Kentucky proposes that this consumer charge increase would become effective in Phase 1 and remain the same when Phase 2 is implemented. In Phase 1 the energy charge for the residential class would actually decrease from current levels, and increase slightly, but still below current levels, during Phase 2 implementation.[4] However, it is South Kentucky's position that should the Commission order the recovery of revenues in an amount less than $6.000 million, the phased approach should be abandoned and rates should be implemented immediately.[5]

Through extensive discovery and a full day of hearing each of South Kentucky's assertions and claims have been explored, discussed and stringently tested by Commission Staff ("Staff") and the Kentucky Attorney General's Office of Rate Intervention ("AG"). As is typical in a contested rate case, there are divergent positions and more than a few disagreements over the merits and amounts of several pro forma adjustments. However, South Kentucky believes that its revenue deficiency analysis and the methodologies employed for calculation of its requested pro forma adjustments are accurate and reliable and should provide the basis for a Commission decision granting most, if not all, of its request in this case.

II. BACKGROUND

On December 14, 2021 South Kentucky tendered its Application with the Commission, pursuant to KRS 278.180, KRS 278.190 and other applicable law, for an adjustment of its retail rates. The Application was accepted for filing on January 10, 2022 retroactive to December 14,

[4] Greater detail regarding the reasons for and mechanics of the proposed two-phase rate implementation is contained in Mr. Seelye's testimony. Reference is made to Application Exhibit 9, Direct Testimony of William Steven Seelye, pages 6-8 (December 14, 2021).

[5] *See* Rebuttal Testimony of Steve Seelye, pages 27-28 (April 13, 2022).

2021. A Motion for Intervention was filed by the AG which was granted by Commission Order on January 10, 2022. South Kentucky responded to four separate sets of data requests from Staff and two sets of data requests from the AG. South Kentucky supported its case with the testimony of three witnesses, Mr. Kenneth E. Simmons and Ms. Michelle Herrman, the Cooperative's President/Chief Executive Officer and Vice President of Finance and Member Services, respectively, and Mr. William Steven Seelye, Managing Partner, The Prime Group, Louisville, Kentucky. The AG tendered the testimony of one witness, Mr. Lane Kollen, Principal, J. Kennedy Associates, Roswell, Georgia. At the hearing of the case on May 10, 2022 these four witnesses were cross-examined by counsel for the Parties, Staff and Commission. Following the hearing South Kentucky provided responses to several post-hearing data requests on May 18, 2022. Upon the filing of simultaneous principal and responsive briefs by South Kentucky and the AG the case will stand submitted for Commission adjudication on June 1, 2022.

III. ARGUMENT

A. Several Factors Contribute to South Kentucky's Need for the Rate Adjustment

South Kentucky is the largest electric distribution cooperative[6] in Kentucky which is subject to the Commission's rate and service jurisdiction. It owns and maintains approximately 7,000 circuit miles of distribution lines connecting 40 substations throughout its 13-county service territory. The service territory has diverse geography from completely cleared gently rolling crop land to very mountainous and rugged terrain. Its main headquarters is in Somerset, Kentucky, and because of its large geographic footprint maintains district offices in Monticello, Whitley City, Albany, and Russell Springs for the convenience of its consumer members.

[6] In terms of consumer meters.

As previously discussed, South Kentucky's last general rate adjustment went into effect pursuant to Commission Order entered March 30, 2012, some ten years ago. The Cooperative's monthly residential Consumer Charge is $13.29, which ranks as the third lowest monthly consumer charge among the 16 distribution cooperatives in the EKPC system.

Although South Kentucky's system is large and reasonably diverse, residential kWh sales have not increased since the 2012 rates went into effect. For example, South Kentucky's 2011 residential kWh sales were 825,681,500, while at test year-end they were only 776,790,917, a 5.8% reduction over the period.[7] This reduction occurred even though there were more residential customers at the end of the test year than there were in 2012. Because residential customer usage accounts for 67.5% of South Kentucky's total electric revenue on a yearly basis any negative, or even flat, load growth can significantly impact net margins since costs in all aspects of its business are continuously increasing, notably materials and supplies, labor and purchased power.

As stated in Mr. Simmons' testimony[8], South Kentucky has seen recent pressure from costs of materials used to insure the reliability of its distribution system resulting from increased commodity prices, demand from other utilities and shortages in essential supplies such as conductor and transformers and has seen double-digit price increases in many essential materials. Other cost drivers contributing to the need for additional revenues include technology with monthly software costs rising by nearly 80% between 2011 and 2022[9], changes in energy efficiency programs from EKPC which has resulted in a 87% loss of revenue just between 2017

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[7] *See* Direct Testimony of Kenneth E. Simmons, p. 6 (December 14, 2021).

[8] *See* Id, pp. 6-8.

[9] *See* Id, p. 7.

and 2021[10], right-of-way maintenance[11], and systemic revisions to the RUS's CoC program which have curtailed South Kentucky's ability to earn interest on its deposits maintained within the program.

Despite South Kentucky's efforts to contain costs for the past ten years, time has finally caught up with it. Stagnant customer and load growth have resulted in mediocre retail energy sales and in financial results that are below what is needed to keep pace with costs and insure an acceptable level of financial integrity. In addition, South Kentucky's existing rate structure does not align with its cost of providing service resulting in revenue erosion caused by having too great a portion of its fixed cost recovery embedded in the variable (energy) charge.

It is against this challenging backdrop that South Kentucky has tried to simultaneously mitigate its loss of energy sales, manage ever-increasing costs throughout all areas of its business while delaying as long as possible further increases to residential rates.

B. The Cost of Service Study Demonstrates that the Proposed Increase in Base Rates is Necessary to Maintain South Kentucky's Financial Health

South Kentucky's case is supported by a revenue deficiency analysis and a fully allocated, embedded class cost of service study in accordance with Commission Regulation 807 KAR 5:001, Section 16(4)(u) prepared by Mr. Seelye. Mr. Seelye's qualifications and experience in conducting revenue deficiency studies, comprehensive class of service studies, and providing many other expert opinions on a wide range of utility rate-making subjects are well-known. He has presented numerous cost of service studies that have been accepted and adopted by the Commission in other dockets during his 43-year career in the utility industry. In this case he has presented very detailed

[10] *See* Id.

[11] *See* Id., pp. 6-7.

revenue deficiency and class cost of service studies which has been thoroughly explained in 36 pages of direct testimony and numerous supporting spreadsheets and other exhibits.[12]

Essentially, South Kentucky's proposed revenue increase was determined by analyzing the revenue deficiency based on financial results for the test period after the application of certain pro forma adjustments which were based on known and measurable changes. The revenue deficiency was determined as the difference between (i) South Kentucky's net margins for the adjusted test period without reflecting a general adjustment in rates, and (ii) South Kentucky's net margin requirement necessary to provide a TIER of 2.00 for the test period. Based on the adjusted test year, the revenue deficiency was determined to be $8.685 million, but later adjusted to $8.669 million.[13]

According to Mr. Seelye, the objective in performing a class cost of service study is to determine the rate of return on rate base that South Kentucky is earning from each customer class, which provides an indication as to whether South Kentucky's service rates reflect the cost of providing service to each customer class. The allocation methodology used in the class cost of service study ensures that a customer class is allocated costs only if the class actually uses the resources for providing electric service as indicated by the relevant cost driver. Thus, customers only have to pay for what they actually use and are not allocated costs if they do not rely on the resources used to provide electric service.[14]

[12] Mr. Seelye's testimony and supporting materials for the class cost of service study are found in Application Exhibit 10. Specific reference is made to all of Mr. Seelye's testimony and materials but because of the highly detailed nature of his work only a summary of the most important findings is provided here.

[13] *See* Rebuttal Testimony of Steve Seelye, Exhibit WSS-3 (April 13, 2022); also filed as Exhibit 1 to this Brief.

[14] *See* Direct Testimony of Steve Seelye, p.17 (December 10, 2021).

Mr. Seelye's Rebuttal Exhibit WSS-3 (Exhibit 1 to this Brief) is the key evidence supporting South Kentucky's rate adjustment request in this case. Mr. Seelye made all necessary and recognized pro forma adjustments which remove revenues and expenses addressed in other rate mechanisms, are ordinarily excluded from rates, or are non-recurring on a prospective basis, consistent with standard Commission practices. Mr. Seelye provided a total of 17 pro forma adjustments which are summarized by list and later discussed in detail in his testimony.[15]

Mr. Seelye relied on the unit costs indicated by the results of the class cost of service study to set the proposed customer, energy and demand charges. For Residential Service, Mr. Seelye's analysis showed the consumer charge should be $26.41 (as shown on Exhibit WSS-8, page 35), but South Kentucky is only proposing an increase to $24.00 in the Step 1 increase, increasing the energy charge in the Step 2 rates to produce the targeted revenue increase in the Step 2 increase.[16] The service charges for the other rate schedules were set approximately equal to cost of service in the Step 1 increase.[17]

Mr. Seelye summarized the average bill impacts of South Kentucky's proposal to all affected rate classes in his Direct Testimony Exhibit WSS-13. Under South Kentucky's proposed two-step rate phase-in a Residential Service consumer member using an average of 1,019 kWh per month would see an approximate 4.91% bill increase for the Step 1 year, and 4.68% for the Step 2 year[18] which is consistent with principles of rate gradualism.

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[15] *See* Direct Testimony of Steve Seelye., pp. 11-15; Exhibit WSS-4, Schedules 2.01 through 2.17.

[16] *See* Id., p. 35.

[17] *See* Id., p. 35.

[18] *See* Id., Exhibit WSS-13.

C. There are Several Pro Forma Adjustments Essential to the Commission's Decision

As is normal in contested rate adjustment cases there are several disputed pro forma adjustments which the Commission must consider in setting South Kentucky's rates. Of the 17 pro forma adjustments discussed in Mr. Seelye's Direct Testimony Exhibit WSS-4, the AG's rate witness, Mr. Kollen, responded by asserting 14 of his own, some of which directly address South Kentucky's pro forma adjustments and some which are his own recommendations. Mr. Kollen's total adjustments to South Kentucky's requested rate increase amount to a whopping \$6.989 million, leaving a total recommended rate increase of only \$1.697 million.[19] However, \$6.444 million, or approximately 92%, of this reduction is subsumed in four of Mr. Kollen's adjustments addressing Utilization of Cushion of Credit Deposits (\$2.064 million), Annualization of Long-Term Debt Interest Expense (\$0.438 million), appropriate TIER level upon which South Kentucky's prospective allowed revenues should be based (\$2.258 million) and Inclusion of Interest Income in Net Margins to Calculate TIER (\$1.684 million). Summary discussion of the relative positions of the Parties' witnesses on these contested pro form adjustments is necessary so the Commission might see the reasonableness of South Kentucky's adjustments compared to those advocated by the AG.

1. South Kentucky's Utilization of Cushion of Credit Deposits

Pursuant to 7 CFR Chapter XVII, § 1785.66, *et seq.,* RUS established a C of C payment program for the stated purpose of promoting rural economic development. Under this program a C of C account was established for each RUS borrower which made a payment after October 1, 1987 exceeding amounts then due on an RUS note. The program provided escrow-like accounts for borrowers such as South Kentucky to deposit excess money and earn steady returns for several

[19] *See* Direct Testimony of Lane Kollen, p. 4 (March 9, 2022).

years. The initial interest rate of return was set at a fixed rate of five percent (5.00%). This program provided an excellent way for cooperatives like South Kentucky to earn returns well beyond anything else available in commercial financial markets at virtually no risk and inured to the substantial benefit of participating cooperatives and their consumer members. Like many other cooperatives South Kentucky fully participated in the C of C program and for several years its members enjoyed the financial benefits provided.

However, significant changes in the C of C program were instituted by Congress in the 2018 Farm Bill resulting in a prohibition of all *future* principal deposits into C of C accounts effective on and after December 20, 2018. While no new principal deposits were allowed *existing* deposits could remain and withdrawals from C of C accounts continued for prepayment on RUS direct or guaranteed loans, and without penalty. However, the fixed interest rate of 5.00% was altered and interest rate reductions were phased in over a period of two years. The 5.00% fixed rate was paid until September 30, 2020. Beginning October 1, 2020 and ending September 30, 2021, C of C deposits were reduced to four percent (4.00%). Beginning October 1, 2021 and thereafter, account balances began earning the applicable, variable one-year U.S. Treasury rate.[20]

At the time of the Farm Bill's passage in late 2018, South Kentucky reviewed all the interest rates within its RUS/Federal Financing Bank ("FFB") loan portfolio. This review showed the interest rates on South Kentucky's RUS/FFB loan portfolio ranged from one percent (1.00%) to 3.699%, with a blended interest rate of 2.59%.[21] The 2018 Farm Bill allowed for the prepayment of RUS/FFB long-term debt using the balance of C of C funds on deposit without penalty, with an election to do so required before September 30, 2020. Since South Kentucky's highest interest

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[20] *See* South Kentucky's response to AG-DR-01-20.

[21] *See* South Kentucky's response to PSC-DR-03-08.

rate loan (3.699%) and blended interest rate (2.59%) within its RUS/FFB loan portfolio was below the 4.00% interest earning rate of the initial phase-down, South Kentucky elected not to pre-pay any long-term RUS/FFB debt and to keep its C of C deposits intact.[22]

However, beginning in December 2021, South Kentucky began allowing its C of C deposits to pay periodic RUS/FFB debt service payments when due. The funds that would normally be used to make these debt service payments are instead being invested with the Cooperative Finance Corporation's ("CFC") commercial paper program. Currently, South Kentucky is working to create an investment policy which will be used in requests for proposals for the enhanced management and investment of these funds.[23]

South Kentucky's decision between late 2018 and the autumn of 2020 to retain its C of C deposits intact and not pre-pay its long-term RUS/FFB loans was based on a consideration of the following factors: (1) the annual reset of the interest rate based upon the variable one-year U.S. Treasury rate at October 1 of each year which has historically been approximately 2.86% (rounded hereafter to 2.90%); (2) the fact that South Kentucky's blended interest rate of 2.59% in its RUS/FFB loan portfolio was below the historical one-year Treasury rate; (3) the advantage of having sufficient C of C funds available on deposit to obviate the need for new RUS/FFB borrowing at future interest rates likely to be higher than either South Kentucky's current blended interest rate or the historical Treasury rate[24]; (4) the flexibility to use C of C funds to make future debt service payments as needed; and, (5) the effect of interest earned due to the principal of

[22] *See* Id.

[23] *See* South Kentucky's response to PSC-DR-02-06.

[24] As of April 30, 2022 South Kentucky had total C of C deposits of $31.098 million; *See* South Kentucky's response to PSC PHDR-14.

compounding for the additional year at 4.00% (between October 1, 2020 and September 30, 2021).[25]

The AG roundly criticizes South Kentucky for its retention of C of C deposits and the decision not to pre-pay all of its RUS/FFB debt almost exclusively on the ground that South Kentucky should have known in 2018-2020 that Treasury rates in 2021 would be "nearly 0%".[26] The AG's rate expert, Mr. Kollen, cited Jackson Purchase Electric Corporation's ("JPEC") recent rate case where it was stated that JPEC had repaid all of its RUS/FFB long-term debt with its C of C deposit funds.[27] Mr. Kollen used this example as support for his criticism of South Kentucky not doing the same thing. However, what Mr. Kollen fails to say is that JPEC's situation is incongruent to South Kentucky's for a very important reason: JPEC's RUS/FFB long-term debt was all at 4.00% or higher.[28] As previously discussed, South Kentucky's *highest* RUS/FFB long-term note was at 3.699%, and its blended interest rate was at 2.59%. Therefore, JPEC made a sound financial decision to pay off its higher interest rate debt, and South Kentucky also made an equally sound decision *not* to pay off its lower interest rate debt.

The assumption made in Mr. Kollen's testimony that in 2018-2020 South Kentucky somehow should have foreseen the COVID-19 pandemic's chaotic effect on the worldwide economy, especially on short-term interest rates as benchmarked by U.S. Treasury notes, is unfair and illogical. The characterization that South Kentucky's decision was an exercise of poor

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[25] *See* South Kentucky's response to PSC-DR-03-08.

[26] *See* Direct Testimony of Lane Kollen, p. 23, line 8 (March 9, 2022).

[27] *See* Id, pp. 25-26.

[28] *See* Id., Exhibit___(LK-12), which is JPEC's response to PSC-DR-02-24(b), where JPEC states: "Jackson Purchase used this option [prepayment] to pay off RUS debt <u>over 4% with these funds. No balance remains in Jackson Purchase's Cushion of Credit"</u> (emphasis added). It stands to reason that if JPEC paid off all RUS debt over 4.00% and no balance remains in its C of C account, all of its debt was over 4.00%.

financial judgment is simply wrong. Moreover, Mr. Kollen fails to mention a key factor in all of this which is that the C of C interest to be earned on remaining deposits is reset each year in October using the one-year Treasury rate. Admittedly, the 2021 rate of 0.09% is very low; however, no reasonable person believes it will stay that low forever. In fact, convention dictates that at the least it should settle near the historical rate of 2.90%. Indeed, just between October 1, 2021, and April 1, 2022, the one-year Treasury rate had increased to 1.72%[29], and with the Federal Reserve's stated policy to impose multiple one-quarter to one-half percent interest rate increases in the coming months as a response to 40-year-high inflation numbers, the Treasury rate should quickly revert to historical territory if not exceed it.

South Kentucky's correct decision on the C of C issue is clearly corroborated by the Net Present Value ("NPV") analysis it performed in response to the Staff's discovery request in this case.[30] The Excel spreadsheet supporting South Kentucky's response to PSC-DR-03-08 shows a NPV analysis which compares interest expense and interest earnings of continuing to maintain current levels of the C of C compared to using a portion of the C of C to pay off South Kentucky's three highest rate FFB loans[31] having a current cumulative principal balance of approximately $28.760 million. The NPV analysis indicates that the net present value of continuing to maintain existing levels of C of C deposits is $3.995 million compared to a net present value of using a portion of C of C deposits to pay off the three loans of $0.790 million. The NPV analysis assumes that earnings on all C of C balances would be reinvested, as has been South Kentucky's historical practice. Not surprisingly, Mr. Kollen asserts that South Kentucky's analysis is "fundamentally

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[29] *See* Rebuttal Testimony of Michelle Herrman, p. 10 (April 13, 2022).

[30] *See* South Kentucky's response to PSC-DR-03-08.

[31] Even though these are South Kentucky's highest interest rate loans, they are still all well below 4.00%, with an average rate of 3.467%.

flawed in every respect"[32], and the result is "unequivocally counterintuitive."[33] Ms. Herrman's rebuttal testimony establishes that Mr. Kollen's protestations are merely noise since the discount rate of 5.74% used in the NPV is based upon the weighted average cost of capital as found in Mr. Seelye's class cost of service study, return on net investment.[34] It is well accepted to use rate of return on net investment as a discount rate in present value revenue requirement analysis.[35] In addition, the other key component of the NPV analysis, the assumed interest rate, is based upon the actual historical average of 2.86% which, in this case, is very conservative when considering that historically, the one-year U.S. Treasury rate *yield* has reached 17.31%.[36]

One additional note of importance must be made on the NPV analysis. For all the darts which the AG has thrown attempting to discredit South Kentucky's NPV analysis it is notable that he chose not to provide a separate and independent NPV analysis for the Commission's consideration. South Kentucky's NPV analysis was concluded and filed several days before Mr. Kollen's rebuttal testimony was due for filing. Rather than merely questioning South Kentucky's assumptions and inputs in his rebuttal testimony the Commission should wonder why Mr. Kollen failed to support his claims with a competing NPV analysis using assumptions and inputs he believed were more accurate. To paraphrase an old proverb, 'it is easier to tear down a house than to build one'.

Lastly, the AG makes the following recommendation to the Commission:

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[32] *See* Direct Testimony of Lane Kollen, p. 32, line 2 (March 9, 2022).

[33] *See* Id, p. 33, line 12.

[34] *See* Direct Testimony of Steve Seelye, Exhibit WSS-8, p. 21 (December 14, 2021). *See also,* South Kentucky's response to PSC-DR-04-01(d).

[35] *See* Rebuttal Testimony of Michelle Herrman, p. 11 (April 13, 2022).

[36] *See Id.*

> *The Commission should direct the Company to use the entirety of the funds formerly on deposit with the RUS to repay its highest cost long-term debt.*[37]

Mr. Kollen's recommendation is that South Kentucky should use current C of C funds to prepay its long-term RUS debt. This recommendation reveals a fundamental misunderstanding by Mr. Kollen of how using C of C funds to prepay RUS debt works. As Ms. Herrman unequivocally stated in her rebuttal testimony using C of C funds to prepay *any* of its current long-term debt would require that South Kentucky pay off *all* of its RUS and FFB long-term debt and would require the Company to fully *exit* the RUS Borrowers Program.[38] This could result in a financial catastrophe to South Kentucky and its consumer members due to unnecessary and likely excessive prepayment penalties, and the inability to maintain the option for future attractive borrowings from RUS.

For the reasons stated the AG's recommended $2.064 million pro forma adjustment should be rejected by the Commission.

2. Annualization of Long-Term Debt Expense

The AG recommends a total pro forma adjustment of $0.534 million for a claimed failure of South Kentucky to correctly annualize interest on long-term debt. This total adjustment is separated into four sub-adjustments contained in the chart on page 4 of Mr. Kollen's Direct Testimony[39] and is described in greater detail at pages 18-22 of that testimony.[40] The largest of Mr. Kollen's adjustment is $0.438 million and is based on his assertion that South Kentucky failed to make an adjustment to reduce the interest expense based on the lower actual outstanding debt

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[37] *See* Direct Testimony of Lane Kollen, p. 31, lines 5-6 (March 9, 2022).

[38] *See* Rebuttal Testimony of Michelle Herrman, pp. 11-12 (April 13, 2022).

[39] *See* Direct Testimony of Lane Kollen, p. 4 (March 9, 2022).

[40] *See* Id., pp. 18-22.

amounts at the end of the test year to annualize the long-term debt interest on all outstanding debt issues other than the new issuances in the first quarter of 2020. He asserts that South Kentucky paid off some of the principal of these other long-term debt issues during the test year and no longer will incur the interest on these amounts.[41]

South Kentucky's response to Mr. Kollen's recommendations on this point is found in Ms. Herrman's rebuttal testimony.[42] Ms. Herrman correctly points out that an annualization based upon the March 31, 2020 end of test year principal balances negates the utilization of a test year as the basis for the determination of South Kentucky's revenue requirements. Any annualization of long-term debt would require the inclusion of future borrowing by the Cooperative, such as its most recent $44.000 million work plan loan with FFB.[43] The premise for the AG's adjustment on this issue is flawed and should be rejected by the Commission.

South Kentucky does agree to a reduction of ($33,819) or ($67,637) based upon a 2.0 TIER calculation to correct two minor interest expense annualization errors for new debt issuances.[44] As a result of these agreed-upon reductions South Kentucky provided a revised Exhibit WSS-4, Schedule 2.08 in Ms. Herrman's rebuttal testimony.[45]

3. TIER Calculation

For decades virtually every electric distribution cooperative appearing before the Commission seeking rate relief has based its underlying request on the ability to earn revenues sufficient to achieve a 2.00 TIER. In this proceeding, South Kentucky did the same. Even though

[41] *See* Id., p. 19.

[42] *See* Rebuttal Testimony of Michelle Herrman, pp. 7-8 (April 13, 2022).

[43] *See* Id., p. 7.

[44] *See* Id., p. 8.

[45] *See* Id., p. 9.

there is a large amount of Commission precedent on this issue, the AG's witness, Mr. Kollen, believes that a TIER of 2.0 for South Kentucky is excessive. Mr. Kollen argues that the Commission should issue a decision that South Kentucky is only entitled to earn revenues sufficient to achieve a 1.50 TIER. Based on the table provided by Mr. Kollen on page 4 of his Direct Testimony filed in this case, the effect of this recommendation would be to reduce South Kentucky's proposed increase by $2.258 million.

The narrative provided by Mr. Kollen in support of this recommendations is contained on pages 34-39 of his Direct Testimony. Mr. Kollen makes several claims as to why a 2.0 TIER is excessive, including: (1) South Kentucky provided no analytical support for the proposed 2.0 TIER; (2) the 2.0 TIER is not necessary to meet loan requirements; (3) the 2.0 TIER is not necessary to increase members' equity; and, (4) an excessive TIER cannot be fully or timely remedied through capital credits.

Each of these recommendations by Mr. Kollen will have the effect of diminishing the financial health of South Kentucky and would set precedent that could cause financial harm to every electric distribution cooperative in Kentucky. Based on this testimony it appears that Mr. Kollen does not understand the inner workings of an electric distribution cooperative and how it functions.

South Kentucky addresses each of these arguments made by Mr. Kollen in the Rebuttal Testimony of Michelle Herrman and William Steven Seelye. The Rebuttal Testimony shows that Mr. Kollen's recommendation of a 1.5 TIER is unreasonable and should be ignored by the Commission.

a. Support for Authorization of 2.00 TIER

In his Rebuttal Testimony, Mr. Seelye points out that the recommendation of Mr. Kollen as to the 1.50 TIER is:

> *arbitrary, punitive, not supported by any empirical analysis, does not consider normative values for electric cooperatives in the United States, and is insufficient to provide for financial contingencies that could arise from numerous uncertainties, such as inflation, economic recessions, storm damage, weather variability, epidemics, etc.*[46]

Mr. Seelye also points out that the Commission recently found in Jackson Purchase Energy Corporation's general rate case[47], that a TIER of less than 2.0 would reduce Jackson Purchase's cash flows and operating margins to an unreasonable level.[48] The same is true for South Kentucky.

Mr. Seelye correctly states that South Kentucky was relying on significant Commission precedent in basing its proposal on a 2.0 TIER and that this is also consistent with the 2.1 TIER awarded to South Kentucky by the Commission in Case No. 2011-00096, which was South Kentucky's last general rate case. The 2.1 TIER awarded to South Kentucky excluded South Kentucky's non-operating income recorded as Generation and Transmission Capital Credits and interest on cushion of credit.[49] Mr. Seelye also points out that the Commission awarded a higher TIER than South Kentucky is currently requesting in this case, at a time when inflation was well below the current record rate. In fact, the consumer price index ("CPI") was increasing by only

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[46] *See,* Rebuttal Testimony of William Steven Seelye p. 16 (April 13, 2022).

[47] *In the Matter of: Electronic Application of Jackson Purchase Energy Corporation for a General Adjustment of Rates and Other General Relief,* Case No. 2021-00358. Order pp 16-18. (Ky. P.S.C., Apr. 8, 2022).

[48] *Id.*

[49] *In the Matter of: Application of South Kentucky Rural Electric Cooperative Corporation for an Adjustment of Electric Rates,* Case No. 2011-00096. Order p. 4, p. 28. (Ky. P.S.C., (Mar. 30, 2012).

1.7%.[50] At the time Mr. Seelye provided his Rebuttal Testimony the CPI had surged to 8.5% which was the fastest annual pace since December 1981.[51] March 2022 made six straight months that inflation was above 6%.[52] The rising costs of products needed by South Kentucky to provide safe and reliable service to its members could have a severe impact on South Kentucky's margins and cash flow.

Moreover, there are no standard methodologies for determining an electric cooperative's TIER as there are for determining return on equity ("ROE") for investor-owned utilities. It would be a waste of resources for an electric distribution cooperative to employ a cost of money expert to provide the type of support for a TIER of 2.00. If the Commission were to make this a requirement, South Kentucky and all other electric distribution cooperatives who would come before the Commission seeking rate adjustments could most likely justify a TIER greater than 2.00. Mr. Seelye discusses the *2020 Key Ratio Trend Analysis* ("KRTA") in his Rebuttal Testimony at page 20. This is prepared by the National Rural Utilities Cooperative Finance Corporation ("NRUCFC"). According to the KRTA, the median OTIER of all utilities in the United States was 2.24 during 2020. The medium OTIER of electric cooperatives similar in size to South Kentucky was 2.11 during that same year. The relevant pages of the KRTA were included as Rebuttal Exhibit WSS-1 to Mr. Seelye's Rebuttal Testimony. Therefore, setting a TIER or OTIER of 1.5 could be devastating to South Kentucky.

b. South Kentucky's requested 2.0 TIER is not excessive and should not be set according to what is required in its financial and credit metrics since the formula for RUS TIER calculation is different than the TIER calculation for ratemaking purposes.

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[50] Seelye Rebuttal p. 19.

[51] *Id*, p. 18.

[52] *Id.*

The position taken by the AG through its witness, Mr. Kollen, is essentially that since South Kentucky is only required to reach a 1.25 TIER, a 1.25 Debt Service Coverage Ratio ("DSC"), and 1.10 Operating TIER ("OTIER"), for its required financial and credit metrics, a 2.00 TIER is excessive. Mr. Kollen is focusing on the *minimum* financial metrics that South Kentucky must meet to satisfy its financial and credit metrics, not what a reasonable TIER is for South Kentucky's continued provision of safe and reliable service to its consumer members. Focusing on the minimum financial metrics will leave no cushion for South Kentucky for anything that may arise that would force South Kentucky to pay higher than normal prices for items it needs to provide safe and reliable service to its members, or for any unforeseen decrease in revenues. What Mr. Kollen does not seem to understand is that there are major differences in what the lenders may set as the minimum requirements to insure that a borrower, or in this case a utility, is financially able to repay its debts, and what is necessary to be set in a rate proceeding to insure the overall financial health of the utility. In fact, the Commission rejected this argument from Mr. Kollen several years ago. In Case No. 2013-00199,[53] in which Mr. Kollen was a witness and made this same argument, the Commission stated, "It is inappropriate to base a cooperative's revenue requirement on the minimum TIER it is required to achieve in order to be in compliance with its mortgage or other controlling loan agreements." In addition, the Commission held "the use of a minimum coverage ratio will provide no 'cushion' in the event of an unexpected decline in revenues or unavoidable increase in expenses."[54] Arguably, this is more important in today's economic environment than it was in 2014 when the Commission issued that Order. During the questioning of Michelle

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[53] *In the Matter of: Application of Big Rivers Electric Corporation for a General Adjustment in Rates Supported by Fully Forecasted Test Period,* Case No. 2013-00199, Order, p. 30, (Ky. P.S.C., April 25, 2014).

[54] *Id.*

Herrman by Chairman Chandler at the May 10, 2022 hearing in this matter, Ms. Herrman discussed the differences in the calculation of TIER, OTIER and DSC that she uses to calculate for the debt covenants, and the calculations that Mr. Seelye used in calculating the TIER for determining the revenue requirement for ratemaking purposes.[55] Her testimony shows how different these are. In addition, Ms. Herrman testified in response to Chairman Chandler's questions regarding non-operating income categories, including dividends, and that Exhibit MDH-2 was her attempt to show there are several things impacting South Kentucky's outcomes over which South Kentucky has no control.[56] Ms. Herrman went on to say that without the inclusion of these below-the-line items, South Kentucky would have failed its benchmarks and failed the two out of three-year test.[57]

Furthermore, in response to Commission Staff's questions regarding why he used a different calculation for TIER than used by RUS, Mr. Seelye explained that this decision was based on Commission precedent of excluding non-operating items such as capital credits from the TIER calculation for rate-making purposes. He also mentioned that interest rates were at an all-time low when the case was filed and South Kentucky was not seeing those amounts. He went on to say that even if South Kentucky were receiving these amounts, this is non-operating income and should be excluded from the TIER calculation for ratemaking purposes.[58] South Kentucky's TIER is currently 2.1, which was established during its last general rate case, and is higher than the 2.0 TIER requested in this case. Even with that higher TIER of 2.1, South Kentucky would not have met its much lower debt coverage benchmarks without the below-the-line items. This

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[55] Hearing Video, May 10, 2022 beginning at 13:38:00.

[56] *Id.* at 13:.49:13.

[57] *Id.* at 13:50:40.

[58] *Id.*at 14:49:30.

demonstrates how Mr. Kollen's suggested TIER of 1.5 would be catastrophic to South Kentucky's financial health. As discussed above, inflation is the highest it has been in decades. The price of nearly everything South Kentucky needs to provide safe and reliable service to its customers is increasing, substantially in some instances.

Based on the foregoing, South Kentucky disagrees with each of Mr. Kollen's proposed adjustments related to interest income, non-operating margins and capital credits. South Kentucky's TIER in this proceeding was calculated in a manner that is consistent with the way TIER has been calculated in prior Commission proceedings, including South Kentucky's last general rate case filing. The Commission typically excludes non-cash operating income such as G&T capital credits and other non-operating credits. RUS has a different calculation for TIER for South Kentucky's debt covenants, but as discussed above, the process of determining whether a utility will be able to repay its debts is much different than setting rates for a utility to insure it has ongoing financial stability. Each of the items listed by Mr. Kollen is a non-operating item which South Kentucky does not have control over the amount, if any, received each year. These items should all be treated as other non-operating credits.

4. Other Disputed Pro Forma Adjustments

a. Capitalized Wages and Salaries

The AG recommends that the Commission should reduce South Kentucky's pro forma adjustment for the annualization of wages and salaries by $0.094 million to remove the capitalized portion of the expense.[59] South Kentucky disagrees with the AG's adjustment because it is based on an overall annual capitalization percentage for regular labor only and does not include overtime labor. The addition of overtime labor would reduce the capitalized labor percentage since overtime

[59] *See* Direct Testimony of Lane Kollen, pp. 9-10 (March 9, 2022).

labor is primarily expensed because of its direct relationship with power restoration caused by weather or accident outages or afterhours reconnection requests.[60]

In addition, each job position within South Kentucky's workforce is unique and the expensed/capitalized portion of labor varies by job position.[61] It is inappropriate to use a generalized capitalization percentage that is based on regular labor only and does not account for overtime labor. For that reason, Mr. Kollen's recommendation should be rejected by the Commission.

b. Temporary Staffing Assistance

The AG proposes to reduce operating expenses by $0.107 million to reflect the elimination of temporary staffing assistance.[62] The AG's recommendation is apparently based on testimony by South Kentucky's CEO, Mr. Simmons, which indicated that pausing the use of temporary staffing resulted in savings to South Kentucky.[63] Mr. Simmons' testimony upon which Mr. Kollen bases his recommendation merely describes extraordinary and temporary cost-containment measures which South Kentucky took to mitigate expense during the COVID-19 pandemic where office closures and other safety measures were implemented. Pausing the use of temporary staffing assistance was one such measure to reduce expenses but was not meant to be permanent. In fact, South Kentucky intends to resume the use of temporary staffing at its district office locations based

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[60] *See* Rebuttal Testimony of Michelle Herrman, pp. 5-6 (April 13, 2022).

[61] *See* South Kentucky's response to PSC PHDR-2, and the supporting Excel spreadsheet which provides labor capitalization rates by department at South Kentucky for the years 2018-2021, and a composite capitalization rate for each year.

[62] *See* Direct Testimony of Lane Kollen, pp. 8-9 (March 9, 2022).

[63] *See* Direct Testimony of Kenneth E. Simmons, p. 8 (December 14, 2021).

upon members' needs when it is financially able to do so.[64] The AG's recommended reduction in expense on this issue should also be rejected by the Commission.

D. DEPRECIATION RATES

As stated, South Kentucky's existing depreciation rates were set by the Commission in the Cooperative's 2011 rate case.[65] Because these depreciation rates have continued unchanged for approximately ten years South Kentucky determined that a comprehensive analysis of its depreciation rates was warranted. Mr. Seelye undertook this task utilizing accepted methodologies to determine proposed reasonable depreciation rates for each major South Kentucky plant account. Mr. Seelye describes the method, procedure and technique employed in developing South Kentucky's proposed depreciation rates in his direct testimony.[66] A summary of the recommended depreciation rates for each distribution plant account is contained in Exhibit WSS-6 to Mr. Seelye's direct testimony.[67]

Mr. Seelye's depreciation study was subject to essentially no discovery in the case and was not challenged by the AG. South Kentucky recommends that the Commission adopt the depreciation rates contained in Mr. Seelye's Exhibit WSS-6.

E. CONCLUSION

Compared to most full rate cases which the Commission must adjudicate, this one is reasonably straightforward. Through effective financial oversight over all aspects of South Kentucky's business, especially in those areas of greatest expense, management has been able to

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[64] *See* Rebuttal Testimony of Michelle Herrman, p. 4 (April 13, 2022).

[65] See Case No. 2011-00096, *Application of South Kentucky Rural Electric Cooperative Corporation for an Adjustment of Electric Rates* (Ky PSC March 30, 2012, pages 5 through 25).

[66] *See* Direct Testimony of Steve Seelye, pp. 15-16 (December 14, 2021).

[67] *See* Id., Exhibit WSS-6.

provide safe and reliable power at reasonable costs to its consumer members without a general rate increase for more than a decade. However, due to economic forces beyond its control the Cooperative finds itself in the uncomfortable financial position of needing to raise its rates. It has gone about the process in systematic fashion retaining a highly qualified and experienced rate expert to perform comprehensive Cost of Service and Depreciation Studies. It has then taken the results of those studies and designed rates which are fair, just and reasonable by (1) proposing to raise the monthly residential consumer charge from one of the lowest among all Kentucky electric distribution cooperatives to one that much more closely aligns to its actual cost of service, even though the class cost of service study shows that it should be even higher; and, (2) proposing a two-year rate phase-in to ameliorate the effect of its consumer members' monthly power bills. Even the AG agrees that South Kentucky's rate phase-in is a good idea.[68]

In developing this case South Kentucky has expended substantial time and energy to ensure that each of its proposed adjustments would withstand Commission scrutiny both as to method and technique. South Kentucky's rate expert and V.P. of Finance are both seasoned veterans of the Commission's regulatory practices and procedures. Beginning at case inception they agreed to err on the side of excluding any adjustment, whether it increased or decreased the revenue requirement, that was not supported by accepted accounting and regulatory practices, especially known and measurable information. This philosophy was stringently observed by South Kentucky and the Commission should have every confidence that the Cooperative's adjustments are both supportable and verifiable.

In this case the AG proposes 14 adjustments to South Kentucky's revenue request totaling $6.989 million, recommending that the Commission only grant a maximum of $1.697 million to

[68] *See* Direct Testimony of Lane Kollen, pp. 4-5 (March 9, 2022).

the Cooperative. The AG's two largest adjustment categories total $6.167 million which are comprised by TIER and TIER-related issues ($4.103 million) and Cushion of Credit ($2.064 million).[69]

In previous cooperative rate cases the AG has consistently recommended that the Commission should base revenues on a 1.50 TIER arguing that this exceeds by 20-30 basis points the minimum TIER threshold required by South Kentucky's lenders. First and foremost, there is virtually no nexus between what is required by South Kentucky to remain in technical compliance with loan covenants and the revenues it needs as a Provider of Last Resort to maintain a financially sound company for the benefit of its consumers who are also its owners. As the Commission has recently found it is imprudent to authorize a TIER lower than 2.00 because to do so would result in less cash working capital thereby impairing cash flow and operating margin to respond to unforeseen expenses.[70] The AG's recommendations on TIER and TIER-related adjustments should be rejected and the Commission should allow revenues based on a 2.00 TIER as requested by South Kentucky.

South Kentucky's decision to retain its Cushion of Credit funds on deposit and not prepay all its RUS/FFB debt made in 2018-2020 has proven to be sound. Because South Kentucky's highest interest loan was only 3.699% and at the time its loan portfolio blended interest rate was 2.59% the decision was made to retain all Cushion of Credit deposits to give South Kentucky more financial flexibility in the future. The Net Present Value Study performed by South Kentucky in response to Staff's Third Data Requests, Item 8, shows a substantially higher NPV (by

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[69] *See* Direct Testimony of Lane Kollen, p. 4 (March 9, 2022).

[70] *See* Case No. 2021-00358, *In the Matter of: Electronic Application of Jackson Purchase Energy Corporation for a General Adjustment of Rates and Other General Relief.* Final Order, pp. 16-17. (Ky. PSC April 8, 2022).

approximately $3.205 million) for not using the Cushion of Credits funds to prepay long-term debt than the alternative. This NPV calculation was performed employing reasonable assumptions and methodology and should be adopted by the Commission. Rather than criticizing South Kentucky's decision, as the AG has done here, the Cooperative should instead be complimented for its stewardship in trying to squeeze every cent it could out of the Cushion of Credit for the good of the Company and its owners. If not for the extraordinarily meager Treasury rate during the test year (0.09%) caused by the economic turmoil flowing from the COVID-19 pandemic it is doubtful that Cushion of Credit would have even been an issue in this case. As discussed, the Treasury rate is now moving back toward historical averages which reinforces the wisdom of South Kentucky's decision.

It gives South Kentucky no pleasure to request an approximately 7.90% rate increase on its consumer members. However, the length of time since its last rate case coupled with recent extraordinary economic factors have coalesced into the rate request currently before the Commission. To their credits, South Kentucky's Board of Directors and management recognized their collective fiduciary duty to consumer members to ensure the continued financial health of the Cooperative and made the tough decision to act upon it.

South Kentucky's proposal in this case is both measured and necessary for its continued financial health. It is based entirely upon a comprehensive and reliable Cost of Service Study employing known and measurable changes to test year expense. It is fair, just and reasonable both in terms of the revenue request and the rate design chosen to implement it. Likewise, the Depreciation Study provides rates which are equally as reasonable. South Kentucky respectfully requests that the Commission enter a final order adopting its request in full, including recovery of rate case expense amortized over a three-year period.

This 25th day of May, 2022.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that the foregoing is a true and accurate copy of the same document filed electronically with the Commission on May 25, 2022; that there are currently no parties that the Commission has excused from participation by electronic means in this proceeding; and by virtue of the Commission's July 22, 2021 Order in Case No. 2020-00085, a copy of the filing in paper medium shall not be required.

Mark David Goss

Mark David Goss

Rebuttal Exhibit WSS-3

South Kentucky Rural Electric Cooperative Corporation

Adjustments to Operating Revenues, Operating Expenses and Net Operating Margins
For the test year April 1, 2019 to March 31,2020

		Reference Schedule (1)	Revenue (2)	Purchased Power Expenses (3)	Operation and Maintenance Expenses (4)	Depreciation Expenses (5)	Other Taxes (6)	Utility Operating Margin (7)	Interest on Long-Term Debt (8)	Interest Exp - Other (9)	Other Deductions (10)	Net Operating Margin (11)	TIER Without Gen and Other Credits (12)
1	**Test-Year Actual per Books**	1.00	$109,771,296	$74,246,944	$19,874,740	$9,078,214	$349,207	$6,222,190	$5,529,181	$45,453	$31,996	$615,560	1.11
2	**Pro-Forma Adjustments:**												
3	Salaries and Wages	2.01			$205,096			($205,096)				($205,096)	
4	Annualization of Board of Director Elections	2.02			$45,000			($45,000)				($45,000)	
5	Bad debt expense recapture	2.03			$1,427,442			($1,427,442)				($1,427,442)	
6	Annual audit fees	2.04			$13,290			($13,290)				($13,290)	
7	Reduction in annual energy assistance from EKPC	2.05			$100,906			($100,906)				($100,906)	
8	Non-recurring back tax payment	2.06					($181,484)	$181,484				$181,484	
9	Interest on cushion of credit	2.07	($1,401,979)					($1,401,979)				($1,401,979)	
10	2020 RUS loans	2.08						-	$251,280 *			($251,280)	
11	Amortization of rate case expenses	2.09			$62,000			($62,000)				($62,000)	
12	Year-End Revenue Adjustment	2.10	$533,835		$451,946			$81,889				$81,889	
13	Normalized Depreciation Expenses	2.11				$522,000		($522,000)				($522,000)	
14	Removal of 401k match	2.12			($186,211)			$186,211				$186,211	
15	Life Insurance Premiums over $50,000	2.13			($40,500)			$40,500				$40,500	
16	Excluded Board of Director Expenses	2.14			($24,586)			$24,586				$24,586	
17	FAC/ES Revenues and Expenses	2.15	$0					($0)				($0)	
18	Charitable and political contributions	2.16						-			($27,307)	$27,307	
19	Total Adjustments		$ (868,144)	$ -	$ 2,054,383	$ 522,000	$ (181,484)	$ (3,263,043)	$ 251,280	$ -	$ (27,307)	$ (3,487,017)	
20	**Test-Year as Adjusted**		$ 108,903,152	$ 74,246,944	$ 21,929,123	$ 9,600,214	$ 167,724	$ 2,959,147	$ 5,780,462	$ 45,453	$ 4,689	$ (2,871,457)	0.50
21	**Revenue Increase**		$8,669,257 **										
22	PSC Assessment Fee	2.17			$ 17,338.51 ***								
23	**Test-Year as Adjusted for Revenue Increase**		$ 117,572,409	$ 74,246,944	$ 21,946,462	$ 9,600,214	$ 167,724	$ 11,611,065	$ 5,780,462	$ 45,453	$ 4,689	$ 5,780,462	2.00
24	Percentage Revenue Increase		7.90%										

* See revised Schedule 2.08 shown in Ms. Herman's Rebuttal Testimony.
** Rounding problem corrected
*** Adjsuted to reflect revised adjusments