

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN EXAMINATION OF THE APPLICATION OF)	
THE FUEL ADJUSTMENT CLAUSE OF DUKE)	CASE NO.
ENERGY KENTUCKY, INC. FROM NOVEMBER)	2014-00229
1, 2013 THROUGH APRIL 30, 2014)	

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 Duke Energy Kentucky, Inc. ("Duke Kentucky") for the six-month period that ended on April 30, 2014. On January 30, 2015, the Commission issued an Order which found, among other things, that certain purchased-power costs amounting to \$11,787 in excess of the fuel cost of Duke Kentucky's own highest-cost generating unit available to be dispatched to serve native load during the reporting expense month would be disallowed in Duke Kentucky's upcoming two-year FAC review proceeding covering the period November 1, 2012, through October 31, 2014.¹

On February 19, 2015, Duke Kentucky filed a petition for rehearing ("Petition"). On March 6, 2015, the Commission granted Duke Kentucky's Petition to allow for further evaluation of the issues presented. In its Petition, Duke Kentucky argues that the Commission's January 30, 2015 Order: ignores that PJM Interconnection, Inc. ("PJM") energy markets are operated on an economic dispatch basis; disregards 807

¹ Duke Kentucky's two-year FAC review proceeding has been docketed as Case No. 2014-00454, *An Examination of the Application of the Fuel Adjustment Clause of Duke Energy Kentucky, Inc. from November 1, 2012 through October 31, 2014* (initiated Feb. 5, 2015).

KAR 5:056, Section 1(3)(b); and is inconsistent with the spirit of that regulation. With this Order, the Commission reaffirms its decision that Duke Kentucky's power purchases are limited for recovery through the FAC and addresses each of Duke Kentucky's arguments below.

Interpretation of "Economic Dispatch Basis"

Duke Kentucky claims that the Commission's January 30, 2015 Order construes 807 KAR 5:056 (the "FAC regulation") too narrowly as it relates to energy purchases made in a regional transmission organization ("RTO"). Duke Kentucky states that it is a member of PJM and operates within the PJM Day-Ahead and Real-Time Energy Markets. Duke Kentucky contends that the Commission's interpretation may be appropriate for a stand-alone utility, but that such an interpretation does not reconcile with the operations of an RTO, like PJM, which centrally dispatches power. Duke Kentucky argues that "whether the net energy cost of any particular energy purchase is recoverable through the FAC Regulation turns exclusively on whether 'such energy is purchased on an *economic dispatch basis*,'"² and that an "economy energy purchase," as referenced by the Commission in its January 30, 2015 Order, is only one type of purchase made on an economic dispatch basis. The Commission has defined "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

² Petition at 4. (Emphasis in original).

cost of the utility's highest-cost generating unit available to serve native load during that FAC expense month.³

Section 1(3)(c) of the FAC regulation allows for the recovery of:

[t]he net energy cost of energy purchases, exclusive of capacity or demand charges (irrespective of the designation assigned to such transaction) when such energy is purchased on an economic dispatch basis. Included therein may be such costs as the charges for economy energy purchases and the charges as a result of scheduled outage, all such kinds of energy being purchased by the buyer to substitute for its own higher cost energy. . . .⁴

Duke Kentucky claims that the Commission is attempting to define all energy purchases made under Section 1(3)(c) of the FAC regulation by the last statement of that section, which reads, "all such kinds of energy being purchased by the buyer to substitute for its own higher cost energy."⁵ According to Duke Kentucky, "Section 1(3)(c) clearly states that 'charges as a result of scheduled outage' may be included in the net energy cost of energy purchased on an economic dispatch basis, and are thus recoverable,"⁶ even though the energy purchased during a scheduled outage is not purchased to substitute for the buyer's own higher-cost energy. Thus, Duke Kentucky concludes that the limitation placed by the Commission on the recovery of fuel costs to the utility's highest-cost generating unit available to be dispatched to serve native load does not reconcile with the FAC regulation. Furthermore, Duke Kentucky claims that all

³ Case No. 2000-00496-B, *An Examination by the Public Service Commission of the Fuel Adjustment Clause of East Kentucky Power Cooperative, Inc. from May 1, 2001 to October 31, 2001* (Ky. PSC May 2, 2002) at 4.

⁴ 807 KAR 5:056, Section 1(3)(c).

⁵ *Id.*

⁶ Petition at 5.

energy purchased through PJM is purchased on an economic dispatch basis and is therefore recoverable under Section 1(3)(c) of the FAC regulation, and “for the Commission to hold otherwise, it must also determine that PJM is not operating in accordance with economic dispatch principles.”⁷

In constructing its argument, Duke Kentucky clearly makes the assumption that the use of the term “economic dispatch basis” refers to the seller’s, i.e., PJM’s, “economic dispatch basis.” The Commission finds that Duke Kentucky’s assumption is flawed. The term “economic dispatch basis,” as it is used in the FAC regulation, clearly refers to Duke Kentucky’s economic dispatch basis and not PJM’s. The economic dispatch referenced in the FAC regulation is the economic dispatch of the utility seeking to recover the changes in fuel costs through the monthly charges to its customers. PJM’s economic dispatch has no relation to the fuel costs of Duke Kentucky’s generation that was constructed or purchased to serve native-load customers. It is only reasonable that the FAC regulation refers to the purchaser’s economic dispatch, as the economic dispatch of generation a seller owns or controls has no relation to the highest cost of energy that a purchasing utility could produce from its own generation. Therefore, even though PJM dispatches the Duke Kentucky and non-Duke Kentucky generation together on a security-constrained economic dispatch basis, the FAC limits Duke Kentucky’s recovery of the net energy cost of energy purchases to its own highest-cost generating unit available to serve native load.

⁷ *Id.* at 6.

Operation of PJM Energy Markets on a Security-Constrained Economic Dispatch Basis

Duke Kentucky states that when PJM employs a security-constrained economic dispatch process, it takes into account various challenges in supplying power across PJM's regional footprint, such as systemwide reliability, transmission grid congestion and losses, and operational conditions. Therefore, PJM's decision whether to dispatch a generating unit is not exclusively based on the costs of the individual unit. Duke Kentucky claims that because of all the factors PJM must consider when it dispatches generation, "it is reasonable that PJM's dispatch process may, after the fact, result in a utility paying more for energy in a particular hour than it could produce from one of its owned, non-dispatched units."⁸

Duke Kentucky states that the relationship between the incremental energy offer of a particular unit and the locational marginal price ("LMP") at the generator bus is critical to whether PJM decides to dispatch the generating unit. Duke Kentucky argues that if it "were to ignore the LMP and self-commit its generation simply because the load zone price exceeded the 'energy only' cost of a particular generator, the Company would regularly incur losses on behalf of customers. In other words, the Company would be incentivized to attempt to self-commit the negatively congested unit, at a significant loss to customers, in order to avoid a regulatory disallowance."⁹ In this proceeding the "regulatory disallowance" Duke Kentucky speaks of is \$11,787. Duke Kentucky concludes that its energy purchases are made through PJM on an economic

⁸ *Id.* at 8.

⁹ *Id.* at 10-11.

dispatch basis and therefore are recoverable under Section 1(3)(c) of the FAC regulation.

Duke Kentucky states that whether the net energy cost of an energy purchase is recoverable through the FAC regulation is based “exclusively” on whether the energy is purchased on an economic dispatch basis.¹⁰ However, as noted above, Duke Kentucky acknowledges in its Petition that PJM’s use of economic dispatch is “not made exclusively based on the individual unit’s cost.”¹¹ It is clear and irrefutable that for years the Commission has interpreted the “economic dispatch basis” referred to in the FAC Regulation as being Duke Kentucky’s economic dispatch of its own generation, not the economic dispatch of generation owned or controlled by PJM or any other seller to Duke Kentucky. It is the economic dispatch of Duke Kentucky’s generation, not the economic dispatch of a seller to Duke Kentucky, that establishes the highest cost of energy for purposes of cost recovery under the FAC. Therefore, recovery through the FAC is limited to Duke Kentucky’s highest-cost generating unit available to be dispatched to serve native load. While Duke Kentucky states that it would be incentivized to self-commit in order to avoid a “regulatory disallowance,” it ignores the fact that the Commission has very clearly stated that these “non-FAC expenses,” i.e., the reasonable costs of fuel and power not recoverable through the FAC, are otherwise eligible for recovery through base rates and, therefore, a regulatory disallowance has not occurred, only an FAC disallowance.

¹⁰ Petition at 4.

¹¹ *Id.* at 7.

807 KAR 5:056, Section 1(3)(b)

Duke Kentucky contends that if the Commission determines that some PJM purchases do not fall under Section 1(3)(c) of the FAC regulation, then those purchases must fall under Section 1(3)(b), which includes “the actual identifiable fossil and nuclear fuel costs associated with energy purchased for reasons other than identified in paragraph (c) of this subsection, but excluding the cost of fuel related to purchases to substitute for the forced outages.” Duke Kentucky claims that Section 1(3)(b) of the FAC regulation does not require a cost comparison of any kind, and that the fuel cost of its highest-cost generating unit available to be dispatched “is entirely irrelevant to a purchase made under Section 1(3)(b).”¹²

While section 1(3)(c) of the FAC regulation permits the inclusion of “economy energy purchases” in the cost of fuel for FAC purposes when such energy is purchased on an economic dispatch basis (the utility’s economic dispatch basis), Section 1(3)(b) of the FAC regulation permits the recovery of “actual identifiable fossil fuel costs associated with energy purchased” in non-economy transactions. In Case No. 2000-00496-B, the Commission stated that “‘non-economy energy purchases’ are purchases made to serve native load that have an energy cost greater than the avoided variable cost of the utility’s highest cost generating unit available to serve native load during that FAC expense month.”¹³

¹² *Id.* at 12.

¹³ Case No. 2000-00496-B, *East Kentucky Power Cooperative, Inc.* (Ky. PSC May 2, 2002), Order at 4.

In its March 21, 2005 Order in Case No. 2004-00430,¹⁴ the Commission modified its definition of “non-economy energy purchases” stating that:

[t]he definition of “non-economy energy purchases” set forth in our Order in Case No. 2000-00496-B too narrowly construes 807 KAR 5:056 and conflicts with the regulation. 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.¹⁵

In its May 2, 2002 Order in 2000-00496-B, the Commission addressed the recovery of “non-economy energy purchases” stating that:

[w]e 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” and, if reasonably incurred, are otherwise eligible for recovery through base rates.¹⁶

As stated in the Commission's January 30, 2015 Order in this proceeding, although the Commission modified the definition of “non-economy energy purchases” in Case No. 2004-00430 to recognize “that the energy costs thereof may be greater or less than the variable cost of the highest cost generating unit available to serve native

¹⁴ 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).

¹⁵ *Id.* at 6.

¹⁶ Case No. 2000-00496-B, *East Kentucky Power Cooperative, Inc.* (Ky. PSC May 2, 2002), Order at 5.

load,”¹⁷ it did not modify the requirement that the utility 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.”¹⁸

Duke Kentucky is mistaken in its belief that Section 1(3)(b) of the FAC regulation does not require a cost comparison of any kind. It would be unreasonable for the FAC regulation to allow for recovery of power purchases made on an economic dispatch basis with “all such kinds of energy being purchased by the buyer to substitute for its own higher cost energy” in one section, but in another section to allow for recovery of all other types of power purchases without limitation. If that had been the regulation’s intent, there would have been no need for separate sections. Section 1(3)(b) of the FAC regulation pertains to “non-economic energy purchases” that are not being made by the buyer to substitute for a utility’s own higher-cost energy. Were Duke Kentucky’s argument to prevail, it would lead to the illogical conclusion that recovery through the FAC of “economy energy purchases” would, by definition, have a limitation but “non-economic energy purchases” would have no limitation. Power purchases made under Section 1(3)(b) of the FAC regulation, being non-economic purchases, are limited for recovery through the FAC to the variable costs of Duke Kentucky’s highest-cost unit available to be dispatched to serve native load.

¹⁷ Case No. 2004-00430, *East Kentucky Power Cooperative, Inc.* (Ky. PSC Mar. 21, 2005), Order at 6.

¹⁸ Case No. 2000-00496-B, *East Kentucky Power Cooperative, Inc.* (Ky. PSC May 2, 2002), Order at 5. (Emphasis added).

Consistency with the FAC Regulation

Duke Kentucky claims that the Commission's statement that the FAC regulation "was never meant to allow the utility to recover 100 percent of fuel costs incurred on a monthly basis, as evidenced by the restrictions set out in the regulation,"¹⁹ is not supported, is unprecedented, and does not comport with the FAC regulation. The Commission notes that the FAC regulation includes restrictions on the recovery of fuel costs related to forced outages, capacity and demand charges, and purchases made on a non-economic basis.

Duke Kentucky also argues that the Commission's January 30, 2015 Order "renders actual, prudent, and reasonable fuel expenses (including purchases) incurred by the Company unrecoverable through the FAC without any legal support."²⁰ However, immediately following this statement, Duke Kentucky admits that these costs could be recovered through base rates, but that recovery would be delayed and more expensive. Duke Kentucky claims that this method of recovery would not only result in regulatory lag, but also that high purchased-power costs incorporated in a base rate test year would continue in rates until revised in a subsequent base rate case, and therefore would result in higher rates for customers. Duke Kentucky fails to consider that any amount of purchased-power costs proposed to be recovered through base rates, or any other mechanism, would be examined for reasonableness and, to the extent those costs were outside of a normal or reasonable level, could be reduced or amortized.

¹⁹ Order (Ky. PSC Jan. 30, 2015) at 7.

²⁰ Petition at 12.

Duke Kentucky further claims that the Commission's January 30, 2015 Order creates "perverse incentives for a utility that is a member of an RTO to have more expensive generation, rather than to seek opportunities to minimize costs or maximize efficiency of generation,"²¹ so that its owned available generation is always more expensive than the energy it purchases in the RTO. According to Duke Kentucky, this would lead to higher costs for customers and a disincentive to reduce the efficiency of its generation. Duke Kentucky maintains that "the application of the FAC Regulation should not be so rigid as to completely ignore, erode or undermine the benefits of participation in an RTO."²²

The Commission has interpreted the FAC regulation to limit recovery of power purchases to the cost of a utility's highest-cost unit available to be dispatched, and such an interpretation has to be applied consistently among the jurisdictional electric utilities, regardless of whether the utility is a member of an RTO. The Commission takes note that in Case No. 2010-00203,²³ Duke Kentucky's Application to joint PJM, Duke Kentucky testified that transferring its transmission assets from the Midcontinent Independent System Operator, Inc. to PJM would not negatively affect its FAC.²⁴

The Commission's January 30, 2015 Order reminded Duke Kentucky that "[c]osts for non-economy energy purchases that are not recoverable through an electric utility's FAC are considered 'non-FAC expenses' and, if reasonably incurred, are otherwise

²¹ *Id.* at 13.

²² *Id.* at 14.

²³ Case No. 2010-00203, *Application of Duke Energy Kentucky, Inc. for Approval to Transfer Functional Control of Its Transmission Assets from the Midwest Independent Transmission System Operator to the PJM Interconnection Regional Transmission Organization and Request for Expedited Treatment* (Ky. PSC Dec. 22, 2010).

²⁴ *Id.*, Direct Testimony of William Don Wathen, Jr. at 11 (filed July 6, 2010).

eligible for recovery through base rates.”²⁵ Duke Kentucky was also reminded that in circumstances where wholesale power market prices significantly exceeded the fuel cost of its highest-cost generating unit available to serve native load, it may apply to the Commission for immediate rate recovery of those costs. For those “non-FAC” costs not recoverable through the FAC, the Commission would determine reasonableness in a proceeding in which recovery was being requested through base rates or some other rate mechanism.

Finally, the Commission reminds Duke Kentucky that utilization of the FAC is not a requirement. It is an option that has been selected by Duke Kentucky. If Duke Kentucky believes that the FAC is no longer advantageous due to its membership in PJM, in its next base rate proceeding it may request to discontinue use of the cost-recovery mechanism and propose to recover a reasonable amount of fuel costs through its base rates.

Having reviewed Duke Kentucky’s petition and being otherwise sufficiently advised, the Commission finds that its January 30, 2015 Order should be upheld in its entirety.

Duke Kentucky’s Motion for Informal Conference

On March 26, 2015, Duke Kentucky filed a motion requesting an informal conference be scheduled for the purpose of clarification on the issue of the FAC recovery of energy purchases.

The Commission finds that there are no disputed issues of fact which would require further evidentiary proceedings, and Duke Kentucky’s Petition fully addressed

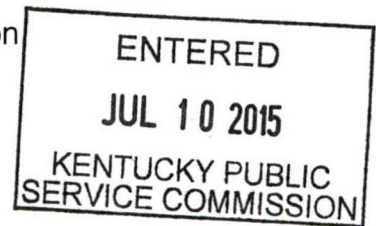
²⁵ Order (Ky. PSC Jan. 30, 2015) at 6; and Case No. 2000-00496-B, *East Kentucky Power Cooperative, Inc.* (Ky. PSC May 2, 2002), Order at 5.

the legal issues it raises therein. For these reasons, the Commission finds that an informal conference is not needed and the motion will be denied as moot.

IT IS THEREFORE ORDERED that:

1. The Commission's January 30, 2015 Order in this proceeding is affirmed and Duke Kentucky's Petition is denied.
2. Duke Kentucky's Motion for Informal Conference is denied as moot.
3. For any expense month in which Duke Kentucky excludes power purchase in excess of its highest-cost generating unit from the FAC, it shall include in the FAC Supplemental Schedules for that expense month, documentation showing the amounts excluded and the calculation of those amounts.

By the Commission



ATTEST:



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