COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION OF THE APPLICATION OF THE FUEL ADJUSTMENT CLAUSE OF KENTUCKY POWER COMPANY FROM NOVEMBER 1, 2013 THROUGH APRIL 30, 2014	))))	CASE NO. 2014-00225

ORDER

Pursuant to 807 KAR 5:056, the Commission established this case on August 13, 2014, to review and evaluate the operation of the Fuel Adjustment Clause ("FAC") of Kentucky Power Company ("Kentucky Power") for the six-month period that ended on April 30, 2014. The Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention, ("AG") and Kentucky Industrial Utility Customers, Inc. ("KIUC") were granted intervention in this matter. The Commission established a procedural schedule that provided for discovery, intervenor testimony, and rebuttal testimony. Commission Staff ("Staff") and KIUC submitted requests for information to Kentucky Power. After KIUC and the AG filed joint testimony, Kentucky Power filed rebuttal testimony. The Commission held a public hearing on this matter on November 12, 2014. Kentucky Power filed a post-hearing brief, and KIUC and the AG filed a joint post-hearing brief. All information requested at the hearing has been filed, and the case now stands submitted for a decision.

Power Purchases

Staff questioned Kentucky Power about the recovery of power purchases through the FAC. Specifically, Kentucky Power was asked whether it was limiting cost recovery, through the FAC, of power purchased under either of the following circumstances: 1) when experiencing a planned outage, or 2) when not experiencing an outage, but making power purchases to meet its load. Kentucky Power responded that it was not limiting recovery of these purchases through the FAC in either scenario.[1]

In FAC review proceedings in 2002, the Commission set forth the definition of "economy energy purchases" and "non-economy energy purchases" and the recoverability of each through the FAC. In Case No. 2002-00495-B involving the six-month FAC review of Kentucky Power (formerly known as American Electric Power Company), the Commission discussed the recoverability of "economy energy purchases" via the FAC.

> We view "economy energy purchases" that are recoverable through an electric utility's FAC as purchases that an electric utility makes to serve native load, that displace its higher cost of generation, and that have an energy cost less than the avoided variable generation cost of the utility's highest cost generating unit available to serve native load during that FAC expense month.[2]

In that same case, the Commission also discussed the recoverability of "non-economy energy purchases" via the FAC.

> We interpret Administrative Regulation 807 KAR 5:056 as permitting an electric utility to recover through its FAC only the lower of the actual energy cost of the non-economy purchased energy or the fuel cost of its highest cost generating unit available to be dispatched to serve native load during the reporting expense month. Costs for non-economy energy purchases that are not recoverable through an electric utility's FAC are considered "non-FAC expenses"

[1] Response to Items 26 and 27 of the Commission's First Request for Information ("Commission's First Request"), attached as the Appendix to the Commission's August 13, 2014 Order.

[2] Case No. 2000-00495-B, *An Examination of the Application of the Fuel Adjustment Clause of American Electric Power Company from May 1, 2001 to October 31, 2001* (Ky. PSC May 2, 2002) at 4.

and, if reasonably incurred, are otherwise eligible for recovery through base rates.[3]

Because Kentucky Power was unique in that it did not own a combustion turbine in 2002, it sought and was granted rehearing in Case No. 2000-00495-B. By Order dated October 3, 2002, Kentucky Power was granted authority to use the "Peaking Unit Equivalent" approach to calculate the level of non-economy purchase power costs to recover through the FAC.[4]

In a March 21, 2005 Order in Case No. 2004-00430[5] involving East Kentucky Power Cooperative, Inc. ("East Kentucky"), the Commission clarified its definition of "non-economy energy purchases," stating, "A more accurate definition of non-economy energy purchases recognizes that the energy costs thereof may be greater or less than the variable cost of the highest cost generating unit available to serve native load."[6] The Commission, however, did not modify the limitation set forth in Case No. 2002-00495-B that a utility could recover through the FAC "only the lower of the actual energy cost of the non-economy purchased energy or the fuel cost of its highest cost generating unit available to be dispatched to serve native load during the reporting expense month."[7]

[3] *Id.* at 5.

[4] The Peaking Unit Equivalent was based on the operating characteristics of a General Electric simple-cycle gas turbine.

[5] Case No. 2004-00430, *East Kentucky Power Cooperative's Request for a Declaratory Ruling on the Application of Administrative Regulation 807 KAR 5:056 to its Proposed Treatment of Non-Economy Energy Purchases* (Ky. PSC Mar. 21, 2005).

[6] *Id.* at 6.

[7] Case No. 2000-00495-B, *An Examination of the Application of the Fuel Adjustment Clause of American Electric Power Company from May 1, 2001 to October 31, 2001* (Ky. PSC May 2, 2002) at 5. (Emphasis added).

Kentucky Power initially stated in this proceeding that it was not limiting recovery of the non-economy purchases because it had interpreted the Commission's March 21, 2005 Order in Case No. 2004-00430 to require that actual fuel costs of non-economy purchases, rather than a proxy, be used in accounting for and reporting fuel costs.[8] However, upon additional questioning, Kentucky Power stated, "Upon review and analysis, the Company recognizes its earlier interpretation of the EKPC Orders was erroneous."[9] During questioning at the hearing, Kentucky Power stated that $83,720.76 in power purchases in excess of the "Peaking Unit Equivalent" should be disallowed for the review period.[10]

Methodology of Allocating Fuel Costs Between Native Load and Off-System Sales

When allocating fuel costs between native load customers and off-system sales, Kentucky Power allocates "no load costs" to native load customers each hour. "No load costs" are defined by Kentucky Power as the fixed fuel and consumable costs incurred when a unit is in operation that are not dependent on the output level of the unit.[11] In addition, Kentucky Power allocates other incremental costs to run the generating units at the minimum level of operation each hour to native load customers to the extent that there is native load to which to allocate the costs. If there is not enough native load in that hour to allocate the other incremental costs, Kentucky Power allocates the costs to

[8] Response to Item 1.b.(1) of Commission Staff's Second Request for Information ("Staff's Second Request").

[9] Response to Item 1.a. of Commission Staff's Third Request for Information ("Staff's Third Request.")

[10] November 12, 2014 Hearing at 15:11:13.

[11] Response to Item 29 of the Commission's First Request.

off-system sales.[12] For costs above the unit minimums, Kentucky Power stacks the costs on a $/MWh basis, and for each hour, for each unit, the unit with the most expensive $/MWh cost of the last megawatt hour ("MWh") produced is assigned to off-system sales.[13] Kentucky Power states that allocating "no load costs" and other incremental costs to run the generating units at the minimum level to native load customers is a historical practice that has been in place for at least 30 years.[14]

Kentucky Power asserts that its fuel allocation methodology is reasonable because: 1) customers have "first call" on its generating assets and, because of this "first call," its customers received net benefits of $9.9 million during the period between January 1, 2014, through April 2014;[15] and 2) its fuel allocation methodology is consistent with historic practice, the methodology used by Louisville Gas and Electric Company and Kentucky Utilities Company, Federal Energy Regulatory Commission guidance, and the Stipulation and Settlement Agreement ("Settlement Agreement") in Case No. 2012-00578 ("Mitchell Case").[16] [17] Kentucky Power notes that the Settlement Agreement states that "[c]ustomers shall at all times be entitled to the least-cost energy

---

[12] Response to Item 4.b.(1) of Staff's Second Request.

[13] Response to Item 29.b. of Commission's First Request.

[14] *Id.*

[15] Rebuttal Testimony of Kelly D. Pearce at pages 8 and 20.

[16] Kentucky Power Post-Hearing Brief at pages 10-16.

[17] Case No. 2012-00578, *Application of Kentucky Power Company for (1) a Certificate of Public Convenience and Necessity Authorizing the Transfer to the Company of an Undivided Fifty Percent Interest in the Mitchell Generating Assets; (2) Approval of the Assumption by Kentucky Power Company of Certain Liabilities in Connection with the Transfer of the Mitchell Generating Station; (3) Declaratory Rulings; (4) Deferral of Costs Incurred in Connection with the Company's Efforts to Meet Federal Clean Air Act and Related Requirements; and (5) All Other Required Approvals and Relief* (Ky. PSC Oct. 7, 2013).

produced by generation owned, leased or purchased by the Company consistent with economic dispatch principles" and that its allocation of the highest incremental fuel costs to off-system sales follows from the economic dispatch of its units. Kentucky Power claims that it acted in good faith in making its representations regarding a $16.75 million fuel savings reported in the Mitchell Case, and that had a net energy cost analysis been performed in that proceeding, it would have demonstrated the significant net fuel cost benefits to its native load customers as a result of the Mitchell Generating Station ("Mitchell Station") transfer. Kentucky Power claims that any change to its fuel allocation methodology can be made only prospectively and only at a time when base rates are modified.

KIUC and the AG object to Kentucky Power's methodology, arguing that: 1) it caused native load customers to pay a disproportionate amount of fuel costs during the review period, as evidenced by a difference in $/MWh of fuel costs allocated to native load compared to the $/MWh allocated to off-system sales;[18] 2) "no load costs" for all Kentucky Power generating units were unfairly allocated to native load customers each hour even when the units were not necessary to serve native load; 3) Kentucky Power claimed $16.75 million in annual fuel savings if it acquired a 50 percent undivided interest in the Mitchell Station, but failed to disclose the impact its fuel allocation methodology would have on native load customers upon acquisition of the Mitchell Station; 4) "no load costs" are similar to fixed environmental costs which are allocated to off-system sales; and 5) Kentucky Power's calculation of $9.9 million of savings from January 1, 2014, through April 30, 2014, related to the transfer of the Mitchell Station

[18] Direct Testimony of Lane Kollen, Exhibit_(LK-3), shows that, for the four months of the review period that fall in the overlap period, the average fuel cost allocated to native load customers was $31.67/MWh, while $24.13/MWh was allocated to off-system sales.

was flawed in that it used unrealistic and incorrect assumptions. KIUC and the AG recalculated Kentucky Power's fuel costs using the methodology used by East Kentucky and recommend that $12.648 million in fuel costs be disallowed, plus an additional $.864 million in interest.[19] [20] In addition, KIUC and the AG recommend that Kentucky Power be required to adopt the fuel-cost allocation of East Kentucky and Duke Energy Kentucky, Inc. hereafter.[21]

DISCUSSION

In Case No. 2012-00578, the Commission approved a non-unanimous Settlement Agreement which authorized Kentucky Power to acquire a 50 percent undivided interest in the Mitchell Station. Because of that approval, during the period January 1, 2014, through May 31, 2015 ("the Overlap Period"), Kentucky Power will own and operate both the 800-megawatt ("MW") Big Sandy Unit 2 and its 50 percent undivided interest in the Mitchell Station, or 780 MW. During the 17-month Overlap Period, Kentucky Power will be operating with an unusually large reserve margin, estimated at 57 percent for 2014.[22] Given that most utilities operate with much smaller

[19] Direct Testimony of Lane Kollen at page 6.

[20] East Kentucky describes its methodology as follows: "Fuel is allocated between native-load sales and off-system sales on a stacked cost basis. EKPC considers each hour of operation, determines if a sale was made from its system during that hour and then allocates the highest cost resource(s) to that sale for FAC purposes. The process of stacking and assigning the highest cost resources to off-system sales protects EKPC's native load from having no-load cost assigned inappropriately." *See* Case No. 2014-00226, *An Examination of the Application of the Fuel Adjustment Clause of East Kentucky Power Cooperative, Inc. from November 1, 2013 through April 30, 2014*, Response to Commission's Initial Request for Information, attached as the Appendix in the Commission's August 13, 2014 Order, Item 29.a.

[21] KIUC and the AG believe the methodology used by East Kentucky and Duke Energy Kentucky, Inc. to be the same or similar as both make reference throughout their joint brief of the "EKPC/Duke" methodology.

[22] *See* Case No. Case No. 2013-00475, *Integrated Resource Planning Report of Kentucky Power Company to the Kentucky Public Service Commission*, page 14, filed Dec. 20, 2013.

reserve margins, Kentucky Power's operations during the temporary Overlap Period cannot be considered "usual" or "normal." For these reasons, the Commission finds that it is inappropriate at this time to determine whether Kentucky Power's methodology for allocating fuel costs between native load and off-system sales is unreasonable under "normal" operating conditions. We will defer consideration of that issue until such time as Kentucky Power is operating under "usual" or "normal" circumstances with respect to the level of reserve margin. The Commission further finds that Kentucky Power's methodology for allocating fuel costs between native load and off-system sales should be evaluated for reasonableness after Kentucky Power has operated for a 12-month period without the effect of the recently terminated American Electric Power Pool Agreement and without the operation of Big Sandy Unit 2. However, the Commission finds that during the Overlap Period, when its reserve margin is unusually large and operating conditions are not "normal," Kentucky Power's fuel allocation methodology is unreasonable because it produces an unreasonable result and that certain fuel costs related to the Mitchell Station should be disallowed as discussed below.

"No Load Costs" Related to the Mitchell Station ("Mitchell 'no load cost'")

As discussed *supra*, the Settlement Agreement approved in Case No. 2012-00578 authorized Kentucky Power to acquire a 50 percent interest in the Mitchell Station. Our approval was premised, in no small part, on the stipulation that the Mitchell acquisition would result in significant fuel savings to Kentucky Power's ratepayers, because the Mitchell Station was fully scrubbed and capable of burning a certain amount of higher-sulfur, lower-cost coal. In that proceeding, in response to Item 10 of Staff's Fifth Request, Kentucky Power provided an exhibit which showed, among other things, that customers would receive a 5.33 percent increase in rates during the Overlap Period as a result of the Mitchell Station acquisition. The relatively small rate impact was a direct function of the then-claimed $16.75 million in annual fuel savings. However, it was discovered in June 2014[23] that this response failed to reflect the "no load costs" related to the Mitchell Station that would be allocated to native load customers as a result of Kentucky Power's fuel allocation methodology. Kentucky Power was asked to revise the exhibit in the current proceeding to reflect the Mitchell "no load costs." The revised exhibit shows $38.252 million in annual "no load costs" related to the Mitchell Station and that, instead of an increase of 5.33 percent, customers are actually experiencing a 12.81 percent increase during the Overlap Period.[24]

Kentucky Power was the only party to the Settlement Agreement aware of and able to disclose the effect that its allocation of Mitchell "no load costs" would have on its customers during the Overlap Period. Kentucky Power did not disclose this information, even though a Kentucky Power witness testified in this proceeding that he had been aware of the allocation of "no load costs" for years,[25] and this same witness participated in the settlement discussions in the Mitchell Case.[26] It is incomprehensible to the Commission how information this significant, resulting in costs of this magnitude, could

[23] The information became known when a meeting was scheduled for June 26, 2014, pursuant to the Commission's Meeting Tracking process, and KIUC requested Kentucky Power to explain the reason for an increase in fuel costs for discussion at the meeting.

[24] Response to Item 9.c. of Staff's Third Request.

[25] November 12, 2014 Hearing at 19:36:35, Kentucky Power witness William Allen stated he has been involved in fuel costs for eight to ten years and was aware of "no-load" fuel costs.

[26] *See* attendance sheets attached to June 28, 2013 Informal Conference Memo in Case No. 2012-00578, which summarized the May 16, 2013, May 22, 2013, and May 24, 2013 Informal Conferences in which the parties to that case engaged in settlement discussions.

have been overlooked by Kentucky Power in the Mitchell Case. The parties entering into the Settlement Agreement in that case had every right to believe that Kentucky Power had fully disclosed all costs related to the transaction. Instead, the Commission and the intervening parties were informed that there would be $16.75 million in annual fuel savings, but were not informed of $38.252 million in annual "no load costs" that would be allocated entirely to native load customers. It is difficult to overstate the importance of the Commission's decision in the Mitchell Case to Kentucky Power's ratepayers, the parties to that proceeding, and the Commission. Transparency is critical, and indeed one of the touchstone principles in the regulatory process. The failure of Kentucky Power to disclose this information in the Mitchell Case is a matter of great concern to the Commission.

DECISION

Administrative Regulation 807 KAR 5:056 requires the Commission, at six-month intervals, to conduct public hearings on a utility's past fuel adjustments. It further requires the Commission to "order a utility to charge off and amortize any adjustments it finds unjustified due to improper calculation or application of the charge or improper fuel procurement practices."

Because the Mitchell "no load costs" and their impact during the Overlap Period were not disclosed by Kentucky Power in Case No. 2012-00578, and because the application of Kentucky Power's fuel cost allocation methodology during the Overlap

Period when its reserve margin is approximately 57 percent produces an unreasonable result,[27] the Commission finds the following:

1. One hundred percent of Kentucky Power's share of Mitchell "no load costs" incurred during the Overlap Period should be disallowed for recovery. For the entire 17-month Overlap Period, the disallowance will total approximately $54 million.[28] For the four months of the Overlap Period that fall in the review period, the amount of the disallowance is $13,155,170.15.[29]

2. Kentucky Power should immediately cease collecting through the FAC "no load costs" related to the Mitchell Station. This cessation should continue through the end of the Overlap Period, May 31, 2015.

3. Mitchell "no load costs" that Kentucky Power has recovered through the FAC since the end of the review period should be disallowed in future FAC review proceedings.

4. Because the $13,155,170.15 of Mitchell "no load costs" was collected over a four-month period and the $83,720.76 of power purchases in excess of the Peaking Unit Equivalent was collected over three months, Kentucky Power should be required to credit through its FAC a total of $13,238,890.91 over four months in equal amounts of

[27] A percentage increase approximately 2.5 times the increase that Kentucky Power indicated would occur as a result of the Settlement Agreement is patently unreasonable. In addition, the difference between the $/MWh of fuel costs allocated to native load and the $/MWh allocated to off-system sales is unreasonable.

[28] $38.252 million divided by 12, multiplied by 17.

[29] Total of columns Mitchell 1 KP and Mitchell 2 KP of Kentucky Power's response to Item 29 of the Commission's First Request, Attachment 2.

$3,309,722.73[30] beginning with the first FAC monthly filing following the date of this Order.

5. Outside of the power purchases in excess of the Peaking Unit Equivalent and the allocation of Mitchell "no load costs" discussed herein, the Commission finds that there is no evidence of improper calculation or application of Kentucky Power's FAC charges or improper fuel procurement practices.

Although the Commission has found that Kentucky Power's allocation of its "no load costs" in the context of FAC recovery during the Overlap Period is unreasonable, such a finding has no impact on our decision in the Mitchell Case that the Mitchell Station acquisition, over the long term, still represents the lowest reasonable cost alternative with respect to the disposition of Big Sandy Unit 2.

The Commission also finds that, in the next FAC review proceedings covering the two-year period November 1, 2012, through October 31, 2014, it will examine the issue of regional transmission organization ("RTO") billing codes and the appropriateness of their inclusion in the FAC calculation for those utilities that are members of an RTO. The Commission further finds that Kentucky Power should file testimony in the next FAC review proceeding on the specific codes that are included in the FAC calculation and an explanation of why each is appropriate for inclusion.

IT IS THEREFORE ORDERED that:

1. One hundred percent of Kentucky Power's share of Mitchell "no load costs" incurred during the Overlap Period is disallowed for recovery.

[30] In order not to exceed the total refund of $13,238,890.91, the fourth month's credit will be equal to $3,309,722.72.

2. For the four months of the Overlap Period that fall in the review period, January 2014 through April 2014, the amount of the disallowance for Mitchell "no load costs" is $13,155,170.15.

3. Power purchases in the amount of $83,720.76 that were in excess of the Peaking Unit Equivalent are disallowed for recovery during the review period.

4. Beginning with its first FAC filing made subsequent to the date of this Order, or as amended if filed prior to the date of this Order, and continuing for a total of four consecutive months, Kentucky Power shall include a credit of $3,309,722.73[31] to refund to customers a total of $13,238,890.91 for power purchases in excess of the Peaking Equivalent Unit and Mitchell "no load costs" during the period under review as discussed herein.

5. Kentucky Power shall cease collecting through the FAC "no load costs" related to the Mitchell Station. This cessation shall continue through the end of the Overlap Period, May 31, 2015.

6. Mitchell "no load costs" that Kentucky Power has recovered through the FAC since the end of the review period shall be disallowed in future FAC review proceedings.

7. Outside of the power purchases in excess of the Peaking Unit Equivalent and the allocation of Mitchell "no load costs" to native load customers discussed herein, the Commission finds that there is no evidence of improper calculation or application of Kentucky Power's FAC charges or improper fuel procurement practices.

[31] *Id.*

8. Kentucky Power shall file testimony in the next FAC review proceeding on which codes are included in the FAC calculation and an explanation for why each is appropriate for inclusion.

By the Commission

ENTERED

JAN 22 2015

KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Executive Director

Honorable Kurt J Boehm
Attorney at Law
Boehm, Kurtz & Lowry
36 East Seventh Street
Suite 1510
Cincinnati, OHIO 45202

Honorable Mark R Overstreet
Attorney at Law
Stites & Harbison
421 West Main Street
P. O. Box 634
Frankfort, KENTUCKY 40602-0634

Jody Kyler Cohn
Boehm, Kurtz & Lowry
36 East Seventh Street
Suite 1510
Cincinnati, OHIO 45202

Judy K Rosquist
Kentucky Power Company
101 A Enterprise Drive
P. O. Box 5190
Frankfort, KY 40602

Larry Cook
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KENTUCKY 40601-8204

Gregory T Dutton
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KENTUCKY 40601-8204

Amy J Elliott
Kentucky Power Company
101 A Enterprise Drive
P. O. Box 5190
Frankfort, KY 40602

Jennifer Black Hans
Assistant Attorney General
Office of the Attorney General Utility & Rate
1024 Capital Center Drive
Suite 200
Frankfort, KENTUCKY 40601-8204

Honorable Michael L Kurtz
Attorney at Law
Boehm, Kurtz & Lowry
36 East Seventh Street
Suite 1510
Cincinnati, OHIO 45202