COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF EAST KENTUCKY POWER COOPERATIVE, INC. FOR AN ORDER APPROVING ACCOUNTING PRACTICES TO ESTABLISH A REGULATORY ASSET RELATED TO CERTAIN REPLACEMENT POWER COSTS RESULTING FROM GENERATION FORCED OUTAGES	)))))))	CASE NO. 2008-00436

ORDER

On October 9, 2008, East Kentucky Power Cooperative, Inc. ("East Kentucky") filed an application seeking authority to establish a regulatory asset for its unrecovered replacement power costs related to the forced outages of its generating units during calendar year 2008 that are not eligible for recovery through East Kentucky's fuel adjustment clause ("FAC").[1] Finding that East Kentucky's precarious financial condition constitutes an extraordinary circumstance that warrants the establishment of a regulatory asset, the Commission, by a majority, will grant the request.

BACKGROUND

East Kentucky requests that its 2008 unrecovered replacement power costs be treated as a regulatory asset, to be amortized over three years. It states that it has incurred non-FAC-recoverable replacement power costs of $12.3 million through

[1] 807 KAR 5:056, Section 1(12) limits recovery of forced outage replacement power costs to the fuel costs associated with the lost generating unit, unless the outage is the result of Acts of God, riot, insurrection or acts of the public enemy.

November 2008.[2] It further states that, subject to approval by the Commission of its request to create a regulatory asset, East Kentucky plans to seek recovery of the resulting amortization expense in its pending rate case, Case No. 2008-00409.[3] In order to address its potential shortfall in net margins for calendar year 2008 prior to closing its books for the year, East Kentucky requested expedited review of its application.

East Kentucky explains that in order to comply with the Debt Service Coverage ("DSC") requirement contained in its Private Credit Facility Agreement, it must realize net margins for calendar year 2008 of approximately $22 million.[4] Based on preliminary estimates, East Kentucky originally projected net margins for calendar year 2008 of $16.8 million.[5] As time has passed, East Kentucky now estimates that its total net margins for calendar year 2008 will only be $13 million, absent approval of its request to establish a regulatory asset.[6] If East Kentucky does not meet the debt covenants in its Private Credit Facility Agreement, the creditors may place East Kentucky in default and refuse to advance additional funds under the $650 million Private Credit Facility

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[2] East Kentucky's December 11, 2008 Response to Commission Staff's Third Data Request, Item 1, p. 1 of 1.

[3] Case No. 2008-00409, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., filed October 31, 2008.

[4] East Kentucky is not at risk of a default, based on its projected 2008 financial results, under the terms (specifically, the definition of net margins) contained in the mortgage agreements with its primary lender, the Rural Utilities Service.

[5] East Kentucky's October 9, 2008 Application, Direct Testimony of Ann F. Wood, Exhibit AFW-2, p. 1 of 2.

[6] East Kentucky's December 11, 2008 Response to Commission Staff's Third Data Request, Item 2(b), pp. 2 and 3 of 4.

Agreement. A default would also allow the creditors to call the amount outstanding, meaning the entire outstanding balance, to be due and payable immediately. East Kentucky states that it could seek a waiver from the creditors, the cost of which it estimates would likely be in the range of $1.5 to $2.0 million in legal fees and waiver fees.[7] It also estimates that its current commitment fee of 17.5 basis points could be doubled or tripled under a grant of waiver, while its current interest rate of 82.5 basis points over the London Inter-Bank Offer Rate ("LIBOR") could increase to anywhere between 350 to 600 basis points over LIBOR.[8]

The only intervenor in this matter is Gallatin Steel Company, which does not oppose the application.[9] A procedural schedule was issued which provided for discovery and the opportunity for the parties to request either a formal hearing or an informal conference. East Kentucky submitted direct testimony and responded to three rounds of discovery issued by Commission Staff. No requests for a hearing or informal conference were received and the case stands submitted for decision.

DISCUSSION

Establishment of a Regulatory Asset

A regulatory asset is created when a rate-regulated business is authorized by its regulatory authority to capitalize an expenditure that under traditional accounting

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[7] East Kentucky's October 9, 2008 Application, Direct Testimony of Ann F. Wood, p. 6.

[8] East Kentucky's November 17, 2008 Response to Commission Staff's Second Data Request, Item 3, p. 2 of 3.

[9] Gallatin Steel Company's December 18, 2008 Comments.

rules would be recorded as a current expense. The reclassification of an expense to a capital item allows the regulated business the opportunity to request recovery in future rates of the amount capitalized. The authority for establishing regulatory assets arises under the Commission's plenary authority to regulate utilities under KRS 278.040 and the Commission's authority to establish a system of accounts under KRS 278.220. Historically, the Commission has exercised its discretion to approve regulatory assets where a utility has incurred: (1) an extraordinary, nonrecurring expense which could not have reasonably been anticipated or included in the utility's planning; (2) an expense resulting from a statutory or administrative directive; (3) an expense in relation to an industry sponsored initiative; or (4) an extraordinary or nonrecurring expense that over time will result in a saving that fully offsets the cost.[10]

East Kentucky's request to create a regulatory asset in the amount of its non-FAC-recoverable forced outage replacement power costs is based upon its need to achieve a 2008 DSC ratio that allows it to avoid a default under the terms of its Private Credit Facility Agreement. As Commissioner Clay's dissent points out, East

[10] Case No. 2008-00456, Application of Louisville Gas and Electric Company for an Order Approving the Establishment of a Regulatory Asset; Case No. 2008-00457, *Application of Kentucky Utilities Company for an Order Approving the Establishment of* a Regulatory Asset; Case No. 2008-00308, Joint Application of Duke Energy Kentucky, Inc., Kentucky Power Company, Kentucky Utilities Company and Louisville Gas and Electric Company for an Order Approving Accounting Practices to Establish Regulatory Assets and Liabilities Related to Certain Payments Made to the Carbon Management Research Group and the Kentucky Consortium for Carbon Storage; and Case No. 2001-00169, Joint Application of Louisville Gas and Electric Company and Kentucky Utilities Company for an Order Approving Proposed Deferred Debits and Declaring the Amortization of the Deferred Debits to Be Included in Earnings Sharing Mechanism Calculations.

Kentucky concedes that these costs are not extraordinary in nature. Nor do they arise from any statutory or administrative directive or industry-wide initiative. However, in exercising discretion to allow the creation of a regulatory asset, the Commission's overarching consideration is the context in which the regulatory asset is sought to be established and not necessarily the specific nature of the costs incurred.[11]

Here, the exigency of East Kentucky's request to establish a regulatory asset is magnified by the overall financial condition of the utility. East Kentucky must realize net margins of approximately $22 million for calendar year 2008. Its failure to do so will – at best – result in significant penalties, higher interest expense costs, and diminished access to capital markets. As the Commission noted less than two years ago in East Kentucky's last general rate case, there is a clear nexus between costs associated with forced outages and credit-worthiness:

> As demonstrated by the outage of the Spurlock No. 1 unit in 2004, the costs of purchasing power are generally higher than generating power. In the event that [East Kentucky] is forced to purchase power in any significant amounts, its credit-worthiness will certainly be an issue.[12]

It is the regulator's duty to employ every lawful and reasonable tool available

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[11] This matter is not entirely dissimilar from that of Big Rivers Electric Corporation in Case No. 2007-00177, in which Big Rivers sought, and received, a certificate of convenience not due to an operational need for a new transmission line, but because the ability to install such a line was needed to demonstrate to creditors and credit rating agencies that it had a contingency plan in place that would permit it to export the power currently supplied to two aluminum smelters to other utility systems, in the event the smelters' demand for electricity were to substantially decrease.

[12] Case No. 2006-00472, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., Interim Order, p. 6 (Apr. 1, 2007).

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

Other considerations support this finding. We note that our historic authorization of requests to establish regulatory assets has typically been in response to requests by investor-owned utilities ("IOU") rather than that of a cooperative utility. Unlike an IOU, East Kentucky has no shareholders to absorb costs associated with purchasing power as a result of forced outages. The financial consequences of a default will fall squarely upon East Kentucky's member distribution cooperatives and, ultimately, upon the residential, commercial, and industrial ratepayer members of those distribution cooperatives.

While we agree with Commissioner Clay that a general rate case is typically the most appropriate forum for taking into account the costs associated with a proposed regulatory asset,[13] we simply note that, even if East Kentucky had sought interim rate relief in its pending general rate case, any relief which might have been

[13] East Kentucky referenced the Commission's approval of the recovery of forced outage costs for the 2004 Spurlock 1 outage in Case No. 2006-00472 in support of its application. Those costs were not approved as a regulatory asset but, rather, were fully considered in the context of a general rate case. In addition, the Commission was very clear in that case that approval of the Spurlock 1 costs was specifically based on the magnitude of the costs and the extraordinary nature of the forced outage event.

awarded would have been too minimal at this point in the year to materially affect East Kentucky's 2008 DSC calculation. The very purpose of a regulatory asset is to provide a utility with a measure of relief outside the context of a general rate case when circumstances – such as material credit challenges and potential insolvency – warrant.

We conclude that it is in the best interests of East Kentucky, its member cooperatives, and the retail customers of those member cooperatives for it to satisfy the requirements of the debt covenants in its Private Credit Facility Agreement. The Commission finds that the regulatory asset authorized herein should be for the full amount of the actual non-FAC-recoverable replacement power costs incurred by East Kentucky through November 30, 2008, which is $12.3 million. We will also require East Kentucky to submit the accounting entries it makes to record the regulatory asset.[14]

Comprehensive Management Audit

Though a majority of the Commission finds that East Kentucky should be authorized to establish the regulatory asset, we are sympathetic to the opinion of Commissioner Clay as expressed in his dissent. In granting East Kentucky interim rate relief during the pendency of its last general rate case we stated:

> As a general matter, prudently managed utilities will not willingly place themselves in a position where interim rate relief during the suspension period is necessary to avoid a material impairment of the utility's credit or operations. This

[14] East Kentucky shall file its accounting entries in the record of its pending rate general rate case, Case No. 2008-00409.

> is especially true of rural electric cooperative corporations. KRS 279.095 provides that a cooperative "shall be operated on a nonprofit basis for the mutual benefit of its members and patrons." While low rates are desirable, this must be balanced against the necessity that a cooperative remain financially and operationally viable.[15]

Recognizing that East Kentucky was in a period of management transition, we further stated, "Although the Commission recognizes and appreciates the commitment of EKPC's new management to reduce costs wherever possible, such reductions, at least in the short term, will be insufficient to reverse its credit impairment."[16] The facts of this case underscore this continuing concern. It is altogether unclear that East Kentucky has, as of yet, arrested the deterioration of its financial condition. That question will be thoroughly addressed in the context of East Kentucky's pending general rate case.

The larger question is whether East Kentucky is fully committed to reversing its weakening financial condition. Ultimately, the responsibility for East Kentucky's viability lies firmly within the province of its board of directors, who have a fiduciary duty to safeguard the financial and operational viability of the cooperative. The Commission cannot and should not usurp the directors' duty to make business judgments, but as the statutorily created regulatory authority, it also cannot and should not turn a blind eye to a situation which does not appear to be getting better. In East Kentucky's last general rate case, we anticipated the conflict inherent in the director's fiduciary duties:

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[15] Case No. 2006-00472, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., Interim Order, pp. 2-3 (Apr. 1, 2007).

[16] Id., p. 8.

> Unlike an investor-owned utility where the equity owners of the utility may or may not also be customers of the utility, an RECC is governed and owned by its members, who are also its customers. While members of the 16 member systems have an interest in keeping their distribution cooperative's rates as low as possible, they also have an interest in keeping their distribution cooperative's equity position in EKPC viable. The directors of [East Kentucky] – who generally are also officers and directors of the 16 member systems – have an obligation to either seek an increase or decrease in [East Kentucky]'s base rates when the balance between low rates for end users and sufficiently high rates to keep [East Kentucky] viable falls out of equilibrium. Though there is a constant friction between these interests, it is one [East Kentucky]'s board members voluntarily undertake. [17]

Pursuant to the authority set forth in KRS 278.255, the Commission will direct East Kentucky to submit to a comprehensive management audit. This audit will have a special focus upon the involvement of its board of directors in the strategic planning, decision-making and management of East Kentucky. In order to mitigate any further financial hardship to East Kentucky, the Commission will take the costs of this comprehensive management audit into account in our review of the record in East Kentucky's pending general rate case.

FINDINGS OF FACT

The Commission, by a majority, having considered the evidence of record and being otherwise sufficiently advised, finds that:

1. East Kentucky's request for authority to establish a regulatory asset based on the amount of its non-FAC-recoverable replacement power costs for 2008 is reasonable, under the circumstances unique to this case and should be approved.

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[17] Case No. 2006-00472, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., Final Order, pp. 26-27 (Dec. 5, 2007).

2. East Kentucky may establish a regulatory asset in the amount of $12.3 million for its non-FAC-recoverable replacement power costs.

3. East Kentucky shall file with the Commission the accounting entries it makes to establish and record the regulatory asset. East Kentucky shall file these entries in the record of Case No. 2008-00409 within 10 days of the date of this Order.

4. The issues of amortization and rate recovery of the regulatory asset authorized by this Order will be considered in Case No. 2008-00409.

5. East Kentucky will be subject to a comprehensive management audit. The scope of the management audit will be comprehensive, but shall specifically examine the involvement of its board of directors in the strategic planning, decision-making and management of East Kentucky.

IT IS THEREFORE ORDERED that:

1. East Kentucky is authorized to establish, for accounting purposes, a regulatory asset in the amount of $12.3 million based on the non-FAC-recoverable replacement power costs incurred in conjunction with the forced outages of its generating units during the first 11 months of 2008, consistent with the findings in this Order.

2. East Kentucky shall file the accounting entries it makes to establish and record the regulatory asset in Case No. 2008-00409 within 10 days of the date of this Order, as described in Finding No. 3 of this Order.

3. Amortization of the asset and rate recovery of the resulting expense shall be reserved for consideration in East Kentucky's pending base rate case, Case No. 2008-00409.

4. East Kentucky shall be subject to a comprehensive management audit as set forth in Finding No. 5 of this Order.

Done at Frankfort, Kentucky, this 23rd day of December, 2008.

By the Commission

DISSENTING OPINION OF
COMMISSIONER JOHN W. CLAY

Although I agree with Chairman Armstrong and Vice Chairman Gardner with regard to the comprehensive management audit, I respectfully dissent on the question as to whether East Kentucky should be authorized to establish a regulatory asset. East Kentucky's testimony and data responses both state that its 2008 forced outage replacement power costs are not unusually high.[18] As such, its request is in no way related to an abnormal, extraordinary, or unprecedented event. East Kentucky's

[18] East Kentucky's October 9, 2008 Application, Direct Testimony of Ann F. Wood, p. 2. Also, East Kentucky's October 31, 2008 Response to Commission Staff's First Data Request, Item 2, p. 1 of 1, which states "[t]hose 2008 costs are not unusually high, in that they do not result from an abnormally high system generation outage rate or a higher than normal market price for replacement power."

failure to achieve the margins necessary to satisfy the DSC requirement in the Private Credit Facility Agreement is not the direct result of the subject forced outages. In fact, it is evident from the record that East Kentucky's request for Commission authority to establish the proposed regulatory asset is based more on its desire to remove expenses from its 2008 financial statements than on the appropriateness of establishing the regulatory asset for the unrecovered forced outage replacement power costs.

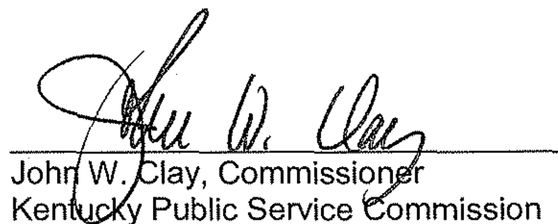
The circumstance in which East Kentucky finds itself is inconsistent with the circumstances which the Commission has historically found justify the creation of a regulatory asset. Establishing a regulatory asset for costs that are otherwise normal, routine, and ordinary establishes a dangerous precedent. Just because the Commission has discretion to approve a regulatory asset, it should not always exercise that discretion.

The majority opinion relies to some extent upon the Commission's Order granting interim rate relief in East Kentucky's last rate case. Even there, however, the Commission noted that "the positive margin EKPC produced in 2006 is largely a product of its revised depreciation schedule and its AFUDC accounting."[20] East Kentucky's financial difficulties are fundamental in nature and no use of unacceptable accounting principles or tricks will ultimately solve the problem. The Commission's decision will keep East Kentucky's creditors at bay for at least one more year, but it will not resolve

[20] Case No. 2006-00472, General Adjustment of Electric Rates of East Kentucky Power Cooperative, Inc., Interim Order, p. 6 (Apr. 1, 2007).

the underlying financial problems. The appearance that all is well could create a disincentive for needed reform.

I understand that East Kentucky is in a fragile financial condition and that it has been the subject of one financial condition investigation and two general rate cases over the past three years. Nevertheless, I believe it to be improper to grant the requested relief without evidence to support the extraordinary nature of the costs. Regulatory assets should not be established to allow a utility to adjust its year-end numbers to reflect a certain financial outcome, which could be viewed as misleading. As stated in the majority's opinion, East Kentucky presently has a rate case pending before the Commission. Pursuant to KRS 278.190(2), East Kentucky may request interim rate relief in that case if it believes that its financial condition will be materially impaired. That is the appropriate forum for allowing East Kentucky to satisfy its creditors' long-term concerns.



John W. Clay, Commissioner
Kentucky Public Service Commission

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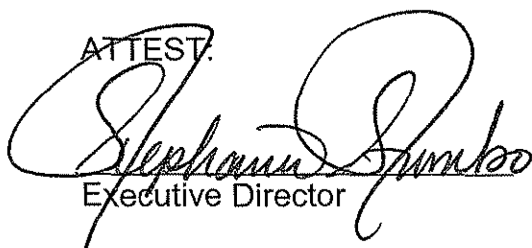

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