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April 21, 2009

EXPRESS MAIL

Mr. Jeff Derouen, Executive Director
Public Service Commission
P.O. Box 615
Frankfort, Kentucky 40602-0615

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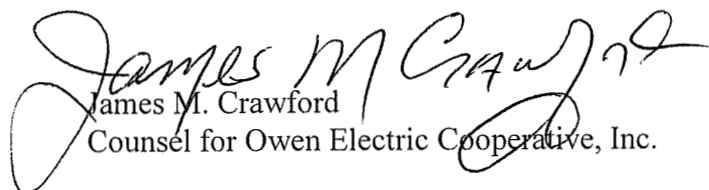
RE: **PSC Case No. 2008-00154**

Dear Mr. Derouen:

Please find enclosed for filing with the Commission an original and ten copies of Owen Electric Cooperative, Inc.'s brief in the above-captioned case.

Respectfully yours,

CRAWFORD & BAXTER, P.S.C.


James M. Crawford
Counsel for Owen Electric Cooperative, Inc.

JMC/mns

Enclosures

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

APPLICATION OF OWEN ELECTRIC)
COOPERATIVE, INC., FOR ADJUSTMENT OF) CASE NO. 2008-00154
RATES)

BRIEF FOR OWEN ELECTRIC COOPERATIVE, INC.

*** **

Comes Owen Electric Cooperative, Inc., (hereinafter referred to as "Owen Electric"), and for its Brief in support of its Application for an adjustment of certain rates in accordance with the proposed tariff filed with its Application, states as follows:

SUMMARY OF TESTIMONY

Owen Electric has approximately 57,000 rate paying members in its nine (9) county service area in Northern Kentucky. Owen Electric CEO Mark Stallons, Transcript of Evidence ("T.E.") at 13. It seeks a rate adjustment in four (4) classifications of service which will result in an annual increase in revenues of \$4,064,395.00. These classifications and the proposed increase in each classification is as follows:

CLASSIFICATION	CURRENT RATE	PROPOSED RATE
Farm and Home	\$ 5.64	\$ 11.20 ¹
Small Commercial	\$ 5.64	\$ 13.48 ²
Security Lights	\$ 5.51-14.43	\$ 7.71-14.43 ³

¹Reference is made to Owen Electric's Application at Exhibit C at 1.

²Reference is made to Owen Electric's Application at Exhibit C at 6.

³Reference is made to Owen Electric's Application at Exhibit C at 11.

Outdoor Lighting Service	\$	8.85-16.52	\$	9.34-17.45 ⁴
(Special Outdoor Lighting Service	\$	9.33-11.11	\$	12.13-14.44 ⁵)

The non-profit cooperative, owned by its members unlike an investor-owned utility, has not sought a rate increase since 1982 in Case No. 8618. Stallons Prefiled Testimony (hereinafter “PT”) at A-15. 2007 is the designated test year. Owen Electric’s purpose in seeking the rate adjustment is two-fold: first, to provide financial stability to the cooperative, and to ensure a TIER ratio of 2.0, and second, to change the retail rate design to promote energy innovation such as efficiency, conservation, demand response and distributed generation. Id. at.A-23.

Financial conditions at Owen Electric have substantially deteriorated since 2003. In that year, Owen Electric had a TIER of 4.3 and a margin of slightly over \$6.6 million. Owen Electric CFO Rebecca Witt, T.E. at 89. Starting in 2004, and continuing to the current year, both the cooperative’s TIER and margins have declined so that by the end of 2006 the TIER was only 1.28. Id. Under mortgaging agreements with Rural Utility Services (RUS) and the National Rural Utilities Cooperative Finance Corporation (CFC), Owen Electric is required to maintain a net TIER of 1.25, and an operating TIER of 1.1. Witt, PT at A. 10 For the 2007 test year, Owen Electric’s TIER was 0.78. T.E. at 173. At the end of 2008, TIER was 1.52, with a twelve (12) month average rolling TIER of 1.46. Witt, T.E. at 114. In addition, Owen Electric has to maintain adequate equity ratios and cash reserves. Witt, PT at A.10.

Owen Electric CFO Rebecca Witt explained that the declines in the cooperative’s margins and TIER can be attributed to four (4) factors. First, 2003 was the last year that Owen

⁴Reference is made to Owen Electric’s Application at Exhibit C at 45.

⁵Reference is made to Owen Electric’s Application at Exhibit C at 47.

Electric received a patronage capital allocation from East Kentucky Power Cooperative⁶, its generating and transmission wholesale power provider. Second, in 2005, Owen Electric was required to enter into a replacement all-requirements contract with a large industrial customer⁷ which resulted in margins being reduced from approximately \$950,000.00 down to \$350,000.00, so that between \$500,000.00 and \$600,000.00 in margins were lost. Third, in 2006, and again in 2007, Owen Electric experienced a decline in growth within its territory which had previously allowed its margins to be maintained. Fourth, the normal costs of doing business have increased since 2003. Id. at 90; 119.

The Cost of Service Study (“COSS”) performed by James R. Adkins and filed with the Application at Exhibit 32, confirms that Owen Electric’s rate schedules are not providing revenue sufficient to meet the cost of providing electricity for the rate classes for which an increase is sought. With the proposed rate increase, all rate schedules would be providing rate revenues greater than the costs of providing the service, with the exception of the three (3) outdoor lighting rate schedules. Adkins PF, Exhibit H-4 at A-11. For the “Farm and Home” and “Small Commercial” rates, it was determined that the increase in revenues should come from the consumer charge, Mr. Adkins testified. Id. at A-12. With the proposed increases in these classifications, Mr. Adkins confirmed that the ‘end result’ would allow Owen Electric to improve its financial condition, “better match”

⁶Owen Electric did receive a patronage capital credit allocation from East Kentucky Power in 2008 of \$969,000.00 which was in effect a ‘bookkeeping entry’ and did not result in cash to the cooperative. Witt, T.E. at 120.

⁷Reference is made to Gallatin Steel/OEC/EKPS Agreement for Electrical Service dated March 25, 2005, approved by the Kentucky Public Service Commission effective June 1, 2005, pursuant to 807 KAR 5:01-1, Section 9 (1).

its revenues with its costs for service of the listed classes, and make some improvement in the current rate design. Id. at A-13.

While increasing margins to a level that will provide adequate financial ratios for compliance with RUS and CFC is mandatory, at the same time, Owen Electric is cognizant that while its current retail rate design not only does not pay for the actual cost of service, it also fails to align the interest of the cooperative and its members with respect to energy innovation, efficiency, conservation, distributed generation and demand response efforts, Owen Electric CEO Mark Stallons testified. PT at A-24. While its current residential customer charge is \$5.64 per member per month, the actual cost of the service is \$21.92 per month. Id. Thus, the \$5.64 monthly charge does not even cover Owen Electric's member-related costs, let alone any of its margins.

Further, with the current rate design, Owen Electric collects all of its margins and a significant portion of its member related 'fixed costs', through an energy charge assessed on a kilowatt hour basis. Thus, if there is a reduction in kilowatt hour sales due to energy innovation, efficiency, conservation and/or a demand response efforts, the cooperative will not recover its 'fixed costs', and thus meet its margins, which is financially harmful to Owen Electric. Id. As CEO Stallons explained, "It is not reasonable to expect Owen Electric to aggressively pursue energy innovation such as conservation, energy efficiency, and demand response programs when every reduction in sales has a negative financial impact on Owen Electric." Id.

The link between sales of electricity, "fixed costs" and margin recovery is referred to in the industry as "throughput incentive." Id. In the past, utilities have had a financial incentive to increase retail sales of electricity to historic levels because the total sales of electricity were used in calculating the utility's base rates. There was a significant incremental fixed cost and margin

recovery as retail sales of electricity increased. For sales above the historic levels that were used for calculating all base rates, all revenue above the variable cost of producing the incremental kilowatt hours would be incremental revenue for a utility. Thus, utilities would maximize the ‘throughput’ of electricity across their wires in an attempt to increase fixed costs and margin recovery. Id.

CEO Stallons testified, “Similarly, utility profits decline when sales are below the historic levels that were used for calculating (the utility’s) base rates, which would result from energy innovation, efficiency, conservation and demand response efforts. Every (kilowatt) hour lost as a result of energy innovation programs reduces margins and diminishes financial stability, regardless (of) how cheap the energy innovation, efficiency, conservation or demand response efforts. The effect of this throughput disincentive is greater for distribution-only utilities, such as rural electric cooperatives, because the revenue impact of electricity sales reduction is disproportionately larger for utilities without generation resources. It is critical to address this throughput incentive if regulators want utilities to become actively involved in energy innovation” Stallons, PT at A-25.

The only way that a rural cooperative can mitigate the ‘throughput incentive’ is through a reasonable form of “decoupling” to allow it to increase its customer charge to a level that is justified based upon the cost of actually providing the electric service. Id. at A-26. This methodology would allow a constant stream of revenue for the cooperative that is not linked to the level of sales of electricity. Effectively, “(o)ne result of such a change is that the energy charge would be reduced as fixed cost and margin recovery was removed from the energy charge,” Stallons explained. As approximately twenty percent (20%) of a member’s bill is for Owen Electric’s expense from its own distribution facilities, and approximately eighty percent (80%) is for the energy

that the cooperative purchases from its supplier⁸, reducing its members' usage has the potential to generate significant reductions in a individual member's energy bill. Id. Thus, allowing Owen Electric to 'decouple' its revenues from its kilowatt sales would result in its being financially able and willing to aggressively pursue innovative energy reduction methods. Id.

Indeed, Owen Electric has already demonstrated its commitment in pursuing energy innovation, conservation, efficiency and demand response to help its members become more energy efficient. From educational programs, to its distribution of compact fluorescent light bulbs, to the performance of energy audits available to all of its customers, to its offer of rebates on energy efficient home building practices and existing home improvements, Owen Electric has taken the initiative to educate and encourage its members about the importance of reducing electricity usage. As a part of its 2009 Strategic Plan, Owen Electric will continue its commitment by developing an energy innovation plan to accomplish ten (10) separate objectives⁹ incorporating The Energy Innovation Paradigm prepared by the Rural Electric Managements Development Council (REMDC). At the same time, it has partnered with East Kentucky Power to develop a comprehensive energy innovation plan that deals with all aspects of energy, including participating in a pilot project called 'Button Up' in which Owen Electric has made ten (10) residences more-energy efficient through sealing and caulking windows, and insulating attics and basements. At a cost to Owen Electric of approximately \$500.00 for each residence, the project may result in savings of as much as 500 kilowatt hours per home per month. Stallons, T.E. at 39. Thus, for Owen Electric to financially

⁸Reference is made to COSS at Exhibit 32.

⁹Reference is made to Owen Electric's Response to the Third Supplemental Response of the Attorney General Item No. 3 at page 3.

participate in energy innovative programs, and cognizant of anticipated federal climate change legislation, continuing rising fuel costs, and increased construction costs for new generation facilities, it is imperative that its customer charge be realigned to the cooperative's 'fixed costs' to \$11.20 per member per month. Stallons, PT at A-38.

ARGUMENT

I.

OWEN ELECTRIC'S PROPOSED RATE INCREASE IS JUST AND REASONABLE

A. OWEN ELECTRIC HAS MET ITS BURDEN OF PROOF THAT A RATE INCREASE SHOULD BE APPROVED

KRS 278.190(3) provides that the utility seeking a new schedule of rates has the burden of proof to show that the increased rate is 'just and reasonable'. While those terms are not defined by the statute, the Fifth Amendment of the Constitution protects utility companies from being limited to a charge that is so 'unjust' as to be confiscatory, and allows the Kentucky Public Commission the flexibility to determine what means best suits its needs in balancing the interest of the utility and the public. See, Duquesne Light Co. Vs. Barasch, 488 U.S. 299 (1989).

Indeed, the COSS filed by Owen Electric confirms that a rate adjustment is required as the cost of producing electricity for the four (4) classifications for which the increase is sought exceeds the charge currently in effect for those classes. All other rate classes are providing rate revenues in excess of the costs to serve. Adkins PF at Exhibit H-4 at Q 8. As the income produced by the rates being charged in these four (4) classes, which impacts the vast majority of Owen Electric's customers, is insufficient to pay the expenses incurred, it comes as no surprise that Owen Electric's financial condition has been on a downhill slide since 2003. The resultant declining

TIERS and margins now jeopardize Owen Electric's mortgage agreements with RUS and CFC which mandate a TIER of 1.25 and an operating TIER of 1.1. Id. at Q 6. Notably, for the 2007 test year, the TIER had dropped to 0.78. Accordingly, the Commission should approve Owen Electric's Application for adjustment of rates in the four (4) requested classifications so that the actual cost of providing electricity to those classes is borne by the users of that electricity.

B. ACTUAL EXPENDITURES OF THE UTILITY WERE USED FOR RATEMAKING PURPOSES

The Attorney General has taken exception to certain of Owen Electric's expenses for ratemaking purposes. KRS 278.192(2)© explains that the 'actual expenditures of the utility' incurred for ratemaking purposes are subject to review by intervening parties. For the test year 2007, Owen Electric had actual expense for interest paid on its short term debt. The position of the Attorney General, however, that Owen Electric's short term debt expense should not be considered an allowable expense for ratemaking purposes, is not supported by the testimony before the Commission.

Indeed, in Owen Electric's application the short-term debt cost rate of 6.4 percent to the test year short-term balance of \$5.7 million resulted in an annualized short-term debt interest expense of \$366,140.00. Zumstein, T.E. at 139. The Attorney General questioned why the rate increase would not result in the repaying of the short-term debt, so as to reduce the annual short-term debt interest. While in most cases, CPA Alan Zumstein explained, a rate increase will repay the short-term debt, in Owen Electric's case "... their short-term debt continued to escalate and even if they would have had their rate increase in effect (on) January the first of that year, (Owen Electric) would not have paid off their short-term debt...." In fact, Mr. Zumstein continued, "...(T)he fact is

(short term debt) increased over \$10 million, and with the rate increase (Owen Electric) still would have borrowed short-term money.... (T)he fact is, in October of 2008, they advanced \$7 million of long-term loans to repay short-term borrowings, and, at the end of December (2008) (Owen Electric) still had about \$5.7 million of debt.” Id. at 140-141. Thus, Owen Electric’s position that its short term debt interest would continue after the test year was correct. Id. Accordingly, as the short term debt interest is a recurring expense, it should be allowable for ratemaking purposes.

Further, the Attorney General has alleged that Owen Electric’s payment of interest on customer deposits should not be an allowable expense for ratemaking purposes, citing the Commission’s Order in Delta Natural Gas Company, PSC Case Number 99-176. However, as Delta Natural Gas is an investor-owned utility not subject to the same RUS and CFC requirements as Owen Electric, this Order cannot support the Attorney General’s claim.

Owen Electric acknowledged that interest on customer deposit was listed as an expense for the 2007 test year at \$130,051.00. Alan Zumstein, T.E. at 133. KRS 278.460 (1) requires Owen Electric to pay interest at six percent (6%) annually on deposits by customers to secure their utility services. “Companies covered by this (statute) must pay customer or credit customer’s bill with interest on customer’s deposit at the rate of 6% per annum” Commonwealth vs. Kentucky Power & Light Company, Ky. 77 S.W.2d 395 (1934). Further, the customer deposits are carried on Owen Electric’s books as a ‘current liability’ of the cooperative rather than income, as they are intended to serve as security and not prepayment of income. Zumstein, T.E. at 134; See, C.I.R. vs. Indianapolis Power & Light Company, 493 U.S. 203 (1991).

At the same time, Owen Electric’s TIER and OTIER requirements and their mortgage times interest earned ratio both include interest on customer deposits as part of the

expenses to arrive at its mortgage covenants. Zumstein, T.E. at 136. As Alan Zumstein, Owen Electric's Certified Public Accountant consultant explained, "As (interest on customer deposits) expenses are a part of (Owen Electric's) TIER requirements, I don't know how they can be excluded for ratemaking purposes for Owen Electric in this case." Similarly, Owen Electric's consultant James Adkins testified that he was unaware of any rural electric cooperative case where the consumer deposit interest has been disallowed by the Commission. Adkins, T.E. at 170. As the Attorney General has no Commission precedent in which a rural electric cooperative has been prevented from claiming as an expense interest on customer deposits, the Commission should not exclude those sum for ratemaking purposes.¹⁰

C. ADJUSTMENTS TO TEST YEAR WERE ACKNOWLEDGED

In preparing for the Commission hearing, it came to the attention of Owen Electric's staff that there needed to be adjustments to the 2007 test year expenses totaling \$34,222.00. These adjustments reflect the following items:

1. Advertisement for home-town cooperative \$1,267.00¹¹;
2. Advertisement for Balloon Glow \$1,267.00¹²;
3. Dues for civic organizations \$693.00¹³

¹⁰There is no Commission order that specifically excludes as an expense for ratemaking purposes in rural electric cooperatives' rate cases interest on customer deposits. In the last two rural electric cooperative cases that went to hearing before the Commission, namely Meade County and Cumberland Valley, in neither case was the interest on customer deposits disallowed.

¹¹Referred to in Answer to Attorney General First Request, response to question #25

¹²Id.

¹³Id.

4. Advertisement for Halloween safety \$800.00¹⁴
5. Youth Tour expenses \$4,800.00¹⁵
6. Sponsorships for communities \$1,000.00¹⁶
7. Director expense, KAEC Hotel \$1,780.00¹⁷
8. Director expense, Congressional Meeting \$1,079.00¹⁸
9. Director expense, Congressional Meeting \$4,287.00¹⁹
10. Advertising expense \$850.00²⁰
11. Key Accounts Outing \$15,221.00²¹
12. Donations \$100.00²²
13. Dues \$1,078.00²³

Owen Electric acknowledges that these expenses should be adjusted to the 2007 test year.

¹⁴Id.

¹⁵Id.

¹⁶Id.

¹⁷Response to Attorney General Second Request at 8.

¹⁸Id.

¹⁹Id.

²⁰Response to Attorney General Second Request at 2.

²¹Id.

²²Response to Attorney General Second Request at 10.

²³Id.

II.

OWEN ELECTRIC'S RATE DESIGN IS FAIR TO ITS MEMBERS AND PROMOTES ENERGY EFFICIENCY

A. THE PROPOSED RATE DESIGN SHOULD BE APPROVED BY THE COMMISSION

Owen Electric's proposed rate design begins to cure the defects in its current rate design which resulted in significant under-recovery of revenue for the four (4) designated rate classes for which adjustments are now sought. Only the rate classes that should receive an increase are those rate classes which result in rate revenues substantially less than what Owen Electric should be recovering for the cost of providing electricity to those users. Adkins, PF at Exhibit H-4 at Q 9-10. As all other rate classes are providing rate revenues in excess of the costs to serve those users, there is no justification to increase the rates of other classifications. Id.

Moreover, reducing the customer charge or maintaining it at or near its present levels and recovering these costs through a kilowatt hour charge would cause continued financial problems for the cooperative. As CEO Stallons explained, "If some of the costs of the minimum system necessary to provide a member with access to the electric grid are recovered through a kilowatt charge rather than through a customer charge, members who use a small amount of electric energy would not pay the costs that they impose on the system and would receive a subsidy from members who use a lot of electricity. With these fixed costs recovered through the kilowatt charge, the cooperative would recover more fixed costs than actually needed when weather was extremely hot or cold and kilowatt sales were high. (At the same time) the cooperative would recover less fixed cost than it needed when the weather was mild and kilowatt sales were low. Rather than making bets on weather, a better outcome for both the cooperative and its members is for the cooperative to

recover these fixed costs through a fixed monthly charge that does not vary with kilowatt sales and with the weather. Stallons, PF at A. 29.

Further Owen Electric's commitment to energy efficiency is best supported by allowing the cooperative to recover a significant amount of its fixed costs through a monthly energy charge as opposed to an energy charge on kilowatt hours. If fixed costs continue to be recovered through sales of kilowatt hours, then the cooperative loses its incentive to have energy innovation, efficiency, conservation, distributed generation and demand response programs, as the decreased sales of electricity will harm the cooperative financially. Allowing Owen Electric to recover its fixed costs through the monthly customer charge would enable it to recover fixed costs regardless of the level of kilowatt sales, and would enable the cooperative to become even more aggressive in assisting its members with energy reduction efforts without harming itself financially.

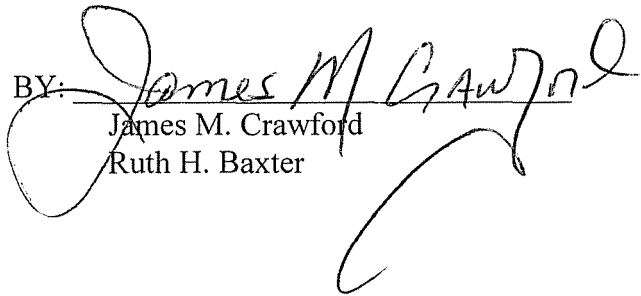
At the same time, the customer/member would not only benefit by being more energy conscience, but would save money on monthly electric bills. As approximately 80% of a member's bill is a direct result of the cost to Owen Electric for energy from its generation and transmission supplier, the customer's energy efficiency will reduce his kilowatt hours thus allowing the customer financial savings. At the same time, Owen Electric will not require as much power from its supplier, East Kentucky Power, and therefore new expensive facilities for transmission and distribution will not be needed. Thus, Owen Electric's proposed rate design of increasing the customer's monthly charge to better cover the cost of electric service, as opposed to recovering costs through a kilowatt hour charge, becomes a 'win - win' for both Owen Electric and its members.

CONCLUSION

For the reasons cited herein, Owen Electric Cooperative, Inc., requests the Public Service Commission of Kentucky to grant its Application for an adjustment of rates in accordance with its proposed tariff filed with its Application. In the event, however, that the Commission makes reductions to its Application, any such reductions should be applied to the energy rate charge.

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CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of the foregoing Brief for Owen Electric Cooperative Corporation was mailed postage pre-paid on this the 21st day of April, 2009, to:

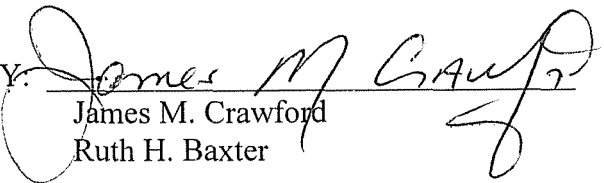
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