COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ELECTRONIC EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIROMENTAL SURCHARGE MECHANISM OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR THE SIXTH-MONTH EXPENSE PERIODS ENDING MAY 31, 2022, NOVEMBER 30, 2022, NOVEMBER 30, 2023, MAY 31, 2024 AND NOVEMBER 30, 2024, THE TWO-YEAR EXPENSE PERIOD ENDING MAY 31, 2023, AND THE PASS-THROUGH MECHANISM OF ITS SIXTEEN MEMBER DISTRIBUTION COOPERATIVES	))))))))))))	**CASE NO. 2025-00013**

DIRECT TESTIMONY OF JACOB R. WATSON

ON BEHALF OF EAST KENTUCKY POWER COOPERATIVE, INC.

Filed: March 31, 2025

COMMONWEALTH OF KENTUCKY

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AN ELECTRONIC EXAMINATION BY THE PUBLIC SERVICE COMMISSION OF THE ENVIROMENTAL SURCHARGE MECHANISM OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR THE SIXTH-MONTH EXPENSE PERIODS ENDING MAY 31, 2022, NOVEMBER 30, 2022, NOVEMBER 30, 2023, MAY 31, 2024 AND NOVEMBER 30, 2024, THE TWO-YEAR EXPENSE PERIOD ENDING MAY 31, 2023, AND THE PASS-THROUGH MECHANISM OF ITS SIXTEEN MEMBER DISTRIBUTION COOPERATIVES	))))))))))))	**CASE NO. 2025-00013**

A F F I D A V I T

STATE OF KENTUCKY)
)
COUNTY OF CLARK)

Jacob Ray Watson, being duly sworn, states that he has read the foregoing prepared testimony and that he would respond in the same manner to the questions if so asked upon taking the stand and that the matters and things set forth therein are true and correct, to the best of his knowledge, information and belief.

Jacob Watson

Subscribed and sworn before me on this 31st day of March 2025.

Gwyn M. Willoughby
Notary Public

GWYN M. WILLOUGHBY
Notary Public
Commonwealth of Kentucky
Commission Number KYNP38003
My Commission Expires Nov 30, 2025

Q. Please state your name, business address, and occupation.

A. My name is Jacob R. Watson and my business address is East Kentucky Power Cooperative, Inc. ("EKPC"), 4775 Lexington Road, Winchester, Kentucky 40391. I am the Manager of Pricing for EKPC.

Q. Please state your education and professional experience.

A. I received a B.S. degree in Accounting, from the University of the Cumberlands in 2011, an MBA from the University of the Cumberlands in 2014, and a Ph.D. in Business Administration with a concentration in Accounting from the University of the Cumberlands in 2021. I am also a Certified Fraud Examiner. Professional experience includes: Financial Analyst for Pepsi MidAmerica, and Internal Auditor for Farmers Capital Bank Corporation. For the last ten years I have been at East Kentucky Power Cooperative having worked as an Accountant, Sr. Load Forecast Analyst, and currently as the Pricing Manger.

Q. Please provide a brief description of your duties at EKPC.

A. As Manager of Pricing, I am responsible for rate-making activities which include designing and developing wholesale and retail electric rates and developing pricing concepts and methodologies. I report directly to the Director of Regulatory and Compliance Services.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to address the following topics:

- Describe how EKPC and its Member Cooperatives have applied the environmental surcharge mechanism and the pass through mechanism in a reasonable manner during the period under review;
- Propose updating the rate of return used in the environmental surcharge calculation; and

- Discuss EKPC and its Member Cooperatives' position concerning a roll-in of the environmental surcharge into EKPC's wholesale base rates.

Q. Is EKPC preparing testimony and responding to data requests on behalf of its Member Cooperatives?

A. Pursuant to the Commission's March 5, 2025 Order, EKPC is preparing testimony on behalf of each Member Cooperative. The Member Cooperatives are: Big Sandy Rural Electric Cooperative Corporation ("RECC"), Blue Grass Energy Cooperative Corporation, Clark Energy Cooperative, Inc., Cumberland Valley Electric, Inc. ("Cumberland Valley"), Farmers RECC, Fleming-Mason Energy Cooperative ("Fleming-Mason"), Grayson RECC, Inter-County Energy Cooperative Corporation ("Inter-County"), Jackson Energy Cooperative, Licking Valley RECC, Nolin RECC ("Nolin"), Owen Electric Cooperative ("Owen"), Salt River Electric Cooperative Corporation, Shelby Energy Cooperative, Inc. ("Shelby"), South Kentucky RECC, and Taylor County RECC. EKPC is also providing Response 2 to the Commission Staff's First Request for Information ("Staff's First Request").

Q. Have other EKPC representatives provided responses to Commission Staff's First Request for Information in this proceeding?

A. Yes. Mark Horn, Director of Fuel and Emissions, has provided emission allowance information in Response 3 to the Staff's First Request. Thomas Stachnik, Vice President – Finance and Treasurer, has provided the debt and average interest rate information in Response 5 to the Staff's First Request.

Q. Would you identify the six-month and two-year review periods included in this proceeding?

A. The Commission's March 5, 2025 Order identified the six-month review periods as being the expense months ending May 31, 2022, November 30, 2022, November 30, 2023, May 31, 2024, and November 30, 2024. The March 5, 2025 Order also identified the two-year review period as the expense month ending May 31, 2023. Upon receipt of the March 5, 2025 Order, EKPC noticed that the listed time periods skipped the six-month period ending May 31, 2023.

Q. Was the Commission Staff notified of this situation and what was the resolution of the missing review period?

A. EKPC's outside counsel informally notified the Commission's Office of General Counsel of the problem with the review periods as well as associated problems with the request for information contained in Appendix B of the March 5, 2025 Order. EKPC and Owner-Member responses include the six-month review period ending May 31, 2023. In Request 5, Staff requests information as of May 31, 2019. EKPC believes staff intended to request information as of November 30, 2024 and have responded as such. Also in Request 5, subpart "c", Staff specifies a 1.50 Times Interest Earn Ratio ("TIER") to be used in the rate of return calculation. As part of the settlement agreement in Case No. 2021-00103,[1] EKPC agreed to use a TIER of 1.475. EKPC responded to Request 5 subpart "c" using the 1.50 TIER as requested and believes moving back to a 1.50 TIER is prudent.

Q. Previous Commission Orders required EKPC to incorporate certain provisions into the calculation of the monthly environmental surcharge factors. Please comment on how EKPC has addressed the most significant aspects of these Orders during the periods under review.

[1] *See In the Matter of Electronic Application of East Kentucky Power Cooperative, Inc. for a General Adjustment of Rates, Approval of Depreciation Study, Amortization of Certain Regulatory Assets, and Other General Relief*, Case No. 2021-00103, (Ky. P.S.C., Sep. 30, 2021).

A. A brief description of each component of the environmental surcharge calculation, applied consistently with Commission Orders, is discussed below.

- **Compliance Plan Projects**

As of the end of the 36-month review period, EKPC has 40 projects in its Environmental Compliance Plan. These projects were approved by the Commission in Case Nos. 2004-00321,[2] 2008-00115,[3] 2010-00083,[4] 2013-00259,[5] 2014-00252,[6] 2017-00376,[7] 2018-00270,[8] 2023-00177,[9] and 2024-00109[10]. In conjunction with the

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[2] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval of an Environmental Compliance Plan and Authority to Implement an Environmental Surcharge*, Order, Case No. 2004-00321, (Ky. P.S.C., Mar. 17, 2005).

[3] *See In the Matter of the Application of East Kentucky Power Cooperative, Inc. for Approval of an Amendment to Its Environmental Compliance Plan and Environmental Surcharge*, Order, Case No. 2008-00115, (Ky. P.S.C., Sep. 29, 2008).

[4] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval of an Amendment to Its Environmental Compliance Plan and Environmental Surcharge*, Order, Case No. 2010-00083, (Ky. P.S.C., Sep. 24, 2010).

[5] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity for Alteration of Certain Equipment at the Cooper Station and Approval of a Compliance Plan Amendment for Environmental Surcharge Cost Recovery*, Order, Case No. 2013-00259, (Ky. P.S.C., Feb. 20, 2014).

[6] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for a Certificate of Public Convenience and Necessity for construction of an Ash Landfill at J.K. Smith Station, the Removal of Impounded Ash from William C. Dale Station for Transport to J.K. Smith and Approval of a Compliance Plan Amendment for Environmental Surcharge Recovery*, Order, Case No. 2014-00252, (Ky. P.S.C., Mar. 6, 2015).

[7] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval to Amend Its Environmental Compliance Plan and Recover Costs Pursuant to Its Environmental Surcharge, Settlement of Certain Asset Retirement Obligations and Issuance of a Certificate of Public Convenience and Necessity and Other Relief*, Order, Case No. 2017-00376, (Ky. P.S.C., May 18, 2018).

[8] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval to Amend Its Environmental Compliance Plan and Recover Costs Pursuant to Its Environmental Surcharge, and for the Issuance of a Certificate of Public Convenience and Necessity*, Order, Case No. 2018-00270, (Ky. P.S.C., Apr. 1, 2019).

[9] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval to Amend Its Environmental Compliance Plan and Recover Costs Pursuant to Its Environmental Surcharge, and for the Issuance of a Certificate of Public Convenience and Necessity*, Order, Case No. 2023-00177, (Ky. P.S.C., Jan. 11, 2024).

[10] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for Approval to Amend Its Environmental Compliance Plan and Recover Costs Pursuant to Its Environmental Surcharge, and for the Issuance of a Certificate of Public Convenience and Necessity*, Order, Case No. 2024-00109, (Ky. P.S.C., Nov. 22, 2024).

establishment of a regulatory asset for the undepreciated balance of the William C. Dale Generating Station assets that were being retired early, EKPC was required in Case No. 2015-00302[11] to remove Project 5, Dale Low Nitrogen Oxide Burners, and Project 10, Dale Continuous Monitoring Equipment, from the environmental surcharge. The monthly environmental surcharge reports, incorporated by reference in this case, show the capital costs for the remaining projects.

- **Base/Current Method**

The surcharge mechanism, as shown in EKPC's Rate ES – Environmental Surcharge, reflects the base/current method through the formula MESF = CESF – BESF.[12] As described later in my testimony, EKPC is proposing no change to the BESF. EKPC has not identified any additional projects or expenses being recovered in both the Environmental Surcharge Compliance Plan and Base Rates.

- **Actual Emission Allowance Expense**

EKPC included only actual sulfur dioxide ("SO_2") and nitrogen oxide ("NO_x") emission allowance expense in the monthly filings.

- **Return on Emission Allowance Inventory and Limestone Inventory**

EKPC has included a return on all environmental surcharge assets, including emission allowances. Any purchase of allowances during the review period is addressed in Response 3 to the Staff's First Request. EKPC has also included a return on its limestone inventory.

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[11] *See In the Matter of Application of East Kentucky Power Cooperative, Inc. for an Order Approving the Establishment of a Regulatory Asset for the Undepreciated Balance of the William C. Dale Generating Station*, Order, Case No. 2015-00302, (Ky. P.S.C. Feb. 11, 2016). Projects 5 and 10 were originally approved as part of EKPC's environmental compliance plan and eligible for surcharge recovery in Case No. 2008-00115.

[12] MESF is the Monthly Environmental Surcharge Factor; CESF is the Current Environmental Surcharge Factor; and BESF is the Base Environmental Surcharge Factor.

EKPC's emission allowance inventories for SO_2 and NO_x reflect operations under the Cross-State Air Pollution Rules ("CSAPR") along with a continuation of the Acid Rain program. Under CSAPR, SO_2 and NO_x allowances are awarded annually with carry-forward of unused balances from prior years. The allowances allocated to EKPC by the Environmental Protection Agency ("EPA") under CSAPR have a dollar value of $0, which is consistent with the valuation afforded EPA allocated allowances under prior programs. EKPC's SO_2 inventory as of the end of the review period reflects the allowances remaining from the Acid Rain program. The NO_x inventory as of the end of the review period has a $0 balance as all the allowances were issued under CSAPR.

- **Return on Construction Work in Progress ("CWIP"), Net of Allowance for Funds Used During Construction**

  As approved in Case No. 2008-00115, EKPC has included a return on CWIP during the period under review.

- **Rate of Return**

  Three rates of return were in effect during the periods under review. For the expense months of December 2021 through January 2024, the rate of return was 5.093%, which was approved by the Commission in Case No. 2021-00103[13]. For the expense months of February 2024 through October 2024, the rate of return was 6.487%, which was approved by the Commission in Case No. 2023-00177. For the expense month of November 2024, the rate of return was 6.484%, which was approved by the Commission in Case No. 2024-00109.

[13] *See In the Matter of Electronic Application of East Kentucky Power Cooperative, Inc. for a General Adjustment of Rates, Approval of Depreciation Study, Amortization of Certain Regulatory Assets, and Other General Relief*, Case No. 2021-00103, (Ky. P.S.C., Sep. 30, 2021).

Per Order in Case No. 2022-00141 dated August 9, 2024, EKPC was allowed revised rate of returns; 4.894% for the six-month period ending May 31, 2022, 4.918% for the six-month period ending November 30, 2022, 6.146% for the six-month period ending May 31, 2023, 6.747% for the six-month period ending November 30, 2023, and 6.481% for December 2023 and January 2024. The under-recovery stemming from this revision is being amortized over 12 months beginning in August of 2024.

In EKPC's base rate case, the Commission approved a unanimous settlement agreement that provided the environmental surcharge would incorporate a TIER of 1.475 in the determination of the rate of return. TIER of 1.475 was used in all of the historic rate of returns detail above. A TIER of 1.50 is used for the rate of return proposed moving forward.

EKPC's rate of return on environmental compliance rate base is determined by multiplying the weighted average debt cost for the debt issuances directly related to projects in the approved compliance plan times a stated TIER.[14] The rate of return on the environmental compliance rate base is updated to reflect the current average debt cost at the conclusion of the six-month and two-year surcharge reviews.[15] The use of debt costs is based on the fact that all of EKPC's environmental compliance investments are financed with long-term debt.[16] The use of a 1.50 TIER was first

[14] As a result of the settlement agreement in Case No. 2021-00103, EKPC's rate of return on environmental compliance rate base also includes a cost of debt component for construction work in progress included in the environmental compliance rate base. The interest rate of EKPC's credit facility is used to determine this portion of the cost of debt.

[15] The determination of the rate of return was a provision in the settlement agreement filed in Case No. 2004-00321, which the Commission approved in ordering paragraph 4 of the March 17, 2005 Order authorizing an environmental surcharge for EKPC.

[16] Many of EKPC's environmental compliance investments are initially funded through existing general funds or short-term debt; however, these forms of financing are later replaced by long-term debt.

authorized in Case No. 2011-00032[17] and reduced to 1.475 TIER in Case No. 2021-00103. This rate-making methodology is different from that employed by investor-owned utilities. The rate of return for the environmental compliance rate base for investor-owned utilities reflects a weighted average cost of capital approach. The weighted average cost of capital reflects the blended interest rates for the investor-owned utilities' long-term and short-term debt and a return on the common equity. The weighted average cost of capital is then "grossed up" for income taxes. Consequently, the rate of return for the investor-owned utilities is higher than the rate of return proposed by or authorized for EKPC.[18]

As discussed in the Direct Testimony of Thomas J. Stachnik in Case No. 2021-00103, EKPC targets a TIER of 1.50 in order to achieve several financial objectives including financial ratios that meet covenants in various EKPC debt agreements and maintaining financial metrics that support strong credit ratings. For the environmental surcharge, EKPC agreed in Case No. 2021-00103 to the slightly lower TIER of 1.475, which the Commission found reasonable, noting that because through the true-up mechanism included in the environmental surcharge the revenue generated by the environmental surcharge is generally considered more stable than revenue generated through base rates.

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[17] *See In the Matter of An Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Period Ending December 31, 2010; and the Pass-Through Mechanism for Its Sixteen Member Distribution Cooperatives*, Order, Case No. 2011-00032, (Ky. P.S.C., Aug. 2, 2011). EKPC requested authority to use the 1.50 TIER as it was consistent with the TIER authorized by the Commission in EKPC's last base rate case, Case No. 2010-00167. The Commission found the request reasonable and approved the use of the 1.50 TIER.

[18] *See In the Matter of Electronic Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Utilities Company for the Six-Month Billing Period Ending October 31, 2019*, Case No. 2020-00170 (Ky. P.S.C., May 20, 2021). Utilizing the weighted average cost of capital approach with a gross up for income taxes, the Commission authorized a rate of return for the Kentucky Utilities Company of 8.86% for its pre-2020 compliance plan projects and 8.48% for its 2020 compliance plan projects.

EKPC's Indenture and current Credit Facility covenants target a 1.1 "Margins for Interest" Ratio, which approximates TIER. In order to achieve this each year, a somewhat higher TIER must be targeted to allow for fluctuations. The rating agencies look more closely at Debt Service Coverage Ratio ("DSC"), which evaluates EKPC's ability to service principal and interest payments and thus is more relevant to lenders than TIER which only considers interest payments. EKPC's Board Policy 203 states that, "The Debt Service Coverage Ratio (DSC) is a financial measurement of EKPC's ability to repay its long-term debt and is computed as depreciation plus interest on long-term debt plus net margins divided by interest on long-term debt plus scheduled principal payments. EKPC shall strive to maintain a DSC of at least 1.25 for each calendar year."

Fitch Ratings ("Fitch") and Standard & Poor's ("S&P"), both prefer high DSC ratios to support EKPC's BBB+ Stable and A Stable credit ratings respectively, which in turn result in lower cost of borrowings. In its October 2015 report on EKPC, Fitch had set a DSC of 1.25 as a threshold that would support EKPC's upgrade to A-, which occurred in October 2016. In its reports, S&P has repeatedly praised EKPC's DSC ratio being at or above 1.25.

Based on the Board Policy and Rating Agency input, EKPC management targets a DSC ratio of 1.35 each year. This target recognizes that the DSC will vary each year as its components vary (for example, mild weather would result in lower margins and a lower DSC) and thus allows for some decline without crossing the 1.25 threshold discussed above. EKPC's current targeted TIER results in maintaining this strong DSC ratio.

EKPC's achieved DSC and TIER[19] were as follows for calendar years 2020 through 2024:

Calendar Year Ending	DSC	TIER
December 31, 2020	1.35	1.28
December 31, 2021	1.38	1.12
December 31, 2022	1.54	1.40
December 31, 2023	1.31	1.17
December 31, 2024	1.31	1.06
Five-Year Averages	1.38	1.21

Based upon the foregoing, EKPC proposes changing to the TIER component of the rate of return to a 1.50 TIER. EKPC only achieved a 1.25 or higher TIER two of the last five years. EKPC is proposing a rate of return of 6.474% in this proceeding, as shown in Response 5 to the Staff's First Request. EKPC's proposed rate of return is consistent with the Settlement Agreement approved in Case No. 2004-00321, which provided that the rate of return on compliance-related capital expenditures would be updated to reflect current average debt cost as of the end of each six-month review period.

- **Operation and Maintenance ("O&M") Expenses**

  EKPC has continued to use a 12-month rolling average for O&M expenses associated with the compliance plan projects. For those instances where the change in the level of O&M expenses exceeded 10 percent, EKPC has provided an explanation. These explanations are provided in Response 4 to the Staff's First Request.

Q. Were the environmental-related amounts included in the monthly surcharge calculation based on booked costs?

[19] DSC is calculated by dividing the sum of depreciation, interest expense, and net margins by the sum of interest expense and principal payments. TIER is calculated by dividing the sum of interest expense and net margins by interest expense.

A. Yes. EKPC continues to use the amounts booked for the various cost categories included in the surcharge calculation and these costs were actual costs and incurred in a prudent manner.

Q. Did EKPC incur any over- or under-recoveries during the period under review?

A. Yes. However, as shown in Response 1 to the Staff's First Request, EKPC applied its November 2024 under-recovery to the December 2024 expense month, which was billed in January 2025. Thus, from the normal operation of the surcharge mechanism, no adjustment is needed in this proceeding to collect any under-recovery from the Member Cooperatives.

Q. Previous Commission Orders also required EKPC's Member Cooperatives to incorporate certain provisions into the calculation of the monthly pass-through factors. Please comment on how the Member Cooperatives have addressed the most significant aspects of these Orders during the periods under review.

A. Under the pass-through mechanism, the environmental surcharge factors computed for retail customers were billed by EKPC's Member Cooperatives at approximately the same time as EKPC billed the Member Cooperatives at wholesale. The calculation of the monthly factors for each Member Cooperative was provided in the monthly reports filed with the Commission. EKPC and the Member Cooperatives adhered to these and all other requirements and provisions of the Commission's Orders for the periods under review.

Q. Did the Member Cooperatives incur any over- or under-recoveries during the review period?

A. Yes. The over- or under-recovery amounts for each Member Cooperative are shown in Response 2 to the Staff's First Request. The determination of the over- or under-recovery amounts has been prepared utilizing the revised methodology approved by the Commission in Case No. 2015-00281.[20]

This 36-month review proceeding includes the fourth two-year surcharge review since the adoption of the revised methodology approved in Case No. 2015-00281. Request 2 directs EKPC and the Member Cooperatives to prepare a summary schedule showing the Member Cooperative's pass-through revenue requirement for the months corresponding with the six-month and two-year reviews. In the previous two-year reviews, Case No. 2017-00326,[21] 2019-00380, and 2022-00141 EKPC provided Excel spreadsheets for each Member Cooperative that included four "tabs". EKPC believes this approach accomplished the desired review of each Member Cooperative's revenue requirement during the previous review periods. EKPC is following this same approach when preparing the response to Request 2 in this review proceeding, with each Excel spreadsheet tab reflecting a six-month review period. Since this review proceeding is examining multiple six-month review periods, a summary tab has been included showing the "net" over- or under-recovery determined for each Member Cooperative.

Q. How will the Member Cooperatives reflect recovery of these over- or under-recovery amounts?

[20] *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Periods Ending June 30, 2014 and December 31, 2014, Two-Year Billing Period Ending June 30, 2015, and the Pass Through Mechanism for Its Sixteen Member Distribution Cooperatives*, Order, Case No. 2015-00281, (Ky. P.S.C., Apr. 8, 2016).

[21] *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Two-Year Billing Period Ending June 30, 2017 and the Pass Through Mechanism for Its Sixteen Member Distribution Cooperatives,* Order, Case No. 2017-00326, (Ky. P.S.C., Jan. 5, 2018).

A. As approved in the Commission's November 5, 2010 Order in Case No. 2010-00021,[22] fifteen of the Member Cooperatives propose that the over- or under-recovery amounts be amortized over a period of six months beginning in the first month after the Commission's Order in this proceeding. Fleming-Mason Energy Cooperative has requested a twelve-month amortization beginning in the first month after the Commission's Order in this proceeding.

Q. Has EKPC updated the rate of return to be used prospectively?

A. Yes. As previously discussed, EKPC proposes an updated rate of return of 6.474%. This updated rate of return reflects an average debt cost as of November 30, 2024 of 4.316% and a TIER of 1.50. The determination of the average debt cost as of November 30, 2024 is shown in Response 5 to the Staff's First Request.

Q. When does EKPC propose to apply the updated rate of return in its surcharge calculations?

A. EKPC proposes to use the updated rate of return in the surcharge calculations in the first month following the Commission's final Order in this proceeding.

Q. Does EKPC believe that its environmental surcharge should be rolled into its wholesale base rates?

A. No. While EKPC is providing the information related to a potential roll-in of the environmental surcharge into the wholesale base rates in Response 6 to the Staff's First Request, EKPC does not believe it is appropriate at this time to roll its environmental surcharge into its wholesale base rates.

[22] *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Six-Month Billing Period Ending December 31, 2009 and the Pass-Through Mechanism for Its Sixteen Member Distribution Cooperatives*, Order, Case No. 2010-00021, (Ky. P.S.C., Nov. 5, 2010).

Q. Would you explain the reasons in support of EKPC's position?

A. Yes. EKPC would initially note that whether or not there are amounts of environmental costs incorporated into wholesale base rates, the effect on EKPC, the Member Cooperatives, and the retail ratepayer is that the total environmental revenue requirement should remain the same. In addition, EKPC believes there are several reasons why a roll-in of the environmental surcharge is not appropriate at this time.

First, like the environmental surcharge mechanisms approved for Kentucky Utilities Company, Louisville Gas and Electric Company, Kentucky Power Company, Duke Energy Kentucky, and Big Rivers Electric Corporation, the environmental costs included in EKPC's revenue requirement represent both investment costs and energy costs. As a general matter, investment costs are usually reflected in demand charges while energy costs are reflected in the energy charge. Because both investment costs and energy costs make up the environmental costs, a roll-in of the surcharge into base rates is more complicated than the roll-in performed in a two-year fuel adjustment clause proceeding. In the two-year fuel adjustment clause proceeding, only energy costs are rolled into the energy charge of base rates. If EKPC is required to roll-in its environmental surcharge into its wholesale base rates, it believes the roll-in will have to be allocated to both the demand and energy charges. Included in Response 6 is a rough allocation of the calculated roll-in amount between demand and energy components. Please note that this rough allocation assumes that the entire return on environmental compliance rate base would be assigned to demand. A cost-of-service study would likely assign the components of the environmental compliance rate base to both demand and energy.

Ideally, such an allocation should be performed utilizing a cost-of-service study. However, there has not been any time in this review proceeding for EKPC to undertake a cost-of-service study that would provide a reasonable allocation of an environmental surcharge roll-in into demand and energy related components. The belief that a cost-of-service study should be the basis for allocating a surcharge roll-in between demand and energy rate components is the primary reason why EKPC believes a roll-in of environmental costs should occur at the time of a wholesale base rate case proceeding. Including a roll-in as part of a wholesale base rate case would allow for the allocation of environmental costs in a manner consistent with other costs through the utilization of a cost-of-service study. EKPC notes that the Commission has accepted the argument that a surcharge roll-in should be undertaken as part of a base rate case in previous environmental surcharge reviews.[23]

The second reason concerns how the change in the wholesale base rates would be reflected in the Member Cooperatives' retail base rates. When the Commission approved the environmental surcharge mechanism for EKPC and the corresponding pass-through mechanism for the Member Cooperatives, there was no discussion of how or when retail base rates would be adjusted to reflect the change in the wholesale base rates resulting from the surcharge roll-in. Clearly any adjustment to the retail base rates should be accomplished in the same proceeding as the roll-in to wholesale base rates and both changes in the base rates become effective at the same time. If a surcharge roll-in was

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[23] *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of Kentucky Power Company for the Six-Month Billing Periods Ending June 30, 2006 and December 31, 2006, and for the Two-Year Billing Period Ending June 30,* 2007, Order, Case No. 2007-00381, p. 6 (Ky. P.S.C., Aug. 19, 2008); *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Two-Year Billing Period Ending June 30, 2009 and the Pass-Through Mechanism for Its Sixteen Member Distribution Cooperatives*, Order, Case No. 2009-00317, p. 5 (Ky. P.S.C., Jan. 28, 2010); *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Two-Year Billing Period Ending June 30, 2011, for the Six-Month Billing Periods Ending December 31, 2011 and June 30, 2012, and the Pass-Through Mechanism for Its Sixteen Member Distribution Cooperatives*, Order, Case No. 2012-00486, p. 5-6 (Ky. P.S.C., Aug. 2, 2013); *See In the Matter of an Examination by the Public Service Commission of the Environmental Surcharge Mechanism of East Kentucky Power Cooperative, Inc. for the Two-Year Billing Period Ending June 30, 2013 and the Pass Through Mechanism for Its Sixteen Member Distribution* Cooperatives, Order, Case No. 2013-00324, p. 6 (Ky. P.S.C., Mar. 21, 2014); also see the April 8, 2016 Order in Case No. 2015-00281, page 9 and the May 6, 2020 Order in Case No. 2019-00380, page 5.

required as part of the two-year review case, EKPC believes the necessary adjustments to the retail base rates need to correspond as closely as possible to the change in the wholesale base rates. The change in the wholesale demand-related base rates should be reflected in the corresponding retail customer charges and demand base rates. The change in the wholesale energy-related base rates should be reflected in the corresponding retail energy base rates. However, as a surcharge roll-in during the two-year review to the wholesale base rates would not be cost-of-service based, neither would the corresponding adjustment to the retail base rates be cost-of-service based.

As with a roll-in to its wholesale base rates, EKPC believes that the corresponding adjustment to retail base rates should be performed in conjunction with a base rate proceeding and not as part of a two-year surcharge review. The amount of the roll-in each Member Cooperative receives as a result of the change in wholesale base rates would be cost-of-service based. The Member Cooperatives indicated a general agreement with this concept during a rate design project EKPC undertook approximately 13 years ago.

While EKPC and its Member Cooperatives have consistently argued that the appropriate proceeding to roll-in the surcharge into base rates was during a base rate case, EKPC did not propose a surcharge roll-in during its last base rate case, Case No. 2021-00103. EKPC did have a cost-of-service study available to allocate its environmental costs, but the Member Cooperatives were utilizing the "flow-through" process available under KRS 278.455. That statute requires the increase in wholesale rates and tariffs must be allocated to each class and within each tariff on a proportional basis that will result in no change in the rate design currently in effect for the Member Cooperative. Thus, EKPC's allocation of its environmental costs would have been based on a cost-of-service study while the Member Cooperatives' share of the EKPC increase in revenues would have been allocated in total on a proportional basis. The Member Cooperatives would not have been able to make corresponding changed in their retail rates that reflected EKPC's allocation of its environmental costs to demand and energy.[24]

A final reason is related to the disclosure of the cost of environmental compliance to retail customers. EKPC's currently approved environmental compliance plan contains 40 projects and the monthly surcharge filings reflect the investment costs and operating expenses associated with those projects. The monthly cost of environmental compliance will be known to EKPC even if there is a roll-in of the surcharge revenue requirement into wholesale base rates. As there to date has been no roll-in of the environmental surcharge into base rates, the Member Cooperatives' monthly surcharge pass-through factors serve as a means to disclose to the retail customer the cost of environmental compliance for the approved projects. However, if there were a roll-in, a significant portion of the EKPC monthly surcharge factor would be collected through wholesale base rates and the corresponding Member Cooperatives' monthly surcharge pass-through factors would be reduced. The monthly surcharge pass-through factors would no longer easily disclose to retail customers the full cost of environmental compliance for the approved projects. Many of the Member Cooperatives believe it is important that retail customers be aware of the full cost of environmental compliance for the approved projects and the impact this compliance cost has on the monthly retail bill. Consequently, until an acceptable method can be developed to facilitate transparency with regard to full cost of environmental compliance, EKPC and the Member Cooperatives believe roll-in should not be undertaken as part of the two-year review proceeding.

[24] *See* Case No. 2021-00103, Application Exhibit 13, Direct Testimony of Isaac S. Scott, at 11, and EKPC's Response to the Commission Staff's Second Request for Information, Request 13a and 13b.

Q. Is EKPC aware of any problems or concerns the Member Cooperatives may have with the surcharge pass-through mechanism?

A. No.

Q. You previously stated that EKPC's surcharge mechanism reflects the base/current method. The Rate ES tariff currently reflects a BESF of 0.34%. Would you explain why EKPC is not proposing a new BESF value?

A. Under the base/current method, the BESF reflects the investment in utility plant and associated operating costs for environmental compliance assets being recovered through base rates that have been replaced or retired early due to the deployment of new environmental compliance assets whose costs are recovered through the environmental surcharge. A BESF of zero indicates there are no investments in utility plant or associated operating costs for environmental compliance assets being recovered through base rates. Primarily due to the environmental compliance plan amendment approved in Case No. 2017-00376, Project 16 – CCR/ELG Rule, EKPC has added new investments in utility plant which retired or replaced utility plant already being recovered in base rates. As those new investments in utility plant have gone into service, it was necessary to recognize the base rate component in the BESF. In addition, as a result of these new investments, EKPC reclassified a dozen employees to be identified specifically with the CCR/ELG work previously the expensed portion of those employees' salaries, payroll taxes, and benefits were recovered through base rates. These items have been addressed in the BESF of 0.34%. EKPC is not aware of any other items that warrant an update to the BESF.

Q. Does EKPC have a request concerning the timing of the issuance of the final Order in this surcharge review proceeding?

A. Yes. EKPC is requesting that the Commission issue its final Order in this case either within the first 10 days of the month or after the 21st day of the month. This is due to the processing procedure for the monthly surcharge factor filing and the critical processing period between the 11th and 20th of the month.

Q. Does this conclude your testimony?

A. Yes.