

March 19, 2018

Due Diligence Report to Investigate:

1) Whether Berea's participation with the Kentucky Municipal Energy Agency in an Interlocal Agreement and Transmission Contract exposes it to unacceptable risk, unappreciated potential costs, or a danger of unreliable service by industry standards

and

2) Whether the Council's recommendation to cancel all memberships, resolutions, agreements, and contracts with KyMEA should be followed, modified, or disregarded by City Administration.

Introduction

On September 19, 2017, the City Council voted 6-1 to terminate Berea's contracts with Kentucky Municipal Energy Agency, a decision that could cost Berea Municipal Utility customers \$1.2M. However, under Kentucky law, this vote constituted only a recommendation to the Mayor and did not affect the validity of the contracts. But, in deference to Council's concern, the Mayor began a "due diligence" investigation to determine whether Berea's participation with KyMEA in the Interlocal Agreement and Transmission Contract exposed the City to **unacceptable risk, unappreciated potential costs, or a danger of unreliable service as judged by industry standards.**

This investigation was completed March 6, 2018 and considered: 1) specific concerns of Council members and responses from BMU staff; 2) answers from the Berea Utility Advisory Board to specific questions; 3) findings and recommendations on potential legal risk from a utility attorney; and 4) findings and recommendations on potential financial risk from an auditor.

This information was used by the Mayor and Administrative staff to decide whether **the Council's recommendation** to cancel all memberships, resolutions, agreements, and contracts with the Kentucky Municipal Energy Agency should **be followed, modified, or disregarded, and what specific "next steps" should be taken by the City.**

The following is a summary of the information considered and the proposed "next steps."

1) Time Line

Berea College began generating electricity for its own consumption in **1913**; lighting street lights and selling electricity to Berea residents in **1914**; and generating electricity "to light the town and secure a profitable income" in **1915**.

In **1947**, Berea College stopped generating electricity and started buying wholesale electricity from Kentucky Utilities for distribution.

In **1975**, the Municipal Electric Power Association of Kentucky (MEPAK) was formed local municipal utilities.

In **2005**, the City purchased the electric utilities from Berea College and assumed its wholesale contract with Kentucky Utilities.

In **2009**, MEPAK began doing business as Kentucky Municipal Utilities Association (KMUA).

In **2011**, KMUA was joined by members from the Municipal Water and Waste Water Association,

In **2014**, the City along with 10 other Kentucky municipal utilities gave KU/LG&E a five-year notice to terminate its wholesale electric purchase contract to take effect in May 2019.

In **2015**, 10 Kentucky cities formed the Kentucky Municipal Energy Agency (KyMEA) with an Interlocal Agreement.

On **June 7, 2016**, Council approved Berea becoming a member of AMP; signing a 5-year wholesale electric contract with American

Municipal Power, Inc.; and directed BMU to decide whether to include capacity in the contract.

On **August 16, 2016**, Council approved Resolution 19-16 which authorized the Mayor to apply for membership in AMP.

On **September 1, 2016**, Mayor Connelly signed a Master Services Agreement with AMP and made Berea a member of that group.

On **September 2, 2016**, Mayor Connelly signed a five-year wholesale electric contract with AMP.

On **September 6, 2016**, Council adopted Ord. 16-2016 which authorized and approved the “formation, creation and establishment of the joint public agency” known as the Kentucky Municipal Energy Agency; approved and authorized Mayor Connelly and the City Clerk to sign the Kentucky Municipal Energy Agency Interlocal Cooperation Agreement “so that KyMEA may constitute a joint public agency of which the City is a member;” and agreed “to be assessed, from time to time, its proportionate share, of such expenses in accordance with the terms of the Agreement and the actions of the KyMEA Board of Directors.

(The Interlocal Agreement provides at page 11 that “The Board of Directors by resolution may from time to time adopt a schedule of assessments, or method for determining assessments, to be paid by each Member to support the administrative budget and operations of the Agency...”).

On **September 22, 2016**, Mayor Connelly signed the First Addendum to the Interlocal Agreement making Berea a member.

In **2017** KMUA represented 42 Kentucky municipal utilities, including the Berea Municipal Utility. (See the Appendix for a list of names).

On **September 19, 2017**, Council voted to terminate all memberships, resolutions, agreements, and contracts with KyMEA and to contract with AMP to provide transmission of all wholesale electric power.

On **October 3, 2017**, Mayor Connelly announced that he would conduct a “due diligence” investigation to evaluate Council’s concerns and its recommendation to terminate all contracts with KyMEA.

2) Concerns Expressed by Council after the vote on 9-19-2017:

- a) **The Transmission Contract allows either party to terminate the contract by giving a 30-day notice.** If KyMEA terminated the Transmission Contract, could the City replace it in 30 days?
- b) **Is KyMEA billing Berea correctly for expenses under the Transmission Contract and Interlocal Agreement?** Does Article IV of the Interlocal Agreement amount to a “blank check” to KyMEA for administration expenses?

3) Response by BMU staff to Council’s concerns:

- a) The parties chose a 30-day notice to give flexibility and limit the extent of Berea’s commitment. In addition, Section 2.2 states: “Absent agreement of the Parties to the contrary, termination of this Agreement shall not terminate any transaction hereunder that may be underway; rather such transactions shall be completed and settled as though this Agreement were still in effect.” The intent of this language is to ensure that both parties have sufficient time to make new arrangements. However, when the Mayor asked if the Transmission Agreement could be amended to substitute a 180-day notice, the KyMEA Board agreed to do so upon Berea’s request.
- b) KyMEA’s annual budget estimates its administrative costs. Berea’s proportionate share is billed quarterly. BMU reconciles each quarterly bill with actual costs on the subsequent invoice. Berea has a representative on the Board who attends meetings regularly and votes on these assessments.

Each member is billed its proportionate share of administrative costs based upon its KyMEA electric load share relative to the category of cost. AMP and other organizations use similar formulas. This process of “socializing shared costs” saves BMU

money in paying costs it would otherwise pay alone. Overall, this process has amounted to a risk reduction, but that proportional share will vary with the number and load levels of members in a particular cost category. Furthermore, not all costs are fixed. To the extent that certain costs decrease or increase as members depart or are added, the incremental impact on remaining members will change.

However, **billing is being conducted accurately under the language of the two contracts.** Transmission activities include a shared cost for transmission studies, applications for service, load forecasts, periodic information requests from transmission owners, and associated planning studies. Ed Fortner and Kevin Howard are Berea's designated representatives to the KyMEA Board of Directors.

Berea joined KyMEA in September 2016 as a transmission-only member. Under this contract, starting in May 2019, KyMEA will deliver electric power from AMP through the KU/LG&E system to BMU's two substations. By Ord. 16-2016, the City agreed to pay Berea's portion of the KyMEA administrative costs set by its Board of Directors.

By attending KyMEA Board meetings, Berea's representative can vote on administrative assessments and help plan for future power supply and transmission needs. In addition, by attending, Berea's representative receives important information on purchased power, capacity, KyMEA activities in the MISO and KU/LG&E systems, various projects including renewable energy and combined cycle gas generation, and other power and transmission-related issues.

By remaining in KyMEA, Berea will save money by continuing to socialize costs for transmission and planning proportionately with other members as illustrated by the \$1.2M it will save in purchasing 10MW of seasonal capacity from KyMEA which is available only to members.

Now that KyMEA has been formed, a director hired, and power contracts are in place, charges for general administration will be

reduced. The annual administrative charge from KyMEA should be approximately \$25,000. By comparison, Berea now pays AMP \$22,000 annually for member administrative costs.

4) Response of **Berea Utility Advisory Board to Specific Questions** from

Mayor Connelly:

- 1) Does the existence of the Interlocal Agreement and Transmission Contract with KyMEA expose the customers of Berea Municipal Utility to unacceptable risk, unappreciated potential costs, or a danger of unreliable service that is unreasonable by industry standards?

Five (5) votes “no”

- 2) Is the purchase of capacity a reasonable strategy for BMU to follow in both of its contracts with AMP for 25MW of capacity and KyMEA for 10MW of capacity to ensure the availability of electricity at peak demand or when the grid is under stress?

Five (5) votes “yes”

- 3) If the purchase of capacity is a reasonable strategy, is it also reasonable to take the lowest, reliable cost even if it is provided by KyMEA rather than AMP?

Five (5) votes “yes”

5) Response by **Utility Attorney Goss to Specific Questions** from Mayor Connelly:

Mark David Goss received his B.A. degree from Transylvania University in 1982 and his law degree from the University of Tennessee in 1985. He began practicing law with his father in Harlan, Kentucky. He later became a member of Frost Brown Todd, LLC in Lexington where he practiced corporate and administrative law, concentrating on regulatory and business issues affecting utilities. He served as Chairman of the Kentucky Public Service Commission from

2004 to 2008, overseeing rates and service for 1500 utilities in Kentucky. He currently practices utility law with Goss Samford, PLLC in Lexington, Kentucky.

Mr. Goss was asked to review the contracts between Berea and Kentucky Municipal Energy Agency (KyMEA) and American Municipal Power, Inc. (AMP) along with other documentation and to advise Berea on its rights and obligations under the contracts and to identify any perceived legal or financial risks that did not comply with accepted industry standards.

After reviewing appropriate documents and talking with utility staff, the mayor, city administrator, two council members, officials from AMP and the city's auditor, Mr. Goss made the following findings:

1. He raised several issues pertaining to the formation and existence of KyMEA. However, he also cautioned that his report did "not constitute a formal legal opinion on the matter" (10) and that, ultimately, the question whether KyMEA had been "legally formed" (11) would be a matter for a Court to decide.
2. He noted that Berea had joined KyMEA to receive transmission services and not to buy wholesale power. AMP was selected to provide Berea's wholesale power along with 25 MW of capacity. KyMEA was contracted to deliver the wholesale power from AMP over lines owned by KU/LG&E to Berea's substations. Later, at the suggestion of AMP, Berea asked KyMEA to provide 10 MW of additional capacity to cover Berea's peak load periods. Mr. Goss concludes that the decision to purchase capacity is a simple "business decision requiring an analysis of cost/benefit and risk/reward."(17)

3. Mr. Goss describes in detail a disagreement between Berea's Council and Administration over whether, under the Transmission Contract and Interlocal Agreement, Berea should be charged two sets of administrative costs or only one if it is limited to "transmission-only" membership. However, he also suggests that Berea's course of conduct in paying the two-tiered charges without objection since the beginning may prevent Berea from objecting to the charges now. (15)

In fact, City Administration believed that Berea's relationship with KyMEA changed from being just for transmission purposes when it agreed to acquire 10 MW of capacity from KyMEA. Furthermore, the clear benefit from socializing joint costs warranted this dual administrative billing system which had actually been formally approved by Council in Ordinance 16-2016. Even Mr. Goss concluded that his report was limited and not dispositive in this area. (17)

Based on these findings, Mr. Goss recommends the following action:

1. Berea should discuss and seek to resolve any concerns with KyMEA over its billing practices and proceed "very cautiously" before seeking to terminate any contract. To do otherwise would be "highly imprudent."(20)
2. Berea should immediately contact AMP to confirm and document the terms of Berea's purchase of 25 MW of capacity. If the price exceeds the minimum specified in the Master Services Agreement of \$1.50, Council should be requested to approve this higher amount.

6) Response by **Auditor Hensley to Specific Questions** from Mayor Connelly:

Mr. Hensley has audited municipal utilities either as a separate engagement or as a proprietary fund of a city's audit for many years and has been the lead partner in audits of the following electric distribution cities with the number of years in parentheses: Berea (22), Falmouth (15), Nicholasville (15), Paris (25) and Williamstown (22). He has been the lead audit partner for the largest municipal audit practice in Kentucky for over 40 years. He wrote *Accounting and Reporting Manual for Kentucky Cities* in 1981 which was produced in response to the enactment of KRS 91A.

Mr. Hensley was asked to review and evaluate Berea's power source agreements and to assess the risk to the City.

After reviewing appropriate documents and talking with utility staff, the mayor, city administrator, Council member Jerry Little, officials from AMP, Mike Withrow, utility manager from Paris, Heather Overby, CFO for KyMEA, Charles Muson from Rubin & Hayes law firm, Brown Thornton of NewGen Strategies, Tom Trauger of Spiegel & McDiarmid, and Mark David Goss of Goss Samford, PLLC; researching Federal Energy Regulatory Commission regulations and accounting releases; researching financial statements, annual reports and related material for municipal energy agencies in Alabama, Indiana, Illinois and Kansas; obtaining and analyzing the costs of power for Paris in FY 2017 and FY 2018 and, with that information, estimating the costs to Berea for FY2020, the first full year of the new contract arrangements, **he made the following findings:**

1. Berea's contract with AMP, who later contracted with NextEra to provide energy at a cost of \$40.51 per MW to be delivered to the Indiana Hub, ensures that its energy needs will be met during the five year contract period.
2. AMP's contract permits it to provide both energy and capacity. The AMP contract with NextEra requires energy to be delivered to the Indiana Hub which is within the Midcontinent Independent System Operator, Inc. (MISO) territory. MISO recommends that capacity be reserved to meet the anticipated load. Berea's AMP contract has reserved 25 MW of capacity from the Smithland Hydro facility. AMP

recommends that Berea use KyMEA to provide an additional 10 MW of capacity on a seasonal basis in winter months.

Capacity is important because, in an emergency, the first load that MISO curtails is non-firm exports. However, an export transaction that is supported by capacity is deemed a firm export and will be curtailed only as a last resort---on the same basis as MSO native load. MISO reported in January 2018 that there had been ten Maximum Generation Emergency declarations in the 18-months since the start of the 2016/17 planning year. By contrast, there had been zero declarations in the two years prior to June 1, 2016.

3. Mike Migliore of AMP recommends that Berea purchase the extra 10 MW of capacity from KyMEA on a seasonal basis rather than from AMP on an annual basis. Most KyMEA members have a summer peak load while Berea has a winter peak load. Capacity would, therefore, be cheaper if purchased from KyMEA seasonally when Berea needed it. AMP would require an annual contract at significantly more cost.

Mr. Migliore obtained a current price for 10 MW as of February 8, 2018 from NextEra for \$3 per KW-month for twelve months or \$360,000 per year compared to an estimated price from KyMEA of \$4 per KW-month for three months or \$120,000 per year. The difference would be a savings of \$1,200,000 over the 5-year contract.

4. Mr. Hensley concludes that KyMEA is a viable entity and that it is operating and providing services to its members. He states: “Contracts are in place to provide energy and capacity to meet the needs of the all requirements members, transmission agreements are in place with KU/LG&E, structures are in place to provide any other services needed, an experienced CEO has been employed and services are being provided.” The Cities of Paris and Benham have been using KyMEA for transmission and AMP for energy and capacity since May 2017 without issue.

The agency is an outgrowth of the electric distribution members of the Kentucky Mutual Utility Association (KMUA) of which Berea, and Berea College before it, has been a member for many years. It is a new agency only in the sense that years of previous cooperation were formalized by the Interlocal Agreement in 2015.

Based on these findings, Mr. Hensley drew the following conclusions:

The City of Berea is presently positioned to experience substantial savings in cost to deliver power to its customers through its contracts with AMP and KyMEA. Membership in KyMEA enabled the City to save transmission study costs and permits the seasonal purchase of capacity to provide the reliability necessary to comply with MISO standards. AMP estimates that seasonal purchase of capacity will save Berea \$1,200,000 over the five year term. KyMEA estimates that the annual administrative cost of membership will be approximately \$25,000 per year. After deducting the cost of KyMEA membership paid to date and the estimated future costs of KyMEA membership (2,100 per month) over the five-year term of the contract, savings amount to **\$955,825**.

The estimated cost of energy, capacity and other services provided by AMP for FY 2020 prepared as of 10/11/2017 when adjusted for future administrative costs leaves an estimated total cost of **\$7,568,449 or 13.5% less than the expected average cost of KU over the five-year period.**

7) Action Items:

- a. Remain a member of KyMEA and continue to cultivate and maintain good relationships with KU/LG&E, AMP and KyMEA. As recommended by Mr. Goss, the City should proceed “very cautiously” and consider fully the “myriad operational and financial ramifications” that would likely result before terminating membership in KyMEA. “To do otherwise would be highly imprudent (Goss 20).”
- b. The City will begin to focus on providing electric power for the period after 2024 by forming a permanent group to study, evaluate and propose the criteria and possible sources for a long term power supply contract with diverse sources and flexible options within the contract to respond to changing market, regulatory, scientific and technological conditions.
- c. The Mayor will ask Council to amend the transmission contract with KyMEA to change the notice of termination provision from 30 days to 180 days.
- d. The Mayor will instruct its representatives on KyMEA’s board to meet with KyMEA to resolve any lingering disputes or misunderstandings over the billing process as suggested by Mr. Goss (Goss 19).
- e. The Mayor will instruct BMU employees to contact AMP and document its commitment to provide 25 MW of capacity and the price of that commitment and also to contact KyMEA and arrange to sign the contract providing 10 MW of capacity on a seasonal basis during the contract term 2019 through 2024.

