BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE CONSIDERATION OF INNOVATIVE APPROACHES TO RATEBASE RATE OF RETURN RATEMAKING INCLUDING, BUT NOT LIMITED TO, ANNUAL EARNINGS REVIEWS, FORMULA RATES, AND INCENTIVE RATES FOR JURISDICTIONAL ELECTRIC AND NATURAL GAS PUBLIC UTILITIES	)	DOCKET NO. 08-137-U

INITIAL COMMENTS OF THE ELECTRIC COOPERATIVES OF ARKANSAS

Pursuant to Order No. 1 in this Docket, the Electric Cooperatives of Arkansas[1] ("Electric Cooperatives") submit their Initial Comments regarding the Arkansas Public Service Commission's ("Commission") consideration of innovative approaches to utility regulation. The Electric Cooperatives appreciate the Commission's consideration of these timely issues and the opportunity to provide comment.

I. Overview of the Electric Cooperatives' Position

Like the Commission, the Electric Cooperatives also observe a growing national interest among regulators and regulated utilities to explore innovative approaches to utility regulation. The Electric Cooperatives believe that much of this interest is fueled by the increased risk of providing additional, capital intensive, generating and

[1] Arkansas Valley Electric Cooperative Corporation; Ashley-Chicot Electric Cooperative, Incorporated; C&L Electric Cooperative Corporation; Carroll Electric Cooperative Corporation; Clay County Electric Cooperative Corporation; Craighead Electric Cooperative Corporation; Farmers Electric Cooperative Corporation; First Electric Cooperative Corporation; Mississippi County Electric Cooperative, Inc.; North Arkansas Electric Cooperative, Incorporated; Ouachita Electric Cooperative Corporation; Ozarks Electric Cooperative Corporation; Petit Jean Electric Cooperative Corporation; Rich Mountain Electric Cooperative, Incorporated; South Central Arkansas Electric Cooperative, Incorporated; Southwest Arkansas Electric Cooperative Corporation; Woodruff Electric Cooperative Corporation; and Arkansas Electric Cooperative Corporation

transmission facilities. If innovative approaches to regulation result in more timely and certain cost recovery, the financial markets will respond with improved credit availability and better credit ratings. For a utility borrowing in the private financial market, improved credit ratings result in lower borrowing costs, which translate into a reduced cost of service for retail members.

II. Current Industry Challenges

The level of challenge currently facing the electric industry has not been equaled since the 1970s and early 1980s. Many of the issues that plagued the industry during those decades exist again: rising fuel costs, fuel scarcity, increasing demand for electricity and the resulting need for new generation, inflation, and credit difficulties. As the electric industry begins the twenty-first century, the industry and its regulators must not forget the lessons of the past but also must strive to find new and innovative solutions for the future. The industry must continue to supply the same safe, reliable, and affordable electric service that greatly improved the standard of living for Americans during the twentieth century.

The Electric Cooperatives believe that the industry's greatest challenge is the development of a new era of base load generation. New generation is needed to meet an ever increasing demand for electricity. While energy efficiency and demand response may slow the rate of growth in electric consumption, they cannot stop it. A growing population, combined with new products, such as plug-in electric vehicles, plasma televisions, and increasingly efficient and economical space heating options, will make load growth inevitable.

At the same time, the United States must make improvements to the transmission infrastructure that are necessary to take full advantage of wholesale markets and to move renewable energy from the site of generation to load centers. This need for investment is occurring during a time of unprecedented global competition for the resources necessary to support expansion. Recent upheavals in the financial markets may make infrastructure improvement efforts even more difficult.

Environmental issues also pose major challenges to the industry. Current environmental requirements increase the cost of electricity, but these environmental costs may be dwarfed if carbon constraint legislation is imposed. While many see renewable generation as a solution to environmental problems, renewable resources are not adequate sources of dependable capacity and are typically more expensive than thermal generation. Ratepayers must ultimately decide their willingness to pay for such renewable resources.

II. Legislative Recognition of the Challenge

The Electric Cooperatives believe that the Arkansas Legislature recognized the significant challenges facing the electric industry when it passed Ark. Code Ann. § 23-18-107. With the passage of § 23-18-107, the Arkansas Legislature provided the Commission with a means of exploring innovative ratemaking. Section 23-18-107 states:

> (a) The Arkansas Public Service Commission may adopt ratemaking policies appropriate to allow utilities to recover from their customers the reasonable and prudent costs and a reasonable return associated with the acquisition or construction by electric utilities of incremental resources.

III. Electric Cooperatives' Financing

This Docket is particularly well timed for the Electric Cooperatives. Historically the Electric Cooperatives have relied on the Rural Utilities Service ("RUS") for loans and

loan guarantees through the Federal Financing Bank for major plant investment. While this source of borrowing may continue to be available for certain projects, the RUS has stated that loan guarantees for base load generation will not be available for the remainder of 2008 and 2009. While the Electric Cooperatives do not know RUS' future intent with regard to financing base load generation beyond 2009, the Electric Cooperatives must place themselves in the best possible position to, if necessary, enter the private financial markets. In private financial markets, financial strength and timely cost recovery improve credit ratings and lower the cost of borrowing.

IV. Historical Innovation

While the Electric Cooperatives understand the Commission's desire to establish a dialogue regarding new and innovative approaches to utility regulation, the Electric Cooperatives believe that a brief review of certain past innovations may be useful.

In the past, the Commission has considered and adopted a number of innovative approaches to traditional regulation. While some of these approaches now seem common place, it must be remembered that even these approaches were once new and innovative.

One example of historical innovation is Arkansas Electric Cooperative Corporation's ("AECC") "Fuel and Purchased Energy Adjustment Rider" (most recently approved by the Commission in Docket No. 08-010-U). This rider allows AECC to recover the cost of purchased (a) economy energy; (b) replacement energy; (c) emergency energy; (d) headwater benefits; and (e) fuel burned in its generating plants. The current Fuel and Purchased Energy Adjustment Rider provides AECC with the necessary cost recovery mechanism to search the regional wholesale energy markets and purchase the most economical wholesale energy available. In turn, AECC's members use

their wholesale power and energy cost adjustment riders to pass these reduced energy costs through to their retail members. In addition, such energy adjustment riders have the added benefit of sending a correct price signal to retail consumers during periods when fuel and purchased energy costs are more or less expensive.

Another innovative rate design approved for certain retail electric cooperatives is the cost of debt adjustment rider. These riders provide participating retail electric cooperatives with a means of adjusting their revenues to reflect changes in interest expense.

While these riders are particularly important to the Electric Cooperatives, the Commission has allowed other utilities to use different cost recovery riders to meet their specific needs. A few examples are nuclear decommissioning, energy efficiency, capacity acquisition, and economic development.

Cost recovery riders have aided the utilities and the Commission in avoiding needless and expensive rate case proceedings under Section 9 of the Commission's *Rules of Practice and Procedure* ("Section 9"), thus reducing utility regulatory costs which must be passed on to consumers.

Another innovative approach allowed by the Commission is reflected in Docket No. U-2811. Docket No. U-2811 allows retail electric cooperatives to revise their retail rates to reflect changes in their wholesale electric supplier's wholesale rate(s) without a Section 9 rate case proceeding. While providing full regulatory review and approval for the Commission, Docket No. U-2811 has avoided countless burdensome and expensive Section 9 filings, thus saving retail ratepayers hundreds of thousands of dollars in regulatory expense.

Another innovative approach allowed for electric cooperatives was TIER (Times Interest Earned Ratio) Indexing. In 1983 (also a time of great challenge, rising costs, and increased risk), the Commission allowed four electric cooperatives[2] to adopt TIER Indexing. TIER Indexing was:

> ... designed to provide electric distribution cooperatives with a less expensive and more expeditious means of adjusting rates than a general rate case procedure available pursuant to Section 9 of the Commission's Rules of Practice and Procedure. Under the TIER Indexing Adjustment, a cooperative may apply for a rate change if it achieves a TIER outside of the range previously set by the Commission.[3]

TIER Indexing was initially developed, on a joint basis, by the Michigan Public Service Commission and the Michigan Electric Cooperative Association. When TIER Indexing was being considered for electric cooperatives, Commission General Staff witness Joseph A. Chrisman described TIER Indexing as follows:

> TIER Indexing is a response to the traditional, time consuming, and expensive rate regulation process. In simplest terms, rates are revised, if necessary, every six months to return the TIER coverage to target levels. If a revenue increase is required, it is collected through an equal per kwh surcharge in the first billing month following the TIER order. In the following months, the surcharge is rolled into base energy rates.[4]

In Docket No. 86-006-R, the General Staff petitioned the Commission to add a new rule to the Commission's *Rules of Practice and Procedure* by which retail electric cooperatives could utilize a "margins adjustment" (a refinement of TIER Indexing)

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[2] Woodruff Electric Cooperative Corporation (Docket No. 83-024-U); North Arkansas Electric Cooperative, Incorporated (Docket No. 83-078-U); Petit Jean Electric Cooperative Corporation (83-070-U); and Clay County Electric Cooperative Corporation (Docket No. 83-139-U)

[3] Arkansas Public Service Commission Docket No. 95-455-U, Comments of the General Staff of the Arkansas Public Service Commission beginning at page 1.

[4] Prepared Testimony of Commission General Staff Witness Joseph A. Chrisman, page 7, Docket No. 83-024-U

through an abbreviated rate proceeding. In Order No. 3 of that docket, the Commission denied the General Staff's Petition for adoption of the proposed rule, noting that the enactment of Arkansas Act 821 of 1987 ("Act 821") (Ark. Code Ann. §§ 23-4-901, et seq.) provided a means by which retail electric cooperatives could adjust their rates without establishing a rate proceeding under Section 9, thus eliminating the need for TIER Indexing or "margins adjustment". On 21 July 1995, the Commission issued Order No. 1 in Docket No. 95-455-U. Order No. 1 proposed to eliminate TIER Indexing as a cost recovery mechanism for retail electric cooperatives. On 15 August 1995, the General Staff filed Comments supporting the elimination of TIER Indexing. On 24 August 1995, the Commission issued Order No. 2 in the docket (also Order No. 2 in Docket No. 93-176-TF) rescinding TIER Indexing for all electric cooperatives for which TIER Indexing was then in use.

The Arkansas Legislature has provided at least two innovative rate recovery options. The previously mentioned Act 821 provides, in certain instances, that retail electric cooperatives are exempt from rate case procedures. Act 821 has been used by retail electric cooperatives to stabilize their margins, thus avoiding expensive and burdensome Section 9 filings. Act 821 is especially appropriate for electric cooperatives because of the Electric Cooperatives' business model. Electric cooperatives are member owned and all margins derived from members belong to members. These margins are assigned as patronage capital and are ultimately returned to the members when patronage capital is retired.

Another example of legislative innovation is Act 310 of 1981 ("Act 310") (Ark. Code Ann. §§ 23-4-501, et seq.). Act 310 was established to provide a means for public

utilities to collect the cost of meeting certain legal requirements arising from legislative or administrative regulations relating to public health, safety, or the environment which could not be recovered in a prompt and timely fashion under existing regulatory procedures. Ark. Code Ann. § 23-4-503 allows a utility to create a surcharge so as to produce:

> ... annual revenues equal to the additional annualized revenue requirement to which the utility would be entitled had the additional expenditures been included in the utility's most recent rate determination by the Arkansas Public Service Commission.

V. Formula Rates and Annual Earnings Reviews

While the Electric Cooperatives believe that traditional Section 9 ratemaking should always be an available option, the Electric Cooperative's believe that innovative approaches should also be considered by the Commission. As suggested in Order No. 1 of this Docket, alternative approaches might include formula rates and periodic earnings reviews. If requested by an electric cooperative and allowed by the Commission, these alternative regulatory methodologies should be designed to expedite the establishment of new rates and provide the electric cooperative with more timely cost recovery and adequate margins. Stable and adequate margins represent reduced risk to lenders and ultimately reduced borrowing costs. Lower borrowing costs translate into cost savings for retail members.

If optional formula rates or annual rate reviews are made available by the Commission, the Electric Cooperatives suggest that these methodologies be designed to use "off the shelf" information contained in reports produced by each electric cooperative when such off the shelf information is current and readily available. Examples of standard reporting formats might include RUS Form 7s and Form 12s (these reports

contain income statements, balance sheets, and other operating information) or other similar reports prepared for the Natural Rural Utilities Cooperative Finance Corporation by non-RUS electric cooperative borrowers. When necessary, such off the shelf information could be adjusted for rate making purposes, or other current and verifiable information could be used. By designing formula rates and annual rate reviews around information readily available, the Commission could further reduce regulatory expense while providing the General Staff and the Commission with the necessary information to review and approve updated formula rates and annual rate reviews.

The Electric Cooperatives further suggest that the design of formula rates and annual earnings reviews for investor owned utilities ("IOU") should be significantly different than for the Electric Cooperatives. This conclusion stems mainly from the fact that IOUs are for-profit and seek to maximize a rate of return on rate base for their investors, whereas the Electric Cooperatives are non-profit and seek to minimize costs for their members. Margins earned by an electric cooperative ultimately belong to its members. However, just as an appropriate rate of return is important for an IOU in attracting investors and capital, appropriate margins are important to the Electric Cooperatives in being able to minimize cost of capital for infrastructure and operations. Currently, IOU profits are typically determined by the Commission using a rate of return on rate base, while an electric cooperative's margins are determined by the Commission using a TIER calculation. Therefore, a margins-based alternative rate methodology would be more appropriate for the Electric Cooperatives than an IOU-type rate of return methodology.

Another material difference between electric cooperative rate making and IOU ratemaking is that interest expense is "above the line" for electric cooperatives while interest expense is a "below the line" expense for IOUs. Another material difference is that electric cooperatives assign and retire patronage capital. Any formula rate or annual rate review for electric cooperatives should account for such patronage capital assignments and retirements. It should also be remembered that electric cooperatives, unlike IOUs, generally do not pay income tax on margins produced from members.

If such rates or reviews are approved, the Electric Cooperatives would welcome the opportunity to work with the General Staff to establish templates which are acceptable to the Commission for the implementation of electric cooperative formula rates and annual rate reviews.

VI. Costs Associated with the Acquisition or Construction of New Facilities

The cost to provide new generation, transmission, and distribution facilities is rising rapidly. This realization is magnified by the fact that the electric industry has generally not made large infrastructure investments for a number of years. One example may be found in the cost of new base load generation. When the White Bluff Steam Electric Station and the Independence Steam Electric Station were brought on line in the early 1980s, AECC's ownership share of investment cost was approximately $600 per kW. The current forecast for the investment cost of a new coal plant is in excess of $3,000 per kW.

In certain instances, the Electric Cooperatives believe that options allowing a more rapid collection of certain construction and acquisition expenses may have value. The Interim Tolling Agreement, under which Entergy Arkansas, Inc. recovered

purchased power costs prior to acquisition of the Ouachita Power Facility and the Capacity Acquisition Rider following its acquisition (Docket No. 06-152-U), provides an excellent example of this type of beneficial innovation.

The Electric Cooperatives suggest that pre-construction developmental project costs should be rate recoverable on a timely and contemporaneous basis, regardless of whether a Certificate of Public Convenience and Necessity or a Certificate of Environmental Compatibility and Public Need has been issued for such project, if the project is consistent with the utility's resource plan and the developmental project costs are prudent. This may be beyond the Commission's current statutory authority and require legislative action.

The Electric Cooperatives also suggest that the Commission consider expedited cost recovery of interest during construction ("IDC") and allowance for funds used during construction ("AFUDC"). For electric utilities regulated by a rate of return on rate base, IDC and AFUDC would be collected by including Construction Work in Progress in rate base.

The collection of IDC and AFUDC prior to project completion will reduce lenders' risk and result in lower borrowing costs for electric cooperatives. In addition, the expedited recovery of certain construction costs such as IDC and AFUDC would somewhat reduce "rate shock" when these facilities are placed into service and incorporated into retail rates.

VII. Decoupling and Revenue Lost from Energy Efficiency

The Electric Cooperatives are aware that successful energy efficiency programs may reduce revenue to a level lower than it otherwise might have been. The Electric

Cooperatives do not require incentive rates designed to charge consumers more because they engage in energy efficiency. The Electric Cooperatives only seek to recover their full cost of doing business plus any margins necessary to maintain long term financial health and favorable credit ratings.

To the extent that annual rate reviews, formula rates or other regulatory mechanisms are offered to utilities as a means of stabilizing margins, by matching revenue to the cost of service on a more timely basis, and to the extent that these options might be considered "decoupling," the Electric Cooperatives are supportive of such mechanisms as options.

VIII. Extraordinary Storm Damage Restoration Expense

The Electric Cooperatives are currently eligible for certain Federal Emergency Management Administration ("FEMA") reimbursements for federally declared disasters. The Electric Cooperatives are, therefore, less affected by extraordinary storm damage expense than IOUs. While the Electric Cooperatives should have the same opportunity to collect non-FEMA reimbursed storm restoration expenses as IOUs, the Electric Cooperatives prefer to reserve comment on this issue until it is more fully developed by other parties in this Docket.

IX. Incentive Based Rates

The Electric Cooperatives do not require incentive rates to make the right decisions for their retail consumers. The Electric Cooperatives' only motivation is to secure the best possible electric supply for their membership at the lowest long-term cost. The various electric cooperatives' boards of directors insure that this goal is always

foremost on the minds of electric cooperative employees who carry out the policies of the boards of directors.

X. Innovative Regulation Should be Optional for Utilities

While the Electric Cooperatives believe that the Commission's investigation into innovative regulatory solutions is in the best interest of Arkansas ratepayers, the ability to select from a menu of regulatory options is extremely important to the Electric Cooperatives. If the Commission determines to offer various rate making options (Section 9, formula rates, annual earnings reviews, etc.), the Electric Cooperatives believe that utilities should be allowed to select from a menu of regulation options and decide for themselves which option best fits the utility's business model and current situation. For example, certain electric cooperatives may prefer to leave rates unchanged until the electric cooperative's cost of service changes in a material way and requires a traditional Section 9 rate proceeding, while other electric cooperatives may prefer the financial security and margin stability offered by annual earnings reviews. Such decisions will be based on factors unique to each electric cooperative, including member preference, capital investments and mortgage requirements.

XI. Conclusion

In summary, the Electric Cooperatives again wish to commend the Commission for its exploration of innovative regulation. The Electric Cooperatives support innovative regulatory approaches, on an optional basis, that would allow the Electric Cooperatives to more quickly and effectively respond to ever-changing and uncertain industry conditions, and thereby better serve their members.

WHEREFORE, The Electric Cooperatives respectfully submit their Initial Comments as set out herein, and pray for all other relief to which they may be entitled.

Respectfully submitted,

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CERTIFICATE OF SERICE

I, Stephen P. Williams, do herby certify that on the 10th day of November 2008, a true and correct copy of the foregoing Initial Comments was mailed by First Class U.S. Mail, with sufficient postage prepaid, to all parties on the service list for this Docket.

Stephen P. Williams
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